

**BETTER POWER FOR A CHANGING WORLD**

**Rolls-Royce designs, develops, manufactures and services integrated power systems for use in the air, on land and at sea.**



We are one of the world's leading producers of aero engines for large civil aircraft and corporate jets. We are the second largest provider of defence aero engines and services in the world. For land and sea markets, reciprocating engines and systems from Rolls-Royce are in marine, distributed energy, oil & gas, rail and off-highway vehicle applications. In nuclear, we have a strong instrumentation, product and service capability in both civil power and submarine propulsion.

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## FINANCIAL HIGHLIGHTS

## How did we perform in 2014?

	2014	2013	Change
Order book £m	73,674	71,612	+3%
Underlying* revenue £m	14,588	15,505	-6%
Underlying* profit before tax £m	1,617	1,759	-8%
Underlying* earnings per share	65.3p	65.6p	-0.3p
Full year payment to shareholders (excluding buyback)	23.1p	22.0p	+5%
Reported revenue £m <sup>†</sup>	13,736	14,642	-6%
Reported profit before tax £m <sup>†</sup>	67	1,700	-96%
Reported earnings per share <sup>†</sup>	3.7p	73.3p	-69.6p
Net cash £m	666	1,939	-66%
Free cash flow £m	254	781	-67%

\* Underlying explanation is in note 2 on page 110.

<sup>†</sup> 2013 re-presented to reflect Energy as a discontinued operation.

All figures in the narrative of the Strategic Report are underlying unless otherwise stated.

## FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements. Any statements that express forecasts, expectations and projections are not guarantees of future performance and guidance may be updated from time to time. Latest information will be made available on the Group's website. By their nature, these statements involve risk and uncertainty, and a number of factors could cause material differences to the actual results or developments. This report is intended to provide information to shareholders, is not designed to be relied upon by any other party or for any other purpose, and the Company and its directors accept no liability to any other person other than that required under English law.

## GROUP AT A GLANCE

# A HIGH-VALUE GLOBAL BUSINESS

The Group is organised into two Divisions: Aerospace and Land & Sea.

Our vision is to create better power for a changing world.

We do this by developing world-leading technology, producing highly efficient products and providing through-life services in each of our chosen markets.

### GROUP



EMPLOYEES (YEAR AVERAGE)

54,100



ENGINEERS (YEAR END)

15,500



ORDER BOOK

£73.7bn



COUNTRIES

50+



INVESTED IN R&D

£1.2bn



PATENTS APPLIED FOR

600

UNDERLYING GROUP REVENUE



■ Aerospace 61%  
■ Land & Sea 39%

UNDERLYING GROUP REVENUE

£14,588m

UNDERLYING GROUP PROFIT BEFORE TAX

£1,617m

## AEROSPACE

The Aerospace Division is a leading producer of aero engines for large civil aircraft and corporate jets. We are the second largest provider of defence aero engines and services in the world.

We power more than 50 types of aircraft across civil and defence markets and have over 29,000 engines in service.

→ PAGES 32 TO 35 FOR MORE INFORMATION

### CIVIL AEROSPACE

UNDERLYING REVENUE MIX



■ OE revenue 48%  
■ Services revenue 52%

UNDERLYING REVENUE

**£6,837m**

UNDERLYING PROFIT

**£942m**

### DEFENCE AEROSPACE

UNDERLYING REVENUE MIX



■ OE revenue 39%  
■ Services revenue 61%

UNDERLYING REVENUE

**£2,069m**

UNDERLYING PROFIT

**£366m**

## LAND & SEA

The Land & Sea Division comprises Power Systems, Marine and Nuclear.

Our Power Systems business includes the world-renowned MTU range of reciprocating engines. Marine has equipment installed on over 25,000 vessels.

We have a growing civil nuclear business and have 55 years of experience in nuclear submarine propulsion.

→ PAGES 36 TO 41 FOR MORE INFORMATION

### POWER SYSTEMS

UNDERLYING REVENUE MIX



■ OE revenue 70%  
■ Services revenue 30%

UNDERLYING REVENUE

**£2,720m**

UNDERLYING PROFIT

**£253m**

### MARINE

UNDERLYING REVENUE MIX



■ OE revenue 63%  
■ Services revenue 37%

UNDERLYING REVENUE

**£1,709m**

UNDERLYING PROFIT

**£138m**

### NUCLEAR

UNDERLYING REVENUE MIX



■ OE revenue 37%  
■ Services revenue 63%

UNDERLYING REVENUE

**£684m**

UNDERLYING PROFIT

**£48m**

### ENERGY

We sold the Energy gas turbines and compressor business to Siemens on 1 December 2014.

UNDERLYING REVENUE

**£724m**

UNDERLYING PROFIT

**£(3)m**

# BETTER POWER FOR A CHANGING WORLD





**Our world is changing, the climate is altering and populations are increasing. We need more power but not at any cost to society. The world needs better power.**

Rolls-Royce is committed to research and technology in order to develop innovative and advanced power systems that can help.

Our vision is to deliver better power for a changing world. The following pages illustrate how we are doing this in the air, on land and at sea.



# BETTER POWER IN THE AIR

## **WORLD'S MOST EFFICIENT LARGE AERO ENGINE**

Launch customer Qatar Airways took delivery of the first Trent XWB-powered Airbus A350 XWB at the end of 2014. The Trent XWB is the world's most efficient large aero engine and is 10% more fuel efficient than the legacy engines it is designed to replace.

This first delivery signifies the start of a major engine production programme for the Group. Customers have ordered over 1,500 Trent XWB engines, representing 49% of the Civil aerospace order book.



### FURTHER AND FASTER ON LESS FUEL

Rolls-Royce continues to be a market leader in powering large corporate jets. The latest version of Cessna's flagship aircraft, the Citation X+, entered service in June 2014, further cementing our position in this important market sector. The improved version of our AE 3007 engines on the Citation X+ delivers an increase in thrust at take-off, coupled with a reduction in fuel burn – helping people to fly further and faster but using less fuel to do it.

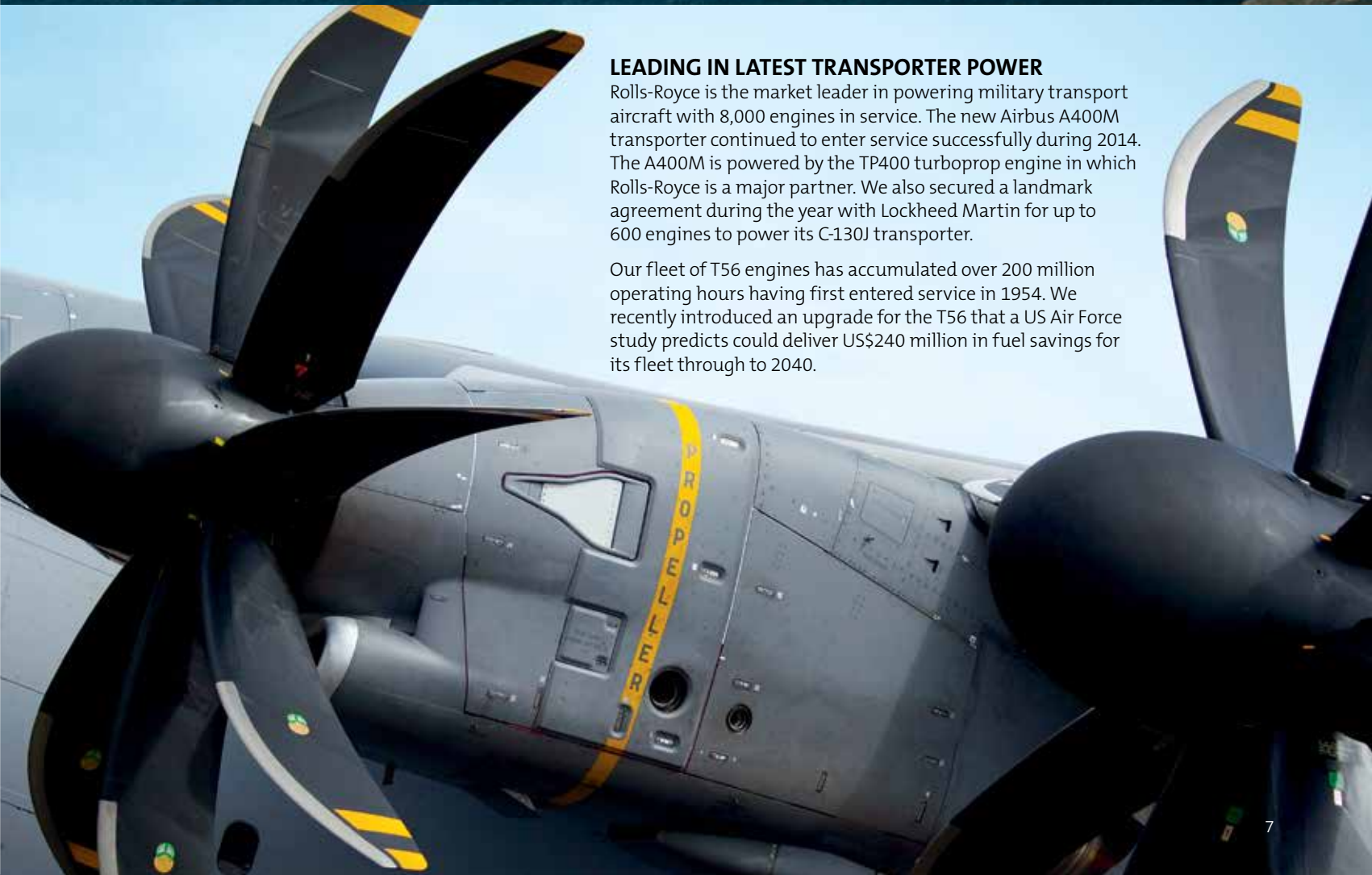
In addition, we strengthened our long-standing relationship with Gulfstream when we were selected in 2014 to power its new G650ER corporate jet.



### LEADING IN LATEST TRANSPORTER POWER

Rolls-Royce is the market leader in powering military transport aircraft with 8,000 engines in service. The new Airbus A400M transporter continued to enter service successfully during 2014. The A400M is powered by the TP400 turboprop engine in which Rolls-Royce is a major partner. We also secured a landmark agreement during the year with Lockheed Martin for up to 600 engines to power its C-130J transporter.

Our fleet of T56 engines has accumulated over 200 million operating hours having first entered service in 1954. We recently introduced an upgrade for the T56 that a US Air Force study predicts could deliver US\$240 million in fuel savings for its fleet through to 2040.



# BETTER POWER ON LAND AND AT SEA

## LOCAL ENERGY – NATURALLY

Efficient, low-emission power systems are in demand across the world for effective solutions to local energy needs. Through MTU Onsite Energy, Rolls-Royce is providing reliable power for applications such as healthcare, data centres, airports, farms and independent power stations.

In Chile for example, two MTU Onsite Energy units powered by Series 4000 engines are now generating 6,400MWh of electricity a year from biogas produced by a local pig farm. These units are the first in the country to generate electricity from a biogas plant. For our customer they provide eco-friendly and profitable power to 2,500 families in the area.



## POWERPACKED ON THE RAILWAYS

Power Systems is a major player in engines for the rail industry. To date, over 20,000 MTU engines have been sold for use in drive systems and electrical generation in this global market. 2014 marked the 90th year of MTU engines being supplied for rail traction.

As well as the anniversary, this year also saw an agreement reached with Polish rail vehicle manufacturer PESA for the supply of up to 940 MTU PowerPacks® to be used in railcars operated by Deutsche Bahn. These PowerPacks are among the most advanced in the industry, meeting all the latest European Union requirements on emissions.





#### **40 YEARS OF OFFSHORE FLAGSHIPS**

The UT-Design series from Rolls-Royce is recognised worldwide as the benchmark for the offshore industry. Today's vessels employ our wave-piercing hull which improves efficiency and reduces fuel consumption. All major propulsion systems are fully integrated with the hull design to give optimum performance.

Rolls-Royce UT-Design vessels have been helping pioneer oil & gas exploration and providing offshore support for 40 years. So far, more than 800 have been built or are currently under construction.

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## CHAIRMAN'S REVIEW

After a decade of strong performance and growth, 2014 was a year of mixed fortunes for our Company.

 We are totally focused on returning the Company to its long-term trajectory of profitable growth and of superior shareholder returns.”

IAN DAVIS  
Chairman

There have been some real pluses and achievements alongside a number of challenges that held back the Company's financial performance.

During the course of the year, our order book reached its highest ever level. We also celebrated the delivery of the first Airbus A350 XWB to our launch customer Qatar Airways, powered by Rolls-Royce Trent XWB engines. Our record of customer service continues to improve, in Civil aerospace for example, we have maintained a record of 100% on-time delivery to Airbus for the past two years. In the same period our Marine business improved original equipment on-time delivery by 11%, while spares delivery improved across the Group. We still have more to do here and we are totally committed to enhancing customer satisfaction with our products and services. However, progress is encouraging and bodes well for the future. Happy customers are a precondition for a successful, long-term business.

Set against these achievements, 2014 was the first year in a decade in which revenue and underlying profits, on a like-for-like basis, did not grow. The Defence business was hit hard by constraints in government expenditure. In our Land & Sea Division, we faced tough market conditions, characterised by pricing pressure and deferred or cancelled orders by customers, particularly in the oil & gas, construction and mining industries.

In addition to some difficult trading conditions, we did not make as much progress as planned on improving our cost and cash performance. We fully recognise this is a priority if we are to provide attractive returns to shareholders as well as to fund the investment requirements that will underpin long-term growth. Ours is a business that requires significant up-front cash investment to generate long-term cash flow.

### SHAREHOLDER DISTRIBUTIONS

Despite the short-term challenges, the fundamentals of the business remain strong. Rolls-Royce is a growth company, well positioned in long-term growth markets that offer the prospect of attractive returns.

We know that shareholders do not invest in growth alone, they invest for growth that's profitable. Our payment to shareholders of 23.1p reflects the confidence the Board has in the Company's profitability and cash generation prospects. At the same time we are committed to retaining a strong balance sheet. Civil aerospace in particular, although an attractive long-term business, can still be prone to external market shocks. Our customers, who depend on our service support for periods of up to 25 years, both expect and demand a financially resilient supplier.

### STRATEGY

Rolls-Royce is intrinsically a long-term business and has to be directed and managed as such. In Civil aerospace for example, products take many years to develop, test and bring to market, and are quite rightly subject to strict regulatory process. Revenue from the sale of original equipment and subsequent aftermarket services generate cash flows for decades.

The Board reviewed the Group's product portfolio and corporate structure in light of these financial and investment characteristics. This review led to the decision to divest our Energy business and we completed its sale to Siemens in December. At the same time we strengthened our position in the core division of Land & Sea by completing the acquisition of the shares held by Daimler in Power Systems. We are focused on the twin pillars of Aerospace and Land & Sea because of their technology and service model synergies and their combined ability to create shared competitive advantage.

Our strong belief is that shareholders, as well as customers and employees, will be best served if the Company continues to focus on expanding its position in the highly attractive global markets for power and propulsion. We have long-established and

## FINANCIAL HIGHLIGHTS

### PAYMENT TO SHAREHOLDERS

**23.1p** (2013: 22.0p)

### UNDERLYING EPS

**65.3p** (2013: 65.6p)

### ORDER BOOK

**£74bn** (2013: £72bn)

### RETURN ON SALES

**11.5%** (2013: 11.8%)

 MORE FINANCIAL INFORMATION ON PAGES 26 TO 31

 The fundamentals of the business remain strong."

# CHAIRMAN'S REVIEW

CONTINUED

## PEOPLE AND TALENT

We are exploring ways of accelerating and broadening career paths for our highest potential talent across the world and for further increasing diversity as an important element of changing and strengthening our culture.

→ MORE INFORMATION  
ON PAGES 42 TO 43



 We are committed to being a leader in environmental and social responsibility and to being regarded as a good corporate citizen.”

competitive technology platforms, as well as customer relationships, in gas turbines, reciprocating engines, nuclear services and controls. We see substantial long-term value creation and growth potential from these products, not least from aftermarket services where Rolls-Royce has been a pioneer. There will be cyclical and volatility – external and internal risks are not insignificant – however, our long-term aspiration is to build on our position as a leading global provider of complex integrated power systems for use in the air, on land and at sea.

## INNOVATION

Innovation has been, and is, critical to the long-term success of Rolls-Royce. We cannot depend on size and scale alone for competitive advantage. We invest more than £1 billion a year in research and development (R&D) to ensure that we conceive, design and deliver world-class technology that meets our customers' current and future requirements.

Innovation is not just about R&D numbers and not just about product technology. An increasing focus, for example, is on data analytics and on control systems to reflect our customers' increasing requirements for integrated solutions. Rolls-Royce has long been an innovator in services and we will be looking to build on this. I am especially proud of our collaborative approach to innovation, particularly our work with leading universities across the world on designated topics and technologies. We are quite clear that we must improve our capital efficiency, our cost competitiveness and our cash generation. However this will not be at the expense of our strategic commitment to innovation and development. These will be the drivers of long-term profitable growth and value creation.

## TALENT AND CAPABILITIES

I would like to touch on some of the key enablers that will be required to deliver our strategy and our operational plans. In particular, we need to attract, develop and retain outstanding talent everywhere we operate, commercial and functional talent as much as engineering talent. In the past year we recruited 354 graduates from 112 universities in 11 countries and we recruited

357 apprentices across the world. I am pleased that 26% of our graduate recruits and 10% of our UK apprentices are female – not good enough but progress. Our community programmes remain directed towards encouraging young people, particularly females, to choose science, technology, engineering and maths (STEM) subjects. We are in the process of reviewing our training and leadership development programmes, particularly for middle managers. We are also exploring ways of accelerating and broadening career paths for our highest potential talent across the world and for further increasing diversity as an important element of changing and strengthening our culture.

## CORPORATE GOVERNANCE

The Board recognises that strong governance is a hallmark of excellent companies. We remain committed to being a leader in ethical behaviour and in environmental and social responsibility. We are updating and upgrading our governance structures and controls, with a particular focus on risk and compliance procedures. The concerns about bribery and corruption involving intermediaries in overseas markets, and the subsequent SFO enquiry, together with wider speculation, have been a body blow to the Company and we have responded accordingly. We have expanded significantly our compliance team, invested heavily in training and awareness building across the Group and strengthened our internal controls. Our staff have received a new Global Code of Conduct, together with mandatory training. We have established or expanded our own offices in many international markets and reduced dramatically the number of external intermediaries. Further details are contained in the Safety and Ethics Committee Report on page 66. We are grateful to Lord Gold who continues to advise us on compliance and ethics best practice.

## BOARD APPOINTMENTS AND CHANGES

Ruth Cairnie, formerly an executive vice president with Royal Dutch Shell, joined the Board in September. In addition, Pamela Coles, previously at Centrica, has joined Rolls-Royce as Company Secretary. We are lucky to have both of them.

I was also very pleased to welcome David Smith to the Board. David was appointed Chief Financial Officer (CFO) in November, replacing Mark Morris who left the Company. David joined Rolls-Royce at the beginning of 2014 as the CFO of the Aerospace Division. Prior to that, he had extensive international experience in engineering and technology companies. A particular focus for David will be to strengthen further our financial controls and management information systems as well as improving our communications with the investment community.

I would like to thank Mark Morris for his years of service and contributions to the Company and to the Board. I would also like to thank Iain Conn who stood down from the Board after nine years of dedicated and exemplary service. He was succeeded as Senior Independent Director by Lewis Booth.

After a successful career spanning 17 years with Rolls-Royce, James Guyette will step down from the Board at the conclusion of the 2015 Annual General Meeting (AGM) and retire from his role as President and Chief Executive Officer of Rolls-Royce North America on 31 May 2015. James has made a tremendous contribution to the Company over many years. He has helped guide the business through a period of significant expansion, especially in the North American market. His energy, good humour and commitment to our customers will be missed by us all.

John Neill has also indicated that he will step down from the Board after just over six years as a Non-Executive Director and will not therefore put himself forward for re-election at the 2015 AGM. I would like to thank John for his tremendous contribution to the Board and his exemplary commitment to Rolls-Royce over the last six years. He will be missed and we wish him well for the future.

I am pleased to announce that Irene Dorner will be joining the Board as a Non-Executive Director with effect from 27 July 2015. She will also become a member of the Nominations and Governance Committee

and the Safety and Ethics Committee from the date of her appointment. She brings a wealth of experience from international banking along with a passion for driving culture change in large organisations.

Irene was CEO and president of HSBC USA until December 2014 where she was responsible for all of HSBC's operations in the US and played a key role in strengthening their risk processes. During her 29-year career at HSBC, she held a number of international roles. She was the first woman to lead HSBC in Malaysia and launched its Islamic banking unit. She is a passionate advocate of diversity and inclusion.

There have been some adjustments to the committee structure of the Board, explained in more detail in my introduction to the Directors' Report on page 56. Safety and Ethics have been combined into one committee under the chairmanship of Sir Frank Chapman, formerly CEO of BG Group. I have also established a Science and Technology Committee, under the chairmanship of Warren East, formerly CEO of ARM Holdings. Science and technology are critical to the Company's success and warrant the attention of a focused committee, in addition to general board oversight.

We have benefited again from the insight and experience of our International Advisory Board (IAB) the composition of which is described on page 57. The role of the IAB is to provide contextual understanding of international economic and political developments, and to help management and the Board better understand long-term geographical opportunities and risks. Members of the IAB are also available to our senior management on specific issues and areas of expertise. We are fortunate to have such a wealth of experience and knowledge at our disposal. I am very grateful to them and in particular to Lord Powell for his exemplary chairmanship of the IAB.

I would like to thank my fellow board members for their diligence and outstanding commitment to Rolls-Royce.

I would also like to thank John Rishton, his management team and all our employees for their hard work and exceptional dedication in a demanding year.

I hope this review demonstrates our understanding of the concerns about Rolls-Royce's financial performance in 2014 and the 2015 outlook. We are totally focused on returning the Company to its long-term trajectory of profitable growth and of superior shareholder returns. We will continue to focus on the 4Cs of Customer, Concentration, Cost and Cash to improve performance, and we will strengthen our financial controls and communications. We will sustain our commitment to innovation and development.

The fundamentals of the business remain strong. They are underpinned by our record order book and our expanding installed equipment base that will generate value for years ahead. This is a sound business with continued growth potential.

**IAN DAVIS**  
Chairman  
12 February 2015

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## CHIEF EXECUTIVE'S REVIEW



Rolls-Royce is in business to deliver better power for a changing world. The integrated power systems that we develop, build and maintain, address the increasing global demand for transport and energy.



We continually seek to reduce cost to remain competitive and to generate the funds we need to invest in future growth.”

**JOHN RISHTON**  
Chief Executive



As society becomes more integrated, population expands and the world becomes more affluent, the requirement for the type of advanced engineering solutions we provide will grow. These are long-term trends that require long-term investment and present us with the opportunity for long-term profitable growth.

The path to growth will not always be smooth. For Rolls-Royce, 2014 has proved a challenging year for reasons that I will explain in some detail. During 2014, Group underlying revenue was 6% lower than in 2013 and underlying profit before tax declined by 8%. However, the Group order book grew to a new record of £73.7 billion, demonstrating the confidence our customers continue to place in our technology and the growth that lies ahead. It is encouraging that the Defence aerospace order book increased for the first time since 2010, with continued growth in the order books of Civil aerospace and Power Systems.

In this review I will explain why we believe our business model is robust, I will describe the transformation we are driving through the Group and the reasons for our confidence in the future. I will also outline the challenges we face and the decisive action we are taking to accelerate a return to our long-term trend of profitable growth.

So let me start with our business model. We invest in technology in order to meet our customers' current and future needs. Through constant innovation we create the opportunity to grow sales and expand our market share. We earn revenue both from the sale of original equipment and from servicing the power systems we produce. We continually seek to reduce cost to remain competitive and to generate the funds we need to invest in future growth.

We have evolved and simplified our strategy to focus on the core areas of: **customer, innovation and profitable growth.**



**Customer:** we put customers at the heart of the organisation. We understand their needs and then focus relentlessly on delivery.



**Innovation:** is at the core of Rolls-Royce and drives a culture of continuous improvement. Delivering relevant innovation is critical to meeting our customers' current and future needs.



**Profitable growth:** by focusing on our customers and presenting them with a competitive portfolio of innovative products and services, we create the opportunity for long-term profitable growth.

This sharper focus enables us to drive our business model harder and will, over time, deliver improving financial returns.

From its earliest days Rolls-Royce has addressed a range of markets where demand exists for advanced engineering solutions. Our 1906 articles of association describe the business as producing technology for use in the air, on land and at sea. More than a century later this approach remains relevant and we run our business through the two Divisions of Aerospace and Land & Sea that you will see described in the pages of this Annual Report.

There is an industrial, commercial and strategic logic that ties these two Divisions together and generates value for the Group.

Industrially, our knowledge of advanced engineering applies across both our Divisions. World-class technology is required by all of our customers and as the power systems we produce become more sophisticated, a deep understanding of materials science, electronics, data management and aftermarket services are increasingly important in every part of the Group.



### BETTER POWER

Our Land & Sea Division is well positioned to meet the requirements for cleaner power that will be driven by future growth in world trade.

**£74bn** Our order book increased in 2014 to a record level



Commercially, we and our competitors recognise the requirement of a broad portfolio and exposure to differing business and investment cycles. It is not a coincidence that there is no pure aerospace power system company in the world.

The scale represented by our two Divisions is important in maintaining a strong balance sheet and protecting our investment grade rating. Scale has also enabled us to maintain a global R&D network comprising 31 University Technology Centres and seven Advanced Manufacturing Research Centres. These facilities envisage, develop and test emerging technologies that have applications across our portfolio. Our breadth increases market access and generates opportunity. For example, our Nuclear business is relatively small but extends our influence and gives us access to the highest levels of government internationally.

# CHIEF EXECUTIVE'S REVIEW

CONTINUED

## INNOVATION

We invest in technology in order to meet our customers' current and future needs. Through constant innovation we create the opportunity to grow sales and expand our market share.

→ MORE INFORMATION  
ON PAGES 20 TO 21



 We continue to make good progress improving quality, delivery, reliability and responsiveness.”

Strategically, our two Divisions address markets where long-term growth is assured and where increasingly sophisticated engineering solutions will be required. We believe both aerospace and land & sea markets offer attractive returns and play to our strengths.

The future growth of air travel is widely understood and reflected in our £63 billion Civil aerospace order book. To give this some perspective, in the past decade we have delivered 1,600 Trent engines. In the decade ahead we expect to deliver 4,000. All of the engines in this expanding fleet will produce service revenues that will extend for decades to come. Our Land & Sea Division is well positioned to meet the requirements for cleaner power that will be driven by future growth in world trade (90% of which is carried by sea), urbanisation, population growth and tighter environmental regulations.

Across the Group, we invest in technology that is continually setting new standards in power efficiency and environmental performance. The complexity of what we do creates barriers to entry and generates new market opportunities. Put simply, there will be significant long-term growth in demand for the complex integrated power systems we deliver, and there are not many companies with the ability to do what we can do.

Despite these fundamental strengths, in 2014 our short-term performance has been negatively affected by a number of factors. In Aerospace our Defence revenues fell by 20%, reflecting reduced government defence spending in our main markets of North America and Europe. In Land & Sea, slowing growth in a number of our major markets including Continental Europe, South America and China has caused some customers to delay or cancel orders. At the same time, sharp declines in the price of oil and other commodities have led customers to reduce or defer expenditure, especially in the oil & gas, mining and construction industries.

In response to these adverse conditions, we have accelerated progress on the **4Cs** of **Customer, Concentration, Cost** and **Cash** – with a particular emphasis on cost. This decisive action is driving a transformation of the business that will, in time, make us a stronger Group and hasten our return to profitable growth.

**On Customer:** we continue to make good progress improving quality, delivery, reliability and responsiveness; the characteristics our customers tell us they value most. The results can be seen across a wide range of programmes. At Group level there has been a further improvement in delivery times – particularly for spare parts. In Aerospace, the Trent 1000 that powers the Boeing 787 Dreamliner has achieved an industry-leading 99.9% engine dispatch reliability after completing over 500,000 flying hours in service. Since launch, we have doubled the time on wing for both our Trent 700 and Trent 800 fleets. In our Civil Small and Medium Engines business, we achieved a 57 percentage points improvement in restoring operational availability for business jets in the past year.

Recognising the progress we have made, Airbus has presented us with its Supply Chain and Quality Improvement Award. The US Government's Defense Logistics Agency recognised Rolls-Royce as a 'first tier supplier' from among 153 companies and we were awarded joint first place by Aviation International News for the quality of our business aircraft support.

In Land & Sea, our delivery on time to Marine customers has improved by 33 percentage points since 2012. Marine also signed its first commercial long-term service agreement. As the power systems we deliver in Land & Sea become more complex, we see further opportunities to expand our aftermarket activities, building on the data and service capabilities we have developed in Aerospace. In Power Systems, we opened an additional logistics centre in Singapore, enabling a 5% improvement in the availability of spare parts and setting a new standard for customer service.

Improving performance in this way strengthens the relationship we have with

our customers, and generates opportunities for us to secure additional business.

**Concentration:** means deciding where we want to invest and where not to.

In August, we were pleased to acquire Daimler's 50% shareholding in Rolls-Royce Power Systems for £1.94 billion. Power Systems adds scale and capability to our reciprocating engines portfolio. It has outstanding technology, operates in long-term growth markets and has proved a valuable addition to our Land & Sea Division.

We also divested a significant business in December, completing the sale of our Energy gas turbines and compressor business to Siemens. This is a business that has excellent technology and a talented workforce, but it lacks the scale required to prosper as part of Rolls-Royce. Siemens has a far bigger power generation business and is a more suitable owner. The sale generated proceeds of around £1 billion. We are returning this to shareholders by way of a share buyback that started in December 2014.

**Turning to Cost:** we have taken action to improve cost performance in every part of the business and in every cost category. We have made good progress in some areas and as a result, Group gross margins improved by 1.7 percentage points in 2014. In Defence, we have improved margins despite declining revenue. In Land & Sea, we closed five plants and are rationalising other parts of the business. For example, we are consolidating production of steering gear in Norway and waterjets into Finland. We are driving down cost by improving quality, simplifying logistics, reducing waste, and adopting processes that allow us to make things better and faster.

In November, we announced a restructuring programme in our Aerospace Division and central functions, which is expected to reduce headcount by 2,600. By the end of 2014, 545 people had left the business, with the majority of the reductions expected in 2015. This programme is expected to result in restructuring charges of around £120 million, of which £56 million was recognised in our 2014 results.

We anticipate annualised cost benefits of around £80 million from 2016 onwards, with £50 million in benefits expected in 2015. Our total Aerospace 2014 restructuring activities cost £164 million (of which £139 million was underlying).

However, in a complex and highly-regulated business, we recognise that it will take some time for the full benefit of our cost programmes to feed through. There are also a number of headwinds in our Civil aerospace business associated with our future growth. For example, we have invested in the capacity required to deliver our record order book, but delay in a number of our customers' major programmes has meant some of this new capacity has come on stream before it is needed, leaving us with under-utilised production facilities. We have also constructed a number of new world-class facilities to replace older, less productive plants. For a period of transition we are carrying the cost of both the old and new facilities.

Group restructuring costs in 2014 were £188 million, of which £149 million was underlying. Over the past two years, the Group has reduced indirect headcount by 18%. We expect Group underlying restructuring costs to be between £90 and £100 million in 2015.

Cost performance will continue to be a major focus, and as we rationalise and transform the Group, we have targeted a 20% reduction in our footprint and a doubling of our lower-cost country sourcing by 2020. We are now accelerating progress towards these targets.

**Cash:** we continue to focus on improving our free cash flow, particularly in the face of near-term headwinds. Our programmes to reduce product and aftermarket costs, lower our headcount and to reduce our footprint all require upfront investment but will deliver cost and cash benefits in the medium term. As revenue increases, we expect to reduce our capital expenditure and R&D as a percentage of sales. The customer progress highlighted earlier is improving our operational performance.

## OUR FIVE PRIORITIES FOR THE GROUP

### DURING 2014 WE OUTLINED THE PRIORITIES FOR THE BUSINESS GOING FORWARD.

#### FIX THE BASICS (THE 4Cs)

This is about improving the bedrock of the organisation: focusing on our customers and their needs; concentrating on what we are good at; attacking cost across the Group and managing our cash position effectively.

#### CULTURE

We want a business-orientated, innovative and cost-conscious culture, one that understands our customers and delivers on their behalf. We must have a culture where ethical behaviour is fully embedded, so that we don't just win but win right.

#### CIVIL WIDEBODY

We are building on success. In the last decade we delivered 1,600 Trents and in the next we will deliver 4,000. We power over 50% of new widebody aircraft. Our next generation engines, Advance and UltraFan™, will help maintain our leading market position.

#### CIVIL NARROWBODY

Narrowbodies represent 70% of the civil aircraft market by volume and 50% by value. We have the requisite skills and technology to return to this market and are determined to do so when the opportunity arises. This is important in the longer term, not just because of the scale this market segment offers but also because of the chance it presents to develop greater customer intimacy.

#### MEDIUM-SPEED RECIPROCATING ENGINES

Medium-speed reciprocating engines power the vast majority of the marine vessels that we design and equip. We have world-class technology, but it is characteristic of this industry that the engine supplier is particularly well placed to pull through other technologies, so our lack of scale in medium-speed engines confers a disadvantage we need to address.

# CHIEF EXECUTIVE'S REVIEW

CONTINUED

## TECHNOLOGY

We have continued to invest in our Land & Sea Division, bringing new technology to market across the portfolio. In September, we unveiled the first of a new family of medium-speed reciprocating engines for power on land and at sea. The new Bergen B33:45 offers a 20% increase in power per cylinder, while reducing fuel consumption, emissions and operating costs.

→ MORE INFORMATION  
ON PAGE 38



Combined with increasing volumes, this will enable us to reduce our inventory buffers.

While a great deal of attention has been focused, quite rightly, on the financial performance of the Group, it is important to recognise significant achievements in 2014 that will support the Group's future profitable growth.

**1,500** Trent XWB engines are on order. The first engines were delivered to Qatar Airways in 2014



We marked a major milestone in the development of carbon titanium (CTi) fan blades with the launch of a test flight programme on board a Boeing 747 flying test bed. CTi technology delivers lighter fan blades that will be incorporated into future aero engines. Combined with a composite fan casing, it forms a system that can reduce weight by up to 1,500lb per aircraft, the equivalent of seven passengers.

In Land & Sea we have also continued to strengthen our portfolio, bringing new technology to market across the Division. In September, we unveiled the first of a new family of medium-speed reciprocating engines for use on land and at sea. The new Bergen B33:45 offers a 20% increase in power per cylinder, while reducing fuel consumption, emissions and operating costs. It is our first new product to combine the engineering strengths of our traditional Bergen engines operation and our new Power Systems business. Because of its greater power range, the new engine increases our addressable market in medium-speed engines by 20%.

In Aerospace in December, we were delighted to celebrate the first delivery of the Trent XWB, powering the new Airbus A350 XWB for launch customer Qatar Airways. The Trent XWB is the most fuel efficient large aero engine operating in the world today. I would like to congratulate everyone at Rolls-Royce who has worked so hard over many years to support the successful delivery of this exceptional aircraft, for which Rolls-Royce is the sole engine provider.

At the Farnborough International Airshow in July, we announced the seventh member of the Trent engine family, the Trent 7000, that will power the new Airbus A330neo. This new engine will incorporate technology from our most recent Trents and will deliver a 10% improvement in specific fuel consumption and halve the noise energy output compared to the current engine on the A330. Rolls-Royce will be the exclusive engine supplier on the A330neo, due to enter service in 2017.

We have continued to bring new world-class facilities on stream in 2014. These include the opening of our new advanced disc manufacturing facility at Washington in the UK and the first production aerofoil from our new Advanced Aerofoil Manufacturing Facility at Crosspointe, Virginia in the US. 2014 saw the inauguration of our new large engine test bed in Dahlewitz, Germany and the opening of a new marine customer training centre outside Rio de Janeiro in Brazil.

In the naval market two important new ships powered by our MT30 gas turbines were officially named: the multi-mission destroyer USS Zumwalt and the Royal Navy aircraft carrier Queen Elizabeth.

In the rail sector, Power Systems has developed an MTU hybrid PowerPack that generates additional power through the braking control system. This technology offers a fuel saving of up to 25% with a proportional reduction in emissions.

For off-highway vehicles, MTU's latest Series 4000 engine has improved fuel consumption by 5%. For a typical application this can represent a saving of up to 100,000 litres of fuel and reduction of 350 tonnes of CO<sub>2</sub> emissions each year.



MTU's latest Series 4000 engine has improved fuel consumption by

**5%**



In our Nuclear business, we were encouraged that, in October, the European Commission approved the construction of the first new commercial nuclear power station to be built for a generation in the UK, at Hinkley Point in Somerset. The Commission concluded that new nuclear power is vital for Britain's energy security and will be key to reducing carbon emissions from the UK's electricity industry. Hinkley Point C is the first of at least 11 new reactors planned for the UK, for which Rolls-Royce is well positioned to supply components, systems and engineering services.

**31** University Technology Centres. This research network extends relationships we have with world-leading universities



As the Chairman said, we continued to strengthen the governance of the Group. We expect the highest standards of behaviour from our employees and we have been explicit that we will not tolerate business misconduct of any sort. The Serious Fraud Office investigation into concerns about bribery and corruption involving intermediaries in overseas markets continues and we are cooperating fully with the investigating authorities. Lord Gold is heading a review of our process and procedures regarding compliance and business ethics.

This year our Global Code of Conduct has been ranked by the Red Flag Group as third among those within the FTSE 100 companies that were assessed. Following the roll-out of our Global Code, dilemma-based ethics training has been deployed to all our employees to ensure continuing attention on this important topic. Training in ethics and compliance will continue in 2015. All employees will be required to certify annually that they have completed their training. We will be setting similar standards for our supply chain through the publication of our Supplier Code of Conduct.

Responding to the difficult circumstances of 2014 has required fortitude and resilience from the talented men and women who work for Rolls-Royce. I would like to thank them for their hard work and for the enthusiasm I encounter wherever in the Company I travel. I am grateful to our suppliers and partners who make such an important contribution to Rolls-Royce and share our commitment to continuous improvement. I would like to thank our customers who continue to place their faith in our technology. Meeting their current and future needs is our highest priority.

This year we held our inaugural Trusted to Deliver Excellence Awards to recognise Rolls-Royce teams who have achieved outstanding results for their customers. The imagination, passion and ability to execute demonstrated by all the finalists is inspiring. You can read more about these awards on pages 42 to 43.

Returning our Group to profitable growth will demand firm resolve and commitment and will take some time. However, as I have described in this review, the business fundamentals of Rolls-Royce remain sound, we have the right strategy and we are clear about the action that is required. Everything I know about this great Company makes me confident that the team will rise to the challenge.

**JOHN RISHTON**  
Chief Executive  
12 February 2015

 Strategically, our two Divisions address markets where long-term growth is assured and where increasingly sophisticated engineering solutions will be required."

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## INNOVATION AND TECHNOLOGY

Technology and innovation are at the heart of Rolls-Royce. We anticipate technology then create products and services that our customers need ahead of market requirements.

In 2014, we spent £1.2 billion gross in R&D and filed for 600 patents.

## ENGINEERING STRENGTH

Our 15,500\* engineers, along with our supply chain, commercialise and deploy the continuous stream of science developed by our university partners into technology then products. Competitive technology comes from combining great people, tools and processes. These fundamental building blocks are used across our two Divisions, Aerospace and Land & Sea. We also continually invest in new talent and in 2014 we recruited 354 graduates (254 of which went into engineering) and 357 apprentices. Technical people are the lifeblood of the Company. Our investment in technical and leadership training allows us to continuously develop world-class professionals.

## INNOVATION

We have a track record over many years of creating new products and services and we continue to strive to be leading edge in everything we do. Innovation cannot be left to chance. It needs to be encouraged, managed, selected and pulled through into products and services. Harnessing the total intellectual power of our people takes enthusiasm and effort. Our new Innovation Portal, Big Ideas Forums and Open Innovation challenge have been successful and each year we reward the most



Our partnership in seven Advanced Manufacturing Research Centres (AMRCs) bridges the gap between research and industrial application; providing facilities for industrial partners and academics to develop new manufacturing technology.

For example, innovative manufacturing techniques developed in our AMRC in Sheffield, UK, are now deployed in our state-of-the-art disc facility in Washington, UK.

innovative ideas at our Sir Henry Royce Technology Awards. We look at innovation in terms of technology and services and also in the way we conduct engineering and manufacturing. This ensures that we continuously simplify and improve processes in order to be efficient and remove waste.

## RESEARCH AND DEVELOPMENT

The strength of our current product portfolio results from consistent and long-term investment in R&D and our ability to bring technology to industrial applications. In addition to our extensive in-house technology capability, we have partnerships with world-leading universities in order to create new technology. We continuously invest in our global network of 31 world-class University Technology Centres (UTCs) where we build the foundation for the next generation of products. These technologies feed into our demonstration programmes, where robust validation takes place before proceeding in a structured and controlled way into new production.

**£1.2bn**  
R&D INVESTMENT



## DEMONSTRATOR PROGRAMMES

During 2014, progress was made on our many new technologies, for example, the carbon titanium fan has flown for the first time this year in the advanced low-pressure systems (ALPS) demonstrator, a modified Trent. The composite fan system has been developed with the help of four UTCs and five AMRCs and will offer over 750lbs of weight saving on our future large engines. We have demonstrated a new mobile MTU gas engine which has been in development since 2013. This high-speed gas engine offers a fuel alternative whilst maintaining the level of performance expected from our high-speed diesel engines. At our Dahlewitz site in Germany, we are building a new test facility for power gearboxes. These gearboxes will be used on the next generation UltraFan engine and should offer a 25% improvement in fuel efficiency when compared to the Trent 700.

\* total as at end of 2014

## OUR 'VISION' APPROACH

### WE LOOK AT TECHNOLOGY ACQUISITION OVER A 5, 10 AND 20-YEAR HORIZON.

#### VISION 5

Vision 5 describes near-term technologies that are ready to introduce into our products. For instance, this year we have successfully demonstrated our low observability propulsion and exhaust system integration capability on the BAE Systems Taranis unmanned aerial vehicle. On reciprocating engines our dual-fuel injector design enables pre-mixed high pressure gas combustion and allows the operator to switch from gas to liquid fuel during operation.

#### VISION 10

Vision 10 describes leading-edge, validated technologies for application in the 'medium term'. Most of these are at demonstration level today and will feature in the next generation of products. For example, the lean burn combustion system for aero gas turbines has been in development for some years and offers a 60% reduction in the pollutant NO<sub>x</sub> and particulate matter (smoke) compared to year 2000 levels. It will reach flight test in 2015 and is supported by the European Clean Sky Programme.

#### VISION 20

Vision 20 describes emerging, or as yet unproven, technologies which may be applied across our product range in both Aerospace and Land & Sea. For example, we are developing concepts for autonomous ships to reduce operating costs and radically simplify onboard facilities.

## MARKET OUTLOOK

The Group has identified markets where our skills and technology add value for our customers and deliver value for shareholders. As a long-term business we assess the market potential over a 20-year horizon.

Through the customer-facing businesses that make up our two Divisions, we are delivering better power in the air, on land and at sea.

Our technology, skills and customer insight position us to have the right products and services today and for the future.



### AEROSPACE DIVISION

### LAND & SEA DIVISION

**Aerospace potential**  
for OE and services  
over the next 20 years



**US\$2,300bn<sup>†</sup>**

#### CIVIL AEROSPACE

We estimate that the global civil engine market will be worth approximately US\$1,900 billion over the next 20 years, with US\$1,250 billion being for original equipment (OE) and US\$650 billion for aftermarket services. Over half of this value comprises engines for twin-aisle airliners and large business jets.

#### POWER SYSTEMS

We estimate the off-highway reciprocating engine markets we address offer an opportunity of £500 billion over the next 20 years for OE. The total service-related market will offer a potential of around a third of that OE value, or £150 billion.

**Land & Sea potential**  
for OE and services  
over the next 20 years



**£1,300bn<sup>†</sup>**

#### DEFENCE AEROSPACE

The defence market opportunity over the next 20 years is US\$125-150 billion in OE and US\$225-250 billion in services.

#### MARINE

We forecast a business opportunity (excluding reciprocating engines) across the offshore, merchant and naval market segments over the next 20 years of £170 billion for OE and £80 billion for associated services.

#### NUCLEAR

The demand for mission-critical equipment, systems and engineering services for civil nuclear could reach £220 billion over the next 20 years, while the demand for associated reactor support services could amount to £140 billion over the same period.

<sup>†</sup> Rounded to the nearest 100bn



# STRATEGY

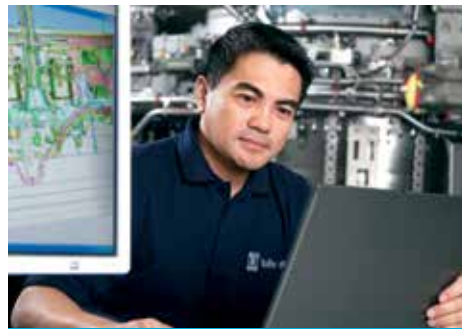
We are a power systems company competing globally. We win in our chosen markets by focusing on, and connecting, three powerful themes: customer, innovation and profitable growth.



## CUSTOMER



Placing the customer at the heart of our organisation is key. We listen to our customers, share ideas, really understand their needs and then relentlessly focus on delivering our promises.



## INNOVATION



This is our lifeblood. We continually innovate to remain competitive. To drive innovation, we create the right environment – curious, challenging, unafraid of failure, disciplined, open-minded and able to change with pace. Most importantly, we ensure our innovation is relevant to our customers' needs.



## PROFITABLE GROWTH



By focusing on our customers and offering them a competitive portfolio of products and services, we create the opportunity to grow our market share. We have to make sure that we are not just growing, but growing profitably. That means ensuring our costs are competitive. We look after our cash and we win right.

## PEOPLE



Our people are the key enabler of our strategy. We are committed to recruiting, developing and retaining the best and to creating a climate for success. We are building a business-orientated, innovative and cost-conscious culture, where our people feel connected to the needs of our customers, the needs of our shareholders and the needs of our broader communities.

SEE PAGES 44 TO 47 FOR MORE INFORMATION ON HOW SUSTAINABILITY PLAYS A PIVOTAL ROLE IN THE DELIVERY OF OUR STRATEGY

# BUSINESS MODEL

We bring advanced technology to market through integrated power and propulsion systems and services for use in the air, on land and at sea.

Engineering excellence is a fundamental source of competitive advantage across the Group. Our methods, processes and experience enable us to deliver complex, high-value programmes. Our ability to optimise and integrate entire systems is a core competence informed by a close understanding of customer needs and decades of domain knowledge.

Addressing complementary markets from a shared capability and technology base brings breadth and scale, diversity and balance, enabling us to invest efficiently, and providing the resilience required to offset new project risk. Our manufacturing model is consistent across the Group; we only produce parts ourselves where we can create and sustain a competitive advantage.

The balance of our supply chain is built around close and long-standing relationships with key partners and suppliers, a model that provides flexibility of capacity and secures access to world-class capability. Some partners, as well as supplying parts, share in the risks and rewards of the whole programme from research and development to manufacture, through risk and revenue sharing arrangements.

Services are an essential part of our business, building customer relationships and providing revenue stability by moderating the effects of new equipment order cycles. Services offer strong growth potential and the opportunity to align incentives through long-term service contracts, providing visibility of costs to our customers and helping us secure future revenues. This is particularly the case in Civil aerospace where contractual and air safety considerations mean that we have rights that secure a large part of the aftermarket spare parts business even where we do not have a TotalCare® agreement.

The operation of our business model over decades has resulted in a substantial and growing installed base of engines at all stages of the product life cycle. Cash flows today from investments made, in some cases many years ago, support investment for the future. We are focused on making this proven business model more effective through relentless focus on costs to generate the funds to sustain the investment necessary to remain competitive.

## CONNECT TECHNOLOGY TO CUSTOMER NEEDS

Our deep understanding of customer needs drives the development of new technologies and products.



## AEROSPACE

Gas turbines

Large & global

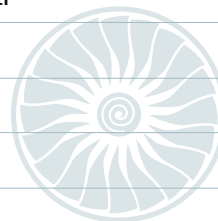
High

High

5-20 years

40+ years

Substantial and growing



## ALLOCATE CAPITAL TO NEW GROWTH

We operate a disciplined capital allocation process across the Group. We invest only where we believe we can create and sustain a competitive advantage and achieve a good return for shareholders.



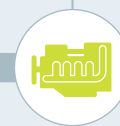
### INVEST IN R&D AND SKILLED PEOPLE

Developing and protecting leading-edge technology and deploying it across our businesses allows us to compete on a global basis and creates high barriers to entry.



### DESIGN AND MAKE WORLD-CLASS PRODUCTS

We differentiate on performance. We win and retain customers by developing and delivering products that provide more capability and offer better through-life value than those of our competitors.



## LAND & SEA

← POWER SOURCE →	Reciprocating engines	Nuclear
← CUSTOMER BASE →	Large & global	Global
← BARRIERS TO ENTRY →	Medium/high	High
← INVESTMENT REQUIRED →	Low/medium	Low/medium
← DEVELOPMENT TIME →	2-8 years	20 years
← PRODUCT LIFE →	20+ years	40+ years
← SERVICE OPPORTUNITY →	Growing	Growing



### SECURE AND MAXIMISE SERVICE OPPORTUNITY

Our equipment is in service for decades. Our deep design knowledge and in-service experience ensures that we are best placed to optimise product performance and availability.



### GROW MARKET SHARE AND INSTALLED BASE

Our substantial order book for both original equipment and services provides good visibility of future revenues and provides a firm foundation to invest with confidence.



## CHIEF FINANCIAL OFFICER'S REVIEW



As I reflect on my new role as Chief Financial Officer at Rolls-Royce, I would like to underline the progress we've made in 2014 and outline my priorities for 2015 and beyond.

This has clearly not been an easy year. However, the Group is fundamentally strong. We are in the enviable position of having a £74 billion order book of products and services that will deliver revenue for decades to come. We operate in markets with excellent long-term growth dynamics and high barriers to entry. We are valued by our customers. Our innovative team is creating products at the forefront of technology. We have set out firmly on the path to transform our industrial structure. Our objective now is to translate these product successes, growth markets and internal transformation into attractive returns and cash flow in the medium term.

In 2014, we made good progress on our business transformation, delivering both in-year improvements on our 4Cs such as customer delivery performance and creating the medium-term platform for improving margins and cash flow.

For example, in Aerospace we have reduced our aftermarket costs for our volume engine, the Trent 700, and also made good progress on our corporate jet and defence contracts. Over the past two years, the Group has reduced indirect headcount by 18%. We also sold our Energy gas turbines and compressor business to Siemens on 1 December 2014.

**DAVID SMITH**  
Chief Financial Officer

## SUMMARY

	2014	2013	Change
Order book £m	73,674	71,612	+3%
Underlying* revenue £m	14,588	15,505	-6%
Underlying* profit before tax £m	1,617	1,759	-8%
Return on sales	11.5%	11.8%	-0.3pp
Underlying* earnings per share	65.3p	65.6p	-0.3p
Full year payment to shareholders	23.1p	22.0p	+5%
Reported revenue <sup>†</sup>	13,736	14,642	-6%
Reported profit before tax <sup>†</sup>	67	1,700	-96%
Reported earnings per share <sup>†</sup>	3.7p	73.3p	-69.6p
Net cash	666	1,939	-66%
Free cash flow £m	254	781	-67%

\* Underlying explanation is in note 2 on page 110.

<sup>†</sup> 2013 re-presented to reflect Energy as a discontinued operation.

All figures in the narrative of the Strategic Report are underlying unless otherwise stated.

We know we need to accelerate our efforts on cost and cash. In November, we announced a restructuring and cost reduction plan that will deliver £80 million in annualised savings and we will make further announcements at the appropriate time. We will also look to reduce our facilities' footprint, increase our activities in lower-cost countries, pursue further aftermarket cost reductions and continue to make progress on inventory, investment efficiency and cash management.

A personal priority is strengthening and streamlining our financial controls and business information. We have excellent

accounting and technical skills, which are critical in our complex business. I will be working to deliver financial and non-financial KPIs that are more forward-looking and have a greater focus on the business fundamentals which are driving our cash and profit performance.

I will also be working to ensure that our communications with shareholders are clear, consistent and helpful. As part of this, we have started to provide a medium-term outlook and will continue to look at additional ways to communicate more clearly. Our share buyback programme is already underway and will return to

shareholders £1 billion in proceeds from the sale of our Energy gas turbines and compressor business.

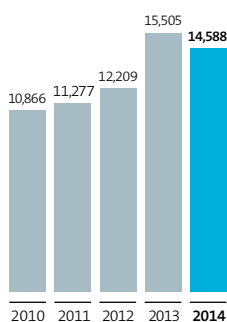
Amid these changes there are certain fundamentals that we will continue to support. These include:

- maintaining a strong balance sheet that gives confidence to our customers and enables our business to invest in future programmes;
- continuing to refine our capital allocation processes and invest in R&D to develop the next generation of products; and
- managing risk prudently including hedging our foreign currency exposures to reduce volatility.

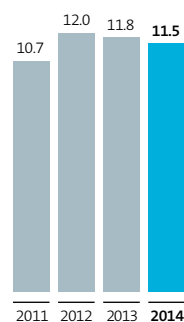
There's no doubt that the recent changes in oil and commodity prices, currencies and geopolitical strains have increased uncertainty. We therefore need to plan cautiously while accelerating our business improvement activity. In 2015, we expect underlying revenue to be flat overall and underlying profit before tax to be down somewhat, reflecting the present phase of our business transformation. We also expect free cash flow to be lower given our restructuring spend.

Looking ahead, our product portfolio transition will see rising deliveries of new civil engines that will significantly increase our installed base. We will also continue to grow our Land & Sea businesses. This and our investment in new technology and industrial transformation will constrain near-term margins and cash generation. However, as we move towards the medium term and this growth and investment phase moderates, we expect both margins and cash conversion to improve in line with our medium-term guidance.

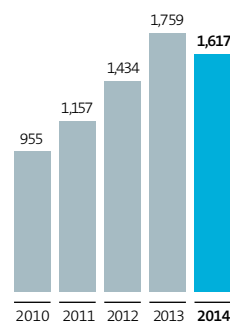
GROUP UNDERLYING REVENUE (£m)



RETURN ON SALES (%)



GROUP UNDERLYING PROFIT BEFORE TAXATION (£m)



➔ PAGES 95 TO 148  
CONSOLIDATED FINANCIAL STATEMENTS

## FINANCIAL REVIEW

2014 has been a mixed year during which underlying revenue fell for the first time in a decade, reflecting reduced spending by our defence customers, macro economic uncertainty and falling commodity prices.

### GROUP UNDERLYING INCOME STATEMENT

£ million	2014	2013	Change
Revenue	<b>14,588</b>	15,505	(917)
Profit before financing	<b>1,678</b>	1,831	(153)
Net financing	<b>(61)</b>	(72)	11
Profit before taxation	<b>1,617</b>	1,759	(142)
Taxation	<b>(387)</b>	(434)	47
Profit for the year	<b>1,230</b>	1,325	(95)
Earnings per share (EPS)	<b>65.31p</b>	65.59p	(0.28)
Payments to shareholders	<b>23.1p</b>	22.0p	1.1p
Gross R&D investment	<b>1,249</b>	1,118	131
Net R&D charge	<b>755</b>	624	131

### SEGMENTAL ANALYSIS

£ million	Revenue			Profit before financing		
	2014	2013	Change	2014	2013	Change
Civil	<b>6,837</b>	6,655	182	<b>942</b>	844	98
Defence	<b>2,069</b>	2,591	(522)	<b>366</b>	438	(72)
<b>Aerospace Division</b>	<b>8,906</b>	9,246	(340)	<b>1,308</b>	1,282	26
Power Systems	<b>2,720</b>	2,831	(111)	<b>253</b>	294	(41)
Marine	<b>1,709</b>	2,037	(328)	<b>138</b>	233	(95)
Nuclear	<b>684</b>	667	17	<b>48</b>	10	38
Intra-segment	<b>(155)</b>	(147)	(8)	<b>(13)</b>	2	(15)
<b>Land &amp; Sea Division (excluding Energy)</b>	<b>4,958</b>	5,388	(430)	<b>426</b>	539	(113)
Energy	<b>724</b>	871	(147)	<b>(3)</b>	64	(67)
<b>Land &amp; Sea Division</b>	<b>5,682</b>	6,259	(577)	<b>423</b>	603	(180)
Central costs				<b>(53)</b>	(54)	1
<b>Group (excluding Energy)</b>	<b>13,864</b>	14,634	(770)	<b>1,681</b>	1,767	(86)
<b>Group</b>	<b>14,588</b>	15,505	(917)	<b>1,678</b>	1,831	(153)

#### GROUP UNDERLYING REVENUE

**£14,588m**

#### GROUP UNDERLYING PROFIT BEFORE TAXATION

**£1,617m**

**Underlying revenue** reduced £0.9 billion to £14.6 billion, a reduction of 6%, of which 3% is due to adverse year-on-year foreign exchange (FX) rate movements. The remaining reduction reflects a 5% decline in original equipment (OE) revenue and a 1% decline in services revenue. Underlying services revenue continues to represent around half (48%) of the Group's underlying revenue. Group services revenue included increases in Defence aerospace and Power Systems partially offset by reductions in our Marine, Nuclear and Energy businesses.

**Underlying profit before financing and taxation** reduced 8% to £1.7 billion. We saw a negative impact from lower volumes, especially in Defence and Land & Sea, increased R&D investment (£140 million) and higher restructuring charges (£100 million), a one-off Marine charge (£30 million), and adverse FX (£49 million). These factors were offset by an improved trading margin which included approximately £150 million benefit from improved retrospective TotalCare contract profitability (£110 million deterioration in 2013), reflecting lower cost, changing operating patterns and reduced contract risk. Trading margins in Defence also

improved, driven by both cost reduction action and an improved mix. In Land & Sea we incurred a loss at our Bergen subsidiary (£33 million), reflecting weaker trading performance. Lower bonus and share incentive costs resulted in a saving of £178 million.

→ PAGES 32 TO 41  
FURTHER DISCUSSION OF TRADING IS INCLUDED  
IN THE BUSINESS REVIEWS

**Underlying financing costs** reduced by 15% to £61 million reflecting reduced financial risk and revenue sharing arrangements (RRSAs) liabilities and other improvements.

**Underlying taxation** of £387 million represents an underlying tax rate of 23.9%, compared with 24.7% in 2013.

→ PAGE 160  
THE GROUP'S TAX PAYMENTS

**Underlying EPS** was marginally lower at 65.31p, with the impact of the lower underlying profit after tax largely offset by the improvement in the underlying tax rate and a lower non-controlling interest in Power Systems, following Daimler's exercise of the put option in April 2014.

At the Annual General Meeting on 8 May 2015, the directors will recommend an issue of 141 C Shares with a total nominal value of 14.1 pence for each ordinary share. Together with the interim issue on 2 January 2015 of 90 C Shares for each ordinary share with a total nominal value of 9.0 pence, this is the equivalent of a total annual **payment to ordinary shareholders** of 23.1 pence for each ordinary share. Further details are on page 162.

**Net underlying R&D charged to the income statement** increased by 21% to £755 million, reflecting a combination of increased net investment of £98 million and lower net capitalisation of £21 million (due to the phasing of major new programmes, in particular the certification of the Trent XWB-84) and £12 million lower net deferral of RRSA entry fees — see page 115. The net investment spend represents 5.8% of Group underlying revenue, although it is expected that this will reduce slightly in the future towards the longer-term target of around 5%. Our gross R&D expenditure of £1.2 billion includes funded programmes.

## PROFIT BEFORE TAXATION

£ million	2014	2013
Underlying	1,617	1,759
Mark-to-market adjustments on derivatives	(1,254)	217
Movements on other financial instruments	(87)	(251)
Effect of acquisition accounting	(142)	(265)
Exceptional restructuring	(39)	–
Acquisitions and disposals	8	335
Post-retirement schemes	(29)	(90)
Other (including discontinued operations)	(7)	(5)
Reported (2013 restated to exclude discontinued operations)	67	1,700

**23.1p** payment to shareholders

## REPORTED PROFIT BEFORE TAX

Consistent with IFRS and past practice, the Group provides both reported and underlying figures. We believe underlying figures are more representative of the trading performance, by excluding the impact of year-end mark-to-market adjustments, principally the GBP:USD hedge book. In addition, post-retirement financing and the effects of acquisition accounting are excluded. The adjustments between the underlying income statement and the reported income statement are set out in more detail in note 2 to the Financial Statements. This basis of presentation has been applied consistently.

**The mark-to-market adjustments** are principally driven by movements in the GBP:USD exchange rate which moved from 1.65 to 1.56 during 2014.

**Movement on other financial instruments** primarily relate to the change in value of the put option on the Power Systems non-controlling interest, which has now been exercised.

The **effects of acquisition accounting** in accordance with IFRS 3 are excluded from underlying profit so that all businesses are measured on an equivalent basis.

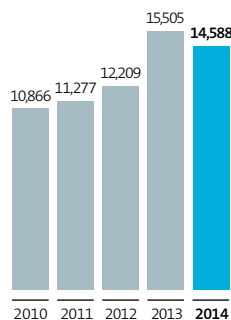
Costs associated with the substantial closure or exit of a site, facility or activity are classified as **exceptional restructuring** and excluded.

Profits and losses arising on **acquisitions and disposals** during the year are excluded.

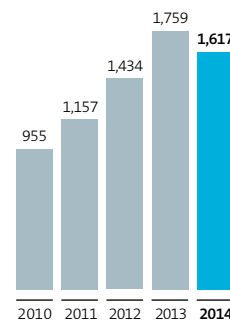
Net financing on **post-retirement schemes** is excluded from underlying profit and, in 2013, the cost of providing a discretionary increase to pensions was also excluded.

Appropriate tax rates are applied to these adjustments, the net effect of which was

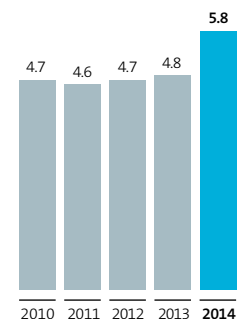
**UNDERLYING REVENUE (£m)**



**UNDERLYING PROFIT BEFORE TAXATION (£m)**



**NET R&D AS A PROPORTION OF REVENUE (%)**



# FINANCIAL REVIEW

CONTINUED

## SUMMARY BALANCE SHEET

£ million	2014	Other changes	Energy disposal (note 25)	2013
Intangible assets	4,804	(77)	(106)	4,987
Property, plant and equipment	3,446	241	(187)	3,392
Joint ventures and associates	539	(6)	(56)	601
Net working capital	(1,134)	229	(393)	(970)
Net funds	666	(1,269)	(4)	1,939
Provisions	(807)	(108)	34	(733)
Net post-retirement scheme surpluses/(deficits)	555	1,348	–	(793)
Net financial assets and liabilities	(855)	732	–	(1,587)
Other net assets and liabilities	(827)	(294)	–	(533)
Net assets	6,387	796	(712)	6,303
Other items				
USD hedge book US\$ billion	25.6			24.7
TotalCare assets	2,492			1,901
TotalCare liabilities (2013 includes £245m not previously included)	(687)			(559)
Net TotalCare assets	1,805			1,342
Customer financing contingent commitments:				
Gross	388			356
Net	59			59

a £239 million reduction in the reported tax charge (2013 £54 million reduction). The adjustment includes a £64 million reduction in the value of recoverable advance corporation tax recognised. A reconciliation of the tax charge is included in note 5.

### BALANCE SHEET

**Intangible assets** (note 9) represent long-term assets of the Group. These assets decreased by £77 million with additional development, contractual aftermarket rights, certification and software costs being more than offset by annual amortisation charges.

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain: reductions in assumed market share; programme timings; increases in unit cost assumptions; and adverse

movements in discount rates. There have been no significant impairments in 2014.

**Property, plant and equipment** (note 10) increased by £241 million due to the ongoing development and refreshment of facilities and tooling as the Group prepares for increased production volumes.

**Investments in joint ventures and associates** (note 11) remain stable as the share of retained profit was offset by dividends received.

**Provisions** (note 18) largely relate to warranties and guarantees provided to secure the sale of OE and services. The increase is largely a result of the recognition of restructuring costs.

**Net post-retirement scheme surpluses/(deficits)** (note 19) increased by £1,348 million, principally due to relative movements in the yield curves used to value the underlying assets and liabilities in accordance with IAS 19. In addition, the scheme rules on the largest UK scheme were amended during the year, resulting in the surplus being recognised (£544 million impact).

The Group's principal pension schemes adopt a low risk investment strategy that

reduces volatility going forward and enables the funding position to remain stable: interest rate and inflation risks are largely hedged and the exposure to equities is around 8% of scheme assets.

**Net financial assets and liabilities** (note 17) include the fair value of derivatives, financial RRSAs, the put option on the non-controlling interest of Power Systems and C Shares. The reduction primarily reflects the settlement of the put option (£1,937 million) offset by a reduction in value of the foreign exchange derivatives (£1,137 million) due to the strengthening of the US dollar.

The USD hedge book increased by 4% to US\$25.6 billion. This represents around four and a half years of net exposure and has an average book rate of £1 to US\$1.61.

**Net TotalCare assets** relate to long-term service agreement (LTSA) contracts (and where appropriate the linked OE contract) in the Civil aerospace business, including the flagship services product TotalCare. These assets represent the timing difference between the recognition of income and costs in the income statement and cash receipts and payments. The increase largely reflects high levels of linked Trent 700 and increasing Trent 1000 engine sales in the year.

 The Group continues to maintain a strong balance sheet, providing reassurance to our customers."



**Customer financing** facilitates the sale of OE and services by providing financing support to certain customers. Where such support is provided by the Group, it is almost exclusively to customers of the Civil aerospace business and takes the form of various types of credit and asset value guarantees. These exposures produce contingent liabilities that are outlined in note 18. The contingent liabilities represent the maximum aggregate discounted gross and net exposure in respect of delivered aircraft, regardless of the point in time at which such exposures may arise.

During 2014, the Group's gross exposure on delivered aircraft increased by £32 million, due largely to the strengthening of the US dollar. On a net basis, exposures remained unchanged with a small reduction being offset by the exchange rate movement.

#### FUNDS FLOW

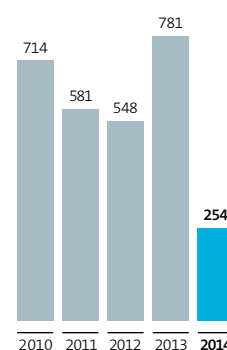
**Movement in working capital** – the increase reflects the growth of the net TotalCare asset offset by a reduction in the amount of customer deposits. This increase compares to a modest decrease in the previous year which is primarily a result of the phasing of customer deposit utilisation.

**Expenditure on property, plant and equipment and intangibles** – the decrease reflects a reduction in additions to property, plant and equipment (£32 million), participation fees and certification costs (£26 million) and software and other intangible assets (£41 million), offset by increased expenditure on contractual aftermarket rights (£41 million).

**Pensions** – contributions to defined benefit pension schemes in 2014 included £33 million to UK schemes to fund the discretionary increases agreed in 2013. The service cost included a past-service credit of £31 million – largely relating to restructuring (2013 past-service cost £71 million – largely relating to the discretionary increases above), which is the main reason for the £116 million increase in the cash contributions in excess of the PBT charge.

The Group's funding of its defined benefit schemes is expected to reduce by around 30% in 2015, as a result of deficit funding requirements ending and the non-recurrence of the payment for discretionary increases.

#### FREE CASH FLOW (£m)



**Shareholder payments** – the increase reflects the C Share issues in 2014 (£51 million increase) and the Power Systems dividend to Daimler (£14 million increase).

**Acquisitions and disposals** include the payment of £2,013 million (including the fair value of derivatives held to hedge the cost) for the additional 50% of Power Systems offset by £1,027 million of net proceeds from the disposal of the Energy business.

#### SUMMARY FUNDS FLOW

£ million	2014	2013	Change
Opening net funds	1,939	1,317	
Closing net funds	666	1,939	
<b>Change in net funds</b>	<b>(1,273)</b>	622	
Underlying profit before tax	1,617	1,759	(142)
Depreciation and amortisation	600	608	(8)
Movement in net working capital	(509)	91	(600)
Expenditure on property, plant and equipment and intangible assets	(1,114)	(1,172)	58
Other	88	(231)	319
<b>Trading cash flow</b>	<b>682</b>	1,055	(373)
Contributions to defined benefit post-retirement schemes in excess of PBT charge	(152)	(36)	(116)
Tax	(276)	(238)	(38)
<b>Free cash flow</b>	<b>254</b>	781	(527)
Shareholder payments	(482)	(417)	(65)
Share buyback	(69)	–	(69)
Acquisitions and disposals	(965)	265	(1,230)
Net funds of businesses acquired	(30)	36	(66)
Foreign exchange	19	(43)	62
<b>Change in net funds</b>	<b>(1,273)</b>	622	
Average net funds	(38)	350	(388)

# BUSINESS REVIEW – AEROSPACE



As a leading manufacturer of aero engines for the civil large aircraft, corporate jet and defence markets, the growing global requirement for cleaner, more efficient, better power, continues to create opportunities for our Aerospace Division.

**TONY WOOD**  
President – Aerospace

Within the civil market we continue to see increasing numbers of people travelling by air. The International Air Transport Association (IATA) reported that available seat kilometres (a measure of civil air traffic) grew by nearly 6% in 2014 and the long-term growth outlook remains at around 5% per annum for the foreseeable future.

In the defence market, despite ongoing pressure on budgets, aviation remains a vital component of defence forces around the world and we secured several important new orders during the year.

In 2014, our engines powered the first deliveries of two new airliners; one for each of our major airframe customers, Airbus and Boeing. We launched the seventh member of our Trent engine family, achieved major milestones for existing Trent engine

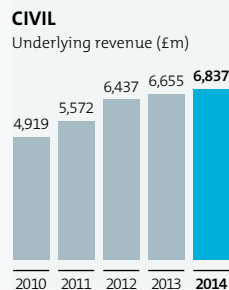
## OVERVIEW

### CIVIL AEROSPACE

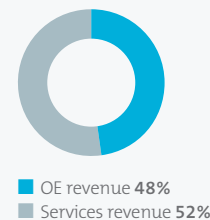
#### KEY HIGHLIGHTS

- First Trent XWB delivered and Trent XWB-97 version on test
- Trent 7000 chosen to power new Airbus A330neo
- Latest Trent 1000 entered service on Boeing 787-9 and Trent 1000-TEN on test
- BR725 selected for Gulfstream G650ER and AE 3007C2 entered service on Cessna Citation X+

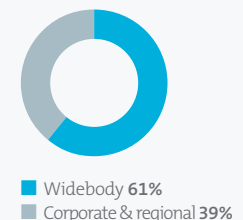
**23,900** Employees



#### CIVIL UNDERLYING REVENUE MIX



#### CIVIL UNDERLYING REVENUE BY SECTOR

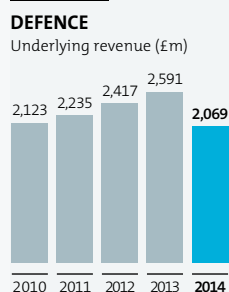


### DEFENCE AEROSPACE

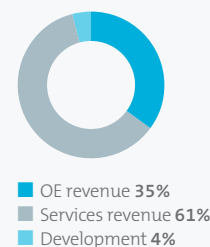
#### KEY HIGHLIGHTS

- Lockheed Martin agreement signed for 600 AE 2100 engines
- A330 MRTT now fully operational in UK and selected by France and Singapore
- A400M transporter deliveries continue
- Business resizing to reduce costs and improve competitiveness is progressing

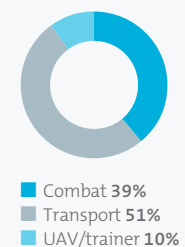
**7,000** Employees



#### DEFENCE UNDERLYING REVENUE MIX



#### DEFENCE UNDERLYING REVENUE BY SECTOR



programmes and made important announcements about civil engine technologies for the future.

Business jet owners and operators continue to seek greater speed, range and the highest levels of service. 2014 saw Rolls-Royce selected by Gulfstream for a new ultra-long range business jet and we powered a new version of the fastest civilian aircraft in the world into service for Cessna. We continue to invest for the next generation of large business jet engines.

Our defence customers are focused on extending the lives and improving the efficiency of their in-service aircraft. Rolls-Royce is helping air forces to do more with less by delivering new or improved engines and services. Looking to the future, we see opportunities to power new

programmes, such as the Korean K-FX combat aircraft and the Anglo-French Future Combat Air System.

We continue to focus on reducing costs to support our strategy of customer, innovation and profitable growth. The investments we have made in new technology and capacity will enable us to increase output and improve efficiency. Delay in a number of customer programmes did result in some capacity being ready earlier than needed, however these programmes are now coming on stream. In June, we opened a new facility in Washington, UK, specialising in advanced manufacturing techniques and robotics which will halve the time to manufacture fan and turbine discs. We are accelerating our plans to consolidate older facilities and transition to newer ones. Towards the end

of the year we announced a programme to further improve operational efficiency and reduce costs across the Aerospace Division over the next 18 months.

Although revenue remained broadly flat through 2014 due to current market conditions and lower defence spending, our cost reduction actions have yielded benefits during the year and laid the foundations required to support mid-term margin improvement for the Division.

## CIVIL AEROSPACE

### PERFORMANCE REVIEW

#### WHO WE ARE

The Civil aerospace business is a major manufacturer of aero engines for the commercial large aircraft and corporate jet markets. We power 35 types of commercial aircraft and have more than 13,000 engines in service around the world.

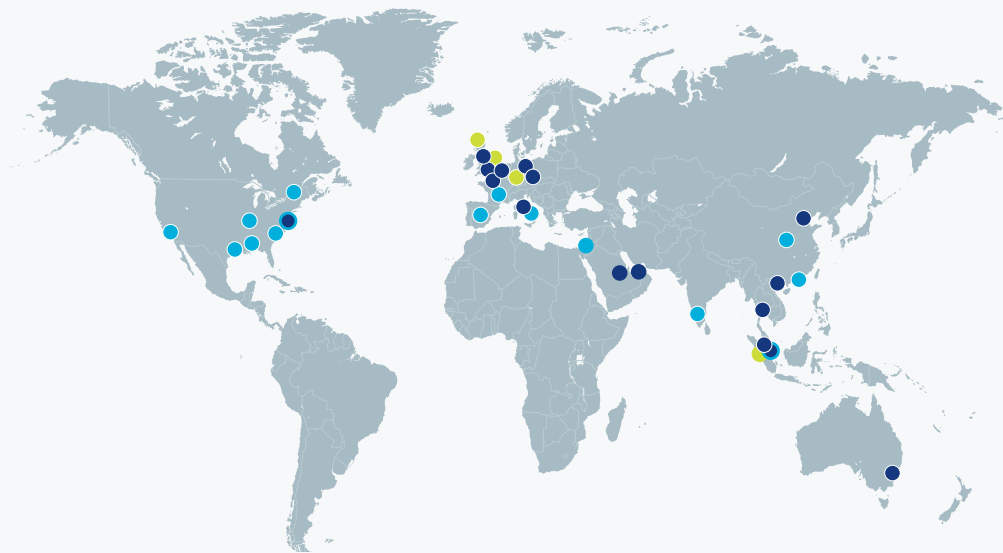
#### FINANCIAL REVIEW

The Civil order book increased 5%. Our net order intake was £11.7 billion. Aftermarket services now constitute 31% of the Civil order book.

Underlying revenue grew 3% (up 4% at constant foreign exchange), on 8% growth in OE that was partially offset by a 1% decline in services. OE growth was primarily driven by a ramp up in Trent 1000 engine production. This was partially offset by a 9% reduction in business jet engine deliveries. The decline in services reflects the expected 24% decline in the RB211 programme. Aftermarket revenue from our Trent fleet increased 6%.

Underlying profit improved by 12%, driven by higher volumes and improved aftermarket margins. Profit benefited from approximately £150 million in improved retrospective TotalCare contract profitability, reflecting lower cost, changing operating patterns and reduced contract risk. Profit also benefited from lower commercial and administrative (C&A) and bonus costs. This was partially offset by £63 million in higher restructuring costs and £151 million in higher R&D costs.

## AEROSPACE LOCATIONS



### Key

- Aerospace locations
- Corporate locations
- Aerospace and Corporate
- Multiple Aerospace locations:
  - England 18
  - Germany 3
  - Scotland 2
  - Singapore 2

# BUSINESS REVIEW – AEROSPACE

CONTINUED

## CIVIL AEROSPACE – KEY FINANCIAL DATA

	2010	2011	2012	2013	2014
Order book £m*	48,490 +3%	51,942 +7%	49,608 -4%	60,296 +22%	<b>63,229</b> <b>+5%</b>
Engine deliveries*	846	962	668	753	<b>739</b>
Underlying revenue £m	4,919 +10%	5,572 +13%	6,437 +16%	6,655 +3%	<b>6,837</b> <b>+3%</b>
Underlying OE revenue £m	1,892	2,232	2,934	3,035	<b>3,265</b>
Underlying service revenue £m	3,027	3,340	3,503	3,620	<b>3,572</b>
Underlying profit before financing £m	392 -20%	499 +27%	743 +49%	844 +14%	<b>942</b> <b>+12%</b>

\* all years before 2012 include IAE order book and engine deliveries include IAE V2500.

The investments we are making in R&D and restructuring will support future profitable growth.

In 2015, we expect revenue between £7.0 and £7.3 billion, with continued growth in Trent XWB and Trent 1000 OE sales and good growth in aftermarket revenue. We expect this to be partially offset by fewer Trent 900 and Trent 700 sales. We expect profit to be between £800 and £900 million, as the retrospective TotalCare accounting adjustments do not repeat at similar levels. This guidance is based on 2014 average exchange rates.

### OUR YEAR

We have over 50% of the engines on order for the widebody airliner market. A number of developments during 2014 helped to consolidate our position as the leading supplier in this sector.

The first Airbus A350 XWB aircraft, powered by our Trent XWB engines, was delivered to launch customer Qatar Airways at the end of the year, marking the start of our largest production programme. Earlier, in July we ran the more powerful 97,000lb thrust version of the Trent XWB for the first time. This version will power the larger Airbus A350-1000 due to enter into service in 2017. In June, Emirates announced the cancellation of its order for 70 A350 XWB aircraft. This was partially offset by new orders and at the end of the year the Trent XWB order book stood at more than 1,500 engines.

The latest version of the Trent 1000 entered into service in July, powering Boeing 787-9 Dreamliners for Air New Zealand and ANA.

Work progressed on the Trent 1000-TEN which will be available from 2016 and will be capable of powering all variants of the Dreamliner.

Airbus received the 1,500th Trent 700 in August, 20 years after the first engine was delivered. Rolls-Royce powers 58% of the Airbus A330s currently in service or on order. A new more fuel-efficient version, the A330neo, will be exclusively powered by our new Trent 7000 engine. By the end of the year we had received commitments for Trent 7000 engines to power 120 A330neo aircraft. This included an order from the major US airline Delta for 25 Trent 7000-powered A330neos together with 25 Trent XWB-powered A350-900s.

**1,500** Trent XWB engines have been ordered



Throughout 2014 we have been engaged in Trent 900 sales campaigns to power new orders for Airbus A380s. Decisions on engine choice have yet to be made in these ongoing campaigns. We continue to work closely with Airbus to support the future of this important programme.

We took significant steps in the development of our future engine programmes. In February, we announced two innovative new engine designs; the Advance turbofan and UltraFan which will feature a power gearbox. These will be available from 2020 and 2025 respectively. A new test bed for power gearboxes is to be built at our site in

Dahlewitz, Germany, representing an investment of €65 million. An additional test bed for future extra-large engines of up to 150,000lbs thrust was also opened in Dahlewitz in November. We maintained our leading position in the business jet market. Our BR725 was selected to power Gulfstream's new ultra-long-range business jet, the G650ER. The year also saw the entry into service of the world's fastest civilian aircraft, the AE 3007C2-powered Citation X+.

To support operators of Rolls-Royce powered business jets we continued to expand our global network of authorised service centres. The number of engines powering corporate aircraft covered by our CorporateCare® programme reached more than 1,600. The level of TotalCare coverage in the commercial transport installed engine base increased to 83% this year and 210 incremental corporate jets were signed up to our CorporateCare programme.

### LOOKING AHEAD

In support of our future growth strategy, we will make investments that enable us to deliver our significant order book and develop the next generation of civil engines with new technologies, advanced manufacturing techniques and more efficient processes.

We will develop TotalCare in line with changing market requirements for services. We will leverage our world-class data management capability through our newly created Controls and Data Services business. We will remain focused on the 4Cs and will embed a modern, dynamic and ethical culture across all areas of the business.

## DEFENCE AEROSPACE

### PERFORMANCE REVIEW

#### WHO WE ARE

We are the leading engine maker for the military transport market and the second largest provider of defence aero-engine products and services globally. Defence has 16,000 engines in service with 160 customers in over 100 countries.

## FINANCIAL REVIEW

The Defence order book grew 12% in 2014, the first increase since 2010. Total order intake increased 55% to £2.54 billion, from £1.64 billion in 2013.

Underlying revenue fell 20% (down 18% at constant foreign exchange), reflecting a 41% decline in OE partially offset by 4% growth in aftermarket services. OE reductions were due to lower volumes across several programmes, including major deliveries in 2013 of two export contracts that were nearing completion: EJ200 to Saudi Arabia and Adour to India. Services revenue grew modestly, as LiftSystem™ and TP400 maintenance started to ramp up.

A smaller decline in underlying profit of 16% (down 14% at constant foreign exchange) reflects significant cost reduction actions and the favourable mix shift towards aftermarket, which represented 61% of Defence revenue. Profit also benefited from lower C&A and bonus costs.

In 2015, we expect revenue of between £1.9 and £2.1 billion and profits of between £360 and £410 million, based on average 2014 exchange rates. Cost reduction activity will continue across our supply chain, operational footprint, headcount and service provision.

## OUR YEAR

Customers in our principal markets of North America and Europe face continued pressure from constraints on government defence spending. As a consequence, pricing and innovation have become even more important as our customers look for ways to do more with less.

## DEFENCE – KEY FINANCIAL DATA

	2010	2011	2012	2013	2014
Order book £m	6,506	6,035	5,157	4,071	<b>4,564</b>
	+1%	-7%	-15%	-21%	<b>+12%</b>
Engine deliveries	710	814	864	893	<b>744</b>
Underlying revenue £m	2,123	2,235	2,417	2,591	<b>2,069</b>
	+6%	+5%	+8%	+7%	<b>-20%</b>
Underlying OE revenue £m	1,020	1,102	1,231	1,385	<b>816</b>
Underlying service revenue £m	1,103	1,133	1,186	1,206	<b>1,253</b>
Underlying profit before financing £m	309	376	395	438	<b>366</b>
	+22%	+22%	+5%	+11%	<b>-16%</b>

In order to be closer to our customers whilst reducing cost, we have concentrated our UK maintenance, repair and overhaul activity into one site in Bristol. We also moved support for the Rolls-Royce LiftSystem® to Indianapolis to support the F-35B Lightning II aircraft programme as it progresses to Initial Operating Capability with the US Marine Corps in 2015. The F-35 programme continues to ramp up, with orders received for production and support of the LiftSystem in 2014 totalling US\$548 million.

We secured a major long-term agreement with Lockheed Martin worth up to US\$1 billion to supply up to 600 AE 2100 engines for the C-130J aircraft, in addition to over US\$200 million in support contracts for AE 2100 engines. Deliveries were made to Turkey, France, Germany and the UK of the TP400-powered Airbus A400M transport aircraft. The 100th TP400 production engine was delivered in November and in the same month, we announced an £18 million investment in facilities at Bristol to support this programme. 2014 saw good progress in the tanker aircraft market where we are a shareholder in AirTanker which operates the A330 Multi Role Tanker Transport (MRTT) on behalf of the Royal Air Force. In 2014, the A330 MRTT was also selected by the defence forces of France and the Republic of Singapore.

There was a softening of demand in the civil helicopter market and this impacted our engine manufacturing load. However, a long-term agreement was signed to install upgraded M250 engines in future Bell 407GX helicopters. The M250 turboprop variant was also selected by Jiangsu A-Star of China to power its Extra EA500 aircraft in a deal worth over US\$50 million.

Service delivery contracts worth US\$1,843 million were secured with defence customers globally, many of which will provide our popular MissionCare® level of engine support. We have further improved the time on wing for our V-22 Osprey customers, delivering a 30% reduction in support costs. The T56 engine enhancement kit, aimed at legacy C-130 Hercules and P-3 customers, was certified by the US Air Force and has exceeded fuel efficiency targets. The US Navy declared Initial Operational Capability for the new T56-powered E-2D Advanced Hawkeye Airborne Early Warning Aircraft.

In the unmanned aircraft market our stealthy, integrated, propulsion system successfully demonstrated its capability in the second round of flight trials of the UK's Taranis demonstrator. Our AE 3007 engine also powered the US Navy's Triton unmanned aerial system on its first trans-America flight. We were named a 'superior supplier' by both the US Navy and US Defense Logistics Agency in 2014 and recognised by Northrop Grumman for our support of its Global Hawk unmanned aerial vehicle programme.

Together with Snecma, we signed an Anglo-French agreement for further funded studies as part of the Future Combat Air System.

## LOOKING AHEAD

We are focused on maintaining our leading position in the transport and patrol markets and will continue to invest in the industrial and technological capability to support future growth in this area. We are actively engaged in offering propulsion solutions to customers in India, Turkey and Korea as they pursue ambitions for indigenous combat aircraft programmes.

We anticipate continued pressure on defence budgets and remain committed to improving both the service lives of products and our cost performance. Cost reduction activity will continue across our supply chain, operational footprint, and service provision, ensuring our business is well placed for the future in the defence sector.

# BUSINESS REVIEW – LAND & SEA



As the world’s population expands and becomes more affluent, as trade increases and we travel more, the requirement for the technology produced by our Land & Sea Division will grow.

**LAWRIE HAYNES**  
President – Land & Sea

According to the World Bank, approximately 200 million people per year will join the middle classes in the decades ahead, requiring the type of power that we deliver to support their rising living standards and to transport the goods they will buy.

Our Land & Sea Division provides power for a wide range of vehicles and vessels. On land we supply engines to power vehicles as varied as locomotives, battle tanks and mining trucks, applying world-leading technology to set new standards of fuel efficiency. We also deliver distributed power generation and support the world’s civil nuclear power industry. At sea we supply

## OVERVIEW

### POWER SYSTEMS

#### KEY HIGHLIGHTS

- Nearly 1,000 MTU rail PowerPacks contracted by PESA
- Launch of new efficient Bergen B33:45 medium-speed engine
- New MTU Onsite Energy 4000 natural gas engine
- MTU and Weir agree to develop power systems for hydraulic fracking industry

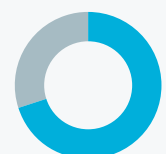
**10,700** Employees

#### POWER SYSTEMS

Underlying revenue (£m)\*



#### POWER SYSTEMS UNDERLYING REVENUE MIX



OE revenue 70%  
Services revenue 30%

#### POWER SYSTEMS UNDERLYING REVENUE BY SECTOR



Marine 39%  
Industrial 20%  
Energy 28%  
Defence & other 13%

### MARINE

#### KEY HIGHLIGHTS

- Largest ever UT vessel designed
- 40 years of leadership in offshore vessels celebrated
- Naming of HMS Queen Elizabeth and launch of USS Zumwalt
- Service network further expanded

**6,400** Employees

#### MARINE

Underlying revenue (£m)\*

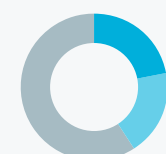


#### MARINE UNDERLYING REVENUE MIX



OE revenue 63%  
Services revenue 37%

#### MARINE UNDERLYING REVENUE BY SECTOR



Naval 22%  
Merchant 19%  
Offshore 59%

### NUCLEAR

#### KEY HIGHLIGHTS

- New propulsion plant design submitted for Vanguard class replacement submarine
- US regulatory approval granted for Spline™ I&C technology
- Business developed across US, Europe (including UK programme) and Asia

**3,900** Employees

#### NUCLEAR

Underlying revenue (£m)\*



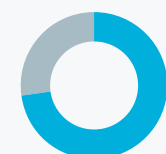
\* Following the creation of the Land & Sea Division in 2014, information on a comparable basis is not available prior to 2013.

#### NUCLEAR UNDERLYING REVENUE MIX



OE revenue 37%  
Services revenue 63%

#### NUCLEAR UNDERLYING REVENUE BY SECTOR



Submarines 73%  
Civil Nuclear 27%

engines, propulsion and advanced engineering products for craft ranging from submarines to complex anchor handlers and seismic vessels used in the offshore oil & gas industry. This broad portfolio of products and services has direct relevance to the long-term demand for better power in our fast-changing world.

Whereas the power supplied from our Aerospace Division is based on gas turbine technology, our Land & Sea Division is to a large degree focused on reciprocating engines. Our high-speed reciprocating engines go to market under the MTU brand and medium-speed engines are from Bergen.

Although the long-term requirement for our technology is certain, a number of the markets that we address are volatile. During 2014, sharp falls in oil and other commodity prices caused a number of our customers to delay or cancel orders. In particular this has affected parts of our Power Systems and Marine businesses. Power Systems was also affected by the trade sanctions imposed by the European Union on Russia.

On land, business has grown across our defence, power generation and services markets and we have had success in launching innovative products in our MTU Onsite Energy range to provide secure, clean

power for industrial applications. We continue to invest in skills and capability in our Civil Nuclear business ahead of significant growth in the world's nuclear power capacity. Although this business is currently relatively small for Rolls-Royce, we already provide components, systems or services to more than half the world's 435 operating reactors, enabling safe and efficient power generation.

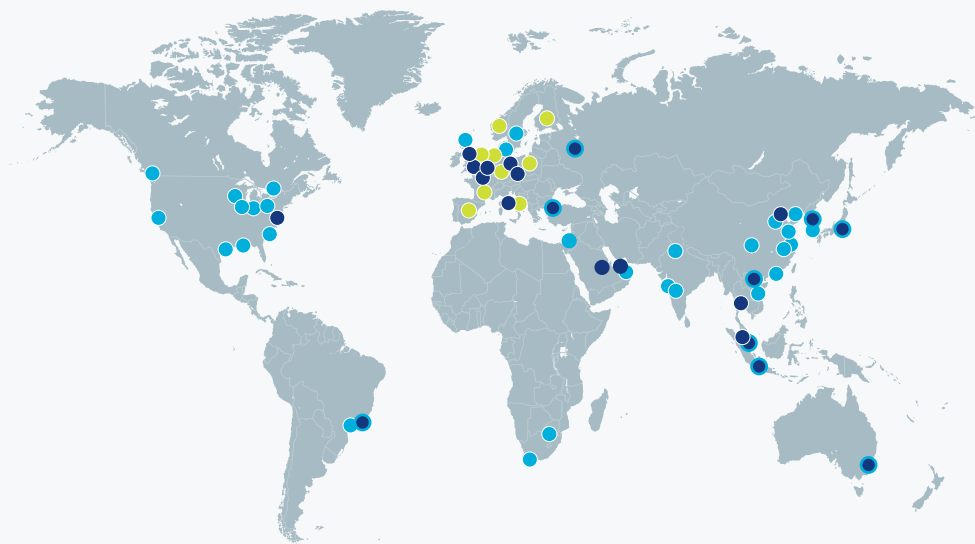
At sea, our Naval business has done well despite continued pressure on defence budgets. Nuclear reactors designed and manufactured by us have been powering the Royal Navy's nuclear submarine fleet for the last 55 years and our engineers are currently designing the next generation for the fleet of the future.

The Division is firmly focused on cost reduction and the management of cash in all areas. We have rationalised a number of our Marine facilities and this work will continue in the year ahead. We will also drive improvement in cost through better supply chain management and continuing to move more of our production to lower-cost countries. We will see further benefits from this during the coming year.

During 2014, we acquired the remaining interest in Rolls-Royce Power Systems from Daimler. Power Systems extends our portfolio and adds deep technical knowledge of high-speed engines and fuel injection systems. It also extends the scale and scope of our market presence.

We have strong long-term relationships with customers, deep product knowledge, powerful and clean engines, efficient propulsion system designs and an established global network. These linked to a truly experienced workforce provide remarkably strong roots, from which the Land & Sea Division can grow.

## LAND & SEA LOCATIONS



**Key**

- Land & Sea locations
- Corporate locations
- Land & Sea and Corporate

**Multiple Land & Sea locations:**

- |            |                  |
|------------|------------------|
| Finland 2  | Netherlands 2    |
| France 2   | Norway 8         |
| Germany 10 | Poland 2         |
| Italy 2    | Spain 2          |
|            | United Kingdom 4 |

**1 in 5** of the world's shipping vessels has Rolls-Royce equipment installed



# BUSINESS REVIEW – LAND & SEA

CONTINUED

## POWER SYSTEMS – KEY FINANCIAL DATA

	2013	2014	Change
Order book £m	1,927	<b>1,971</b>	<b>2%</b>
Underlying revenue £m	2,831	<b>2,720</b>	<b>-4%</b>
Underlying OE revenue £m	2,004	<b>1,893</b>	<b>-6%</b>
Underlying services revenue £m	827	<b>827</b>	<b>–</b>
Underlying profit before financing £m	294	<b>253</b>	<b>-14%</b>

Following the creation of the Land & Sea Division in 2014, information on a comparable basis is not available prior to 2013.

## POWER SYSTEMS

### BUSINESS PERFORMANCE REVIEW

#### WHO WE ARE

The business consists of the MTU, MTU Onsite Energy, Bergen and L'Orange product ranges. MTU high-speed engines and propulsion systems power ships, railway locomotives, defence and heavy off-highway vehicles. They are also used for applications in the oil & gas industries. Diesel and gas genset systems from MTU Onsite Energy deliver heat and power. Bergen medium-speed engines are used in both marine and land-based power generation applications. L'Orange is a world-leading specialist company that designs and manufactures complex fuel injection systems for large engines.

#### FINANCIAL REVIEW

The Power Systems order book grew 2%. Order intake was £2.6 billion.

Underlying revenue declined 4% mainly due to adverse foreign exchange effects. Growth in defence and power generation was offset by substantially lower sales to European construction, industrial and agricultural customers. Marine revenue also declined, driven by weaker yacht markets. As in previous years, revenue was biased towards the second half.

Underlying profit declined 14% due to adverse foreign currency effects and losses in the Bergen business. Profit benefited from lower C&A and bonus costs.

In 2015, we expect revenue between £2.5 and £2.75 billion and profit between £200 and £250 million. We expect growth in the industrial, power generation and

commercial marine end markets, offset by lower revenue from defence customers, particularly naval marine. We expect profit headwinds from a deteriorating mix. We are taking actions to improve the operating performance and cost controls at Bergen. Our guidance is based on 2014 average exchange rates.

#### OUR YEAR

Slower growth in Eurozone countries and emerging economies presented challenges to our business in 2014. However, the breadth of our portfolio presented opportunities for growth in some parts of the business.

Our Naval marine business benefited from stronger defence budgets in Asia and an increased demand for security at sea in the region; this resulted in orders to power several types of military vessels.

The market for the commercial marine application of both our medium and high-speed diesel engines recovered in 2014. The demand for mega-yachts weakened in 2014 due to fewer vessels being built, particularly in Europe.

2014 saw the launch of a new family of medium-speed engines for the marine market, with future variants for land-based power generation. The Bergen B33:45 uses diesel or gas fuel and features a new modular design that can be developed to suit a wide range of ship types. It uses less fuel, has lower emissions and produces 20% more power per cylinder than the previous Bergen range. Together with our Marine colleagues, we secured orders for it to power two ships, with the first entering operation in 2015, there is also strong interest from the merchant vessel market.

Two projects further highlighted the synergies between our Marine and Power Systems businesses: as part of a Rolls-Royce UT ship design, we supplied MTU diesel-electric propulsion systems and onboard power generators for two platform supply vessels for Chinese shipbuilder COSCO; and, in Brazil, MTU engines were specified for Rolls-Royce UT 535E oil-spill response vessels.

Sales in the European construction, industrial and agriculture sectors were substantially lower in 2014 compared with the high volumes ordered in 2013. Sharp falls in commodity prices led customers in the mining and oil & gas industries to delay or cancel orders for OE.

The Energy business for high-speed engines showed stronger growth in the higher power ranges and in the market for packaged MTU Onsite Energy power systems, for example in data centres and other industrial applications. We introduced an upgraded Series 4000 L64 natural gas engine with improved efficiency.

In the medium-speed market served by the Bergen range, sales decreased. Nevertheless we see an ongoing trend towards gas fuel. One example is a 100MW power plant in Mozambique where Bergen will deliver gas-driven B35:40 generating sets.

2014 saw an improvement in our land defence business. This was helped by a production increase for the German infantry fighting vehicle, the MTU-powered Puma.

Growth in the market for injection systems made by L'Orange continued in 2014, driven by increased demand for injection systems used by dual-fuel engines.

#### LOOKING AHEAD

We will invest in future technologies such as gas engines for commercial marine applications and are configuring our different engine series to meet tougher emissions standards in Europe and North America. At the same time, we will continue to improve efficiency and maintain our focus on costs and cash in all areas.



**MARINE – KEY FINANCIAL DATA**

	2013*	2014	Change
Order book £m	1,622	<b>1,567</b>	<b>-3%</b>
Underlying revenue £m	2,037	<b>1,709</b>	<b>-16%</b>
Underlying OE revenue £m	1,288	<b>1,070</b>	<b>-17%</b>
Underlying service revenue £m	749	<b>639</b>	<b>-15%</b>
Underlying profit before financing £m	233	<b>138</b>	<b>-41%</b>

\*2013 figures restated due to transfer of Submarines to Nuclear business.

**MARINE****BUSINESS PERFORMANCE REVIEW****WHO WE ARE**

Marine supplies complex propulsion and handling systems to the maritime market, across three distinct sectors: Offshore, Merchant and Naval. We have more than 4,000 customers, and our equipment is installed on around 25,000 vessels.

We have an extensive range of technology for propulsion and cargo handling that allows us to provide fully integrated systems for a variety of ship types.

Our capability in ship design means we can also combine our technology into complex vessels, where Rolls-Royce technology can account for around 40% of the total value of a typical offshore vessel and up to 10% of a high specification naval combatant.

As part of the Land & Sea Division, we now also offer MTU high-speed diesel engines as part of our propulsion systems, particularly for naval craft, ferries and offshore vessels.

**FINANCIAL REVIEW**

The Marine order book declined 3% in 2014, with a 1% reduction in order intake to £1.82 billion. At constant exchange rates, the order book increased 6%.

Underlying revenue decreased 16% (down 9% at constant foreign exchange), reflecting a 17% decline in OE and a 15% decline in services. OE reduction was driven by a combination of pricing and the expected decline in Offshore, driven by 2013's weak order intake. Service revenue declined in Offshore and Merchant, as ship owners deferred overhaul and maintenance.

Underlying profit fell 41%. Excluding foreign exchange translation and a one-off charge of £30 million to cover the resolution of a quality issue, profit declined 25% as a result of lower revenue and an adverse mix, reflecting pricing pressure and lower services revenue. The business also incurred restructuring costs as it continued to streamline its global footprint, reduce indirect headcount, and consolidate manufacturing activity. Profit benefited from lower C&A and bonus costs.

In 2015, we expect revenue between £1.45 and £1.65 billion and profit between £90 and £120 million. We anticipate that the market will remain challenging in the short term, reflecting external factors, particularly in Offshore. We will accelerate our cost reduction focus on our footprint, our supply chain, and our overhead costs in order to drive a more competitive business while also adapting to volume risks. Our guidance is based on 2014 average exchange rates.

**OUR YEAR**

2014 saw continuing challenges in the global maritime market, and there is a mixed picture across the market segments in which we operate. In the offshore support sector, demand was encouraging for sophisticated anchor handling vessels, including our own UT ship designs, which incorporate a wide range of Rolls-Royce technology. However, the rapid decline in the price of oil in the second half of the year dented confidence in the oil & gas industry, slowed demand and order intake as we approached year end, a trend we expect to continue into 2015.

In merchant shipping, many owners continued to delay investment in new ships and equipment, or are extending maintenance intervals.

Improving competitiveness remains a key priority for the Marine business and we took important steps in the year, including the announcements of facility restructuring or closures in South Korea, US, UK, Norway and Sweden to consolidate our manufacturing activities at fewer locations. We made strong progress in improving the external supply chain management and reducing our indirect headcount.

We are narrowing our product portfolio by focusing on the products that provide the most return to the business and add most value to our customers. We have exited non-core product lines such as well intervention equipment used for extracting oil from mature wells.

We continue to focus on efficiency and cost reduction, addressing areas including our supply chain, operational footprint and indirect headcount. We have reduced the number of suppliers to Marine by almost 40% in the last four years (half of that in 2014) and reduced indirect headcount by more than 500 people over the past two years.

**“A ship fit for a queen”**

was how First Sea Lord, Sir George Zambellas, described the new aircraft carrier for the Royal Navy at its naming ceremony held at Rosyth, UK, in July 2014.

HMS Queen Elizabeth has two Rolls-Royce MT30 gas turbines as main power units and they drive Rolls-Royce propellers that each weigh 33 tonnes and measure seven metres in diameter.



# BUSINESS REVIEW – LAND & SEA

CONTINUED

We are streamlining our global footprint and have consolidated manufacturing of some key products either into fewer locations or into the external supply chain.

Our programmes to improve competitiveness will continue throughout 2015 and beyond, as we aim to manage the impact of a slowdown in the oil & gas sector. Further changes to the structure of the business are planned.

In the commercial market, our UT-Design celebrated its 40th successful year – it is the benchmark ship design for the offshore oil & gas industry, with almost 800 now in service or on order. We continue to lead ship innovation in this sector and this year we contracted to supply the largest ever vessel, the UT 777 for Island Offshore. This vessel is being built in Japan to a high specification and will be deployed on drilling operations in the Arctic.

## AT SEA

For 55 years we have been designing and manufacturing the reactors that power the Royal Navy's fleet of nuclear submarines. In 2014, we submitted designs to our customer for the next generation of propulsion plant.

## ON LAND

Our Nuclear business currently provides components, systems and services to over half the world's 435 operating civil nuclear reactors.



Naval continued to perform well. We are contracted to a number of key international programmes which to date have been largely unaffected by defence budget cuts. These include the UK Type 26 frigates and the US Navy's Littoral Combat Ship and ship-to-shore-connector hovercraft programmes. We also delivered the first MT30 to the Republic of Korea Navy for the first of its eight new frigates. Other highlights were the naming of the US Navy's sophisticated multi-mission destroyer USS Zumwalt and launch of the Royal Navy's aircraft carrier HMS Queen Elizabeth, both of which are powered by our MT30 gas turbine.

Our services business continues to adapt to support our customers' needs and this year we expanded our global workshop network with a new facility in Bergen, Norway.

## LOOKING AHEAD

Ship efficiency, and ship intelligence, where the smart use of data in more complex ships will improve efficiency, will be key market drivers in the future, as will the demand for more environmentally-friendly power and propulsion systems to drive down the costs of operating ships.

We are strongly positioned to provide efficient solutions and have the necessary integration capability as ships become more complex in the future.

Our unified bridge, which entered service recently, is one example of the type of intelligent control system that we believe will become commonplace on new vessels over the next five years.

In the near term, we expect the market to remain challenging especially in the Offshore sector where we may see project deferrals and temporary lay-ups of vessels as they come off-charter.

We have begun to transform our business to improve our competitiveness in all areas and this programme will continue, again focusing on consolidation of manufacturing, our external supply chain and reducing our overhead costs. We will adapt to the market conditions in our biggest market sector,

Offshore, which accounts for around two-thirds of our business, responding to the uncertainties caused by the significant decrease in oil prices over recent months.

## NUCLEAR

### BUSINESS PERFORMANCE REVIEW

#### WHO WE ARE

Rolls-Royce manages all aspects of nuclear plant design, safety, manufacture, performance and through-life support for the UK Submarine Programme.

In the civil nuclear market, we provide nuclear reactor vendors and utility operators with integrated, long-term support services and solutions spanning the whole reactor life cycle, from concept design through to obsolescence management and plant-life extension.

We have been a key player in the nuclear industry for over 50 years, with expertise in component manufacturing, licensing, project and supply chain management, as well as world-class engineering.

#### FINANCIAL REVIEW

The order book for the continuing business declined 4%, reflecting lower order intake following the receipt of a multi-year submarines contract in 2013.

Underlying revenue increased 3%, driven by good growth in the Civil Nuclear services business, which has been the focus of recent acquisitions. Our services capabilities include remote inspection, plant-life extension and obsolescence management and these performed well in 2014.

Underlying profit increased £38 million, including £20 million from better operating performance, lower C&A and bonus costs and a non-repeat of 2013 one-time charges.

In 2015, we expect revenue between £670 and £730 million and profit between £40 and £50 million. This is based on 2014 average exchange rates.

**NUCLEAR – KEY FINANCIAL DATA**

	2013	2014	Change
Order book £m	2,617	<b>2,499</b>	<b>-4%</b>
Underlying revenue £m	667	<b>684</b>	<b>3%</b>
Underlying OE revenue £m	236	<b>254</b>	<b>8%</b>
Underlying services revenue £m	431	<b>430</b>	<b>0%</b>
Underlying profit before financing £m	10	<b>48</b>	<b>380%</b>

**OUR YEAR**

In 2014, we made progress on our long-term projects for the UK Submarine Programme. We submitted the design of the new propulsion plant for the Vanguard class replacement submarine for customer approval. Construction of the Core Manufacturing Facility in Derby, UK, has progressed well and we successfully introduced several innovations to the programme which brought cost savings for our customer (as part of the foundation contract designed to deliver savings of £200 million over ten years). Our support to the Royal Navy submarine flotilla is mission critical and contributes to maintaining the UK's continuous at sea deterrent.

During 2014, we performed well against our strategic intent of growing a global civil nuclear business as a technology-independent partner to the industry.

Civil nuclear power is increasingly important to the energy policy of a growing number of countries and regions such as China, India, Middle Eastern countries and Central and Eastern Europe. Increased focus on low-carbon electricity generation and security of energy supply, continued to drive demand for the upgrade, plant-life extension and replacement of nuclear capacity. More countries are considering adopting nuclear power for the first time, with governments seeking to develop a nuclear industrial and supply chain strategy designed to benefit local economies and capability (Turkey and Poland being examples).

For the UK civil nuclear new build programme, we continued to carry out early works to support developers and operators and we continue to recruit and develop capability in line with market growth projections for future years. The UK has one of the largest new build programmes in the western world with 11 reactors expected to

be built by 2030. European Union Commission approval in 2014 of the investment contract for the first new reactor to be built at Hinkley Point C in Somerset was a significant milestone.

During the year we were awarded a contract by Fortum, the owner and operator of the Loviisa nuclear power plant in Finland, to modernise the safety and non-safety instrumentation and control (I&C) systems. We also received US Nuclear Regulatory Commission licensing of Spinline, our safety-critical I&C technology, and this will help us access new markets.

We won a contract to supply and commission pressure transmitter technology for the Flamanville 3 reactor in France and continued to deliver against our customer commitments on the world's largest I&C upgrade of the 20-strong French fleet of reactors. We continued to be

successful in China, as an important supplier to the world's largest nuclear programme.

We introduced equipment obsolescence services and engineering support to new customers in the UK, France, Belgium, and South Africa. We also provided reactor inspection services to EDF Energy's UK operations.

**LOOKING AHEAD**

Our priorities will be focus on customers, winning new orders and high-quality delivery. A key feature will be continuously improving operational efficiency and performance as we expand our products and services, and the markets in which we operate. We will build on our manufacturing capability, engineering excellence and supply chain relationships to ensure that we contribute positively to new build programmes in the UK and other international markets.

We will focus on further extending the suite of products and services that we offer to operational reactor utilities to enable them to achieve safe, efficient and reliable lifetime operations while enabling us to further grow our nuclear services presence.

**ENERGY BUSINESS****PERFORMANCE REVIEW**

On 1 December, we concluded the sale of our Energy gas turbines and compressor business to Siemens for a £785 million cash

consideration, and a further £200 million for a 25-year licensing agreement.

**ENERGY – KEY FINANCIAL DATA**

	2013	2014
Order book £m	1,226	–
Underlying revenue £m	871	<b>724</b>
Underlying OE revenue £m	329	<b>302</b>
Underlying service revenue £m	542	<b>422</b>
Underlying profit before financing £m	64	<b>(3)</b>

# OUR PEOPLE

The engagement of our people is essential to the success of our strategy.

In 2014 we launched the **Trusted to Deliver Excellence Awards**. Over 500 submissions were received, each of which demonstrates the talent, innovation, commitment and ambition of Rolls-Royce men and women.

The achievements of all the entries that resulted in the final award winners showcased here, prove what's possible when we put ourselves in customers' shoes.

image: our advanced new unified bridge design for an offshore support vessel.

## CELEBRATING SUCCESS: AWARD WINNERS' STORIES

### SIMPLE TOUCH SCREEN TO HELP MARINE CUSTOMERS

MARINE  
ÅLESUND, NORWAY

On the bridge of a marine customer's ship, the team from Ålesund saw the array of different panels, uncoordinated operating systems and audible alerts that face our customers every day. They saw first-hand what could be a source of frustration, fatigue and a trigger for human error. The team redesigned an overlay to the operating system. This coordinated, both functionally and visually, the range of essential controls via a simplified touch screen to provide a unified bridge design.

### 100% RIGHT-FIRST-TIME DISC PRODUCTION

SUPPLY CHAIN  
WASHINGTON, UK

The £100 million investment in the High-Performance Disc Manufacturing facility in Washington set the record for the fastest new Rolls-Royce facility build in the Group's history. A combination of state-of-the-art equipment, training and up-skilling programmes has established a culture of continuous improvement. This has resulted in 100% right-first-time production and it means that the discs, which are integral to gas turbine engines, can be delivered in half the time.

The delighted right-first-time team from Washington, UK.



## CHALLENGING CONVENTIONAL THINKING

ENGINEERING AND TECHNOLOGY  
UK AND GERMANY

The engineering and technology team discovered that by challenging traditional thinking about how air flows through a compressor, they could measurably improve fuel efficiency. They started with numerical flow simulations and then worked with teams across the globe to decrease air leakage and improve performance. For our customers, the result means less energy lost and improved long-term fuel efficiency for their engines. The technology has already been deployed in the Trent XWB engine and will be followed by testing on Boeing 787 and A350-1000 aircraft.

## STANDING IN OUR CUSTOMERS' SHOES

CIVIL SMALL & MEDIUM ENGINES  
MONTREAL, CANADA

Every quarter, the Montreal team rolls out a red carpet on the factory floor. Employees from across the business stand up in front of their colleagues, role-playing the customers' view of what we deliver to them. Employees audition to tell the stories behind the order forms and engine part serial numbers. Others volunteer to follow customers' orders through the manufacturing process – from order to shipment. This innovative approach is spurring new highs in employee engagement, creating a deeper understanding of what our customers need and has increased customer satisfaction by almost 10%.

The winners from Montreal get the red carpet treatment themselves as they pick up their award.



## IMPROVED TURBINE BLADE QUALITY AT LESS COST

SUPPLY CHAIN  
ROTHERHAM, UK

A new standard has been achieved in the high-performance turbine blade industry at the Advanced Blade Casting Facility in Rotherham. Lead times and scrap rates are on-track to be halved. The team integrated, sharpened and automated critical stages in the manufacturing process and, in so doing, improved the production precision of our complex single crystal turbine blades. For our customers, it means a perfect blade delivered more efficiently, more quickly and at a dramatically reduced production cost.

## MONITORING THRUSTERS AT SEA TO PLAN MAINTENANCE

ENGINEERING AND TECHNOLOGY  
UK AND FINLAND

Azimuth thrusters give marine and offshore vessels superior manoeuvrability. Our ability to assess the health of these thrusters at sea saves our customers time and money by preventing unscheduled and unnecessary maintenance. Until now, technology hasn't been able to monitor thrusters in small and medium-sized ships – which represent 80% of the marine market.

Working in collaboration, our Strategic Research Centre, Marine Services Azimuth Thruster team and the University of Sheffield's Technology Centre came up with the Thruster Wireless Link. The new technology enables us to read the vital signs of all our operating thrusters on all sizes of vessels and platforms. It also opens a new, lucrative market for our services. For customers, it means the ability to plan maintenance three to six months ahead of time and avoid costly propulsion failures at sea.




## SAVING CUSTOMERS MONTHS OF TIME IN COMMISSIONING

NUCLEAR  
DERBY, UK

The UK team that supports the build of the Astute class of nuclear submarines has cut the time and cost of delivery dramatically. The complex pipework and valve systems require a flushing process that used to take a total of 190 days to complete. Following on-site visits, our team saw the opportunity to collaborate with our partners to redesign the process. The initial time required for most flush paths was reduced from 60 hours to just one. This will save the customer four months of commissioning time per submarine. It means delivery of the same high-quality submarines quicker and at a lower cost to the UK Government, one of our most important customers.



 We need to work with people who make the whole production process smarter and more cost effective. People like these award winners.”

Nicole Piasecki, VP and General Manager, Propulsion Systems Division of Boeing Commercial Airplanes, presented the awards to the winners.

# SUSTAINABILITY

Our strategy focuses on customer, innovation and profitable growth to ensure a sustainable business.

## OUR APPROACH

Sustainability is inherent to our strategy. For Rolls-Royce that means driving profitable growth whilst achieving a positive economic, social and environmental impact.

### BETTER POWER

#### HELPING OUR CUSTOMERS DO MORE, USING LESS

We use our engineering expertise to develop and deliver integrated power systems for our customers, helping them to do more using less. Our commitment is to continuously improve the environmental performance of our products and services.

#### IMPROVING ENVIRONMENTAL PERFORMANCE

Our environmental strategy reflects the main focus of our investment and effort, concentrating on three areas: supporting our customers by further reducing the environmental impact of our products and services; developing new technology for future low-emission products; and maintaining our drive to reduce the environmental impact of our business activities.

#### PRODUCT SAFETY

Our products are often deployed in mission critical environments. We are committed to delivering products and services that achieve the highest standards of product safety. We have a consistent approach to safety across the Group and systematically pursue proactive opportunities for improvement. More details can be found in the Safety and Ethics Committee report on page 66.

### BETTER FUTURE

#### COMMITTED TO INNOVATION, POWERING BETTER, CLEANER ECONOMIC GROWTH

This year, we invested over £1.2 billion in gross R&D. As a result of engineering expertise and our strong tradition of innovation, many of our products are currently market-leaders in terms of environmental performance. Innovation is embedded in all our products and services and is key to our competitive edge.

#### OUR PEOPLE

The Group employed a total of 54,100\* people in 2014. We know that our future depends on the skills, knowledge and passion of all of our people and work to create an environment where all employees can reach their full potential.

We encourage diversity, engagement and development. We give full and fair consideration to all employment applications from people with disabilities, and support disabled employees helping them to make the best use of their skills and potential.

A diverse workforce will help ensure our continued success as a global business and contribute towards a better future. More information on our approach to diversity and gender distribution can be found in the Nominations and Governance Committee report, on page 65.

Average number of employees by region*	2013	2014
UK	24,800	<b>24,500</b>
USA	8,500	<b>7,900</b>
Canada	1,600	<b>1,500</b>
Germany	10,500	<b>10,500</b>
Nordics	4,100	<b>4,000</b>
Rest of world	5,700	<b>5,700</b>
Average number of employees by business unit*		
Civil aerospace	23,400	<b>23,900</b>
Defence aerospace	7,900	<b>7,000</b>
Marine	6,900	<b>6,400</b>
Power Systems	10,700	<b>10,700</b>
Nuclear	3,900	<b>3,900</b>
Energy	2,400	<b>2,200</b>
<b>Total*</b>	<b>55,200</b>	<b>54,100</b>

\*Headcount data is calculated in terms of average full time employees (FTEs) for 2014. Therefore, this includes FTEs associated with our Energy gas turbines and compressor business disposed of in December 2014. The transfer of this business unit has had minimal impact on the average headcount numbers for the year. Marine and Nuclear data for 2013 has been restated to reflect the transfer of our Submarines business from Marine to Nuclear.

#### EMPLOYEE INVOLVEMENT

We use a variety of channels to communicate with our employees, including face-to-face and online communications. We encourage collaboration, employee suggestions and feedback through these systems. In addition we have mechanisms in place for employees to be able to raise concerns both formally and anonymously, including through the Rolls-Royce Ethics Line.

We have established frameworks for managing employee, trade union and representative participation, including formal information and consultations. Our incentive schemes and all-employee share plans enable every employee to have the opportunity to share in our success.

#### EARLY CAREER DEVELOPMENT PROGRAMMES

We continue to attract large numbers of high quality graduates and apprentices, and have well-established early career programmes in 11 countries worldwide.

In 2014, we introduced non-engineering graduate and apprenticeship programmes in Germany. We continue to focus on expanding

our offerings beyond the UK, particularly in India and Germany.

We have won a number of awards this year, including TargetJobs Winner of 'The most popular graduate recruiter – engineering, design and manufacture' in the UK, for the fifth year running.

#### HUMAN RIGHTS

Our human rights approach is aligned with our Global Code of Conduct. It draws together relevant internal controls that oversee the range of issues encompassed by human rights. Our policy sets out our commitment to respect the human rights of our employees through core labour standards. This covers employee involvement, diversity and equality, pay and benefits, working hours, forced labour and child labour.

We comply with the local laws of the countries where we operate. In the event that our Human Rights policy imposes higher requirements than local law, we adhere to that higher requirement. We set equivalent standards for our supply chain through our Global Supplier Code of Conduct. This is part of our broader aim to align the standards of our suppliers to those of the Group.

#### EMPLOYEE WELLBEING

We work to enhance the personal wellbeing of our people to help them reach their full potential. We are committed to empowering and enabling employees to lead a healthy lifestyle at work.

We launched new wellbeing initiatives across our global locations this year. These include physiotherapy and employee assistance programmes in the UK, employee sports days in China and Germany, and a Wellbeing Month across our US facilities. Over 4,000 employees worldwide participated in the Global Corporate Challenge, amassing a combined total of over five billion steps.

#### COMMUNITIES

Our community investment and education outreach programmes support our Group strategy. We recognise that talented engineers are the key to our future and work actively to increase interest and encourage

diversity amongst those taking science, technology, engineering and mathematics (STEM) subjects.

#### GLOBAL PARTNERSHIPS

We engage in dialogue and partnerships with governments and industry bodies aligned to our business needs. This year we have worked with the UK Government on the implementation of the Aerospace Growth Partnership. In the EU, we have focused on preventing unintended consequences of the inclusion of aviation in the European Union Emissions Trading Scheme. In North America, we continue to engage with a range of political stakeholders on issues including defence appropriations, aviation policy, Federal Aviation Administration approval of our products, and trade proposals.

Our joint venture in India has now reached full production and exports to our other locations around the world. Through our subcontractors TCS and Quest we have over 1,000 engineers serving the Group's needs globally. In China we are present in more than 30 locations including joint ventures. Our manufacturing and services centres in Singapore are the heart of a multi-business and multi-function regional hub, where our first major Customer Service Centre opened in early 2015.

## BETTER BUSINESS

### INVESTING IN TECHNOLOGY, PEOPLE AND IDEAS TO IMPROVE ALL ASPECTS OF OUR PERFORMANCE AND TO DRIVE PROFITABLE GROWTH

#### ETHICS

High ethical standards, supported by good governance, are fundamental to how we run our business. We have a strong focus on ethics that helps ensure we win right every time. This year our Global Code of Conduct has been ranked by the Red Flag Group as third among those within the FTSE 100 companies that were assessed.

Rolls-Royce does not make any corporate contributions or donations to political parties or causes, as outlined in our Global Code of Conduct.

More information on our approach to ethics can be found in the Safety and Ethics Committee report on page 68.

#### HEALTH, SAFETY AND ENVIRONMENT

We regard the health and safety of our employees at work as paramount. It is therefore with particular regret that we report the death of four employees in a single drowning incident which occurred in 2014. This tragic incident took place outside work whilst deployed at a customer location. This incident is not reported in our annual data because it occurred outside working hours. We have sought to learn from this incident in terms of managing remote field-service activities.

We continue to monitor safety performance in the workplace and are continuing with the process of integrating our Power Systems business into our HS&E management system. At present, Power Systems does not collect its HS&E data in a manner consistent with the Group and therefore this data has been excluded from our 2013 and 2014 HS&E figures.

In 2014, our total reportable injury (TRI) rate fell by 16% to 0.37 TRIs per 100 employees, compared to 0.44 in 2013\*. In the UK we were fined £200,000 and £176,000 in costs for a source radiography event that occurred in 2011. We improve the performance of our operations by reducing energy, greenhouse gas emissions and waste. We support our external suppliers to do the same.

\* The TRI rate excludes Power Systems, and has been adjusted to reflect the disposal of our Energy gas turbines and compressor business in December 2014. Entities that were part of the Energy business that were not part of the disposal have been included. See note at the bottom of page 46.

#### ACCELERATING PROGRESS




Our goal is to be recognised as a leading sustainable business. To achieve this we have established a dashboard of higher stretching targets, showing progress towards improved sustainability performance.

These targets are baselined on our 2014 performance data, with the exception of the ACARE Flightpath 2050 goals.

Our 2014 sustainability performance and targets are detailed overleaf.

# 2014 PERFORMANCE

Sustainability is inherent to our strategy. To be recognised as a leading sustainable business we will deliver better power for our customers, use innovation to secure a better future, and develop a better business, ready to meet the opportunities ahead.

CUSTOMER 	INNOVATION 	PROFITABLE GROWTH 
<p><b>BETTER POWER</b></p> <p><b>In the air</b> Our new Trent 7000 engine will deliver a 10% improvement in specific fuel consumption and halve the noise energy output compared to the current engine on the A330. Announced this year, our Advance and UltraFan next generation designs will offer at least 20-25% better fuel burn and CO<sub>2</sub> emissions than first generation Trent engines.</p> <p><b>On land</b> Our MTU technology installed on Deutsche Bahn's diesel Coradia Lint 54 and 81-type trains reduces particulate emissions by 90% and contributes to reducing fuel consumption and CO<sub>2</sub> emissions. Our nuclear technology is installed in over 200 reactors across 20 countries worldwide, making a significant contribution to low-carbon electricity generation.</p> <p><b>At sea</b> Our innovative ship design and propulsion systems and pioneering use of new cleaner fuel solutions are reducing emissions for our customers. Our Environship design reduces CO<sub>2</sub> by up to 40% compared to conventional diesel powered vessels and received the Heyerdahl Award this year.</p> <p><b>7,900</b> customers supported with our product learning solutions</p> <p>Hosted almost <b>14,000</b> visitors at our Customer Training Centres</p>	<p><b>BETTER FUTURE</b></p> <p>Over <b>1,000</b> employee STEM ambassadors globally</p> <p>Supporting a global network of 31 University Technology Centres, engaging over <b>700 academics</b> in fundamental research into cutting edge technologies</p> <p>Recruited <b>354 graduates</b> and <b>357 apprentices</b></p> <p><b>£10.6 million</b> invested in supporting communities, a <b>31%</b> increase since 2013</p> <p><b>40,000</b> employees directly accessed our learning system, completing 250,000 individual courses</p> <p>In 2014 we invested <b>£1.2 billion</b> in gross R&amp;D and filed for <b>600 patents</b></p>	<p><b>BETTER BUSINESS</b></p> <p>A <b>Global Code of Conduct</b> issued to all employees in <b>21</b> different languages</p> <p>Reduced year-on-year energy consumption normalised by revenue by <b>16%</b> since 2010</p> <p>Invested <b>£4 million</b> in energy efficiency improvement projects</p> <p><b>565 ktCO<sub>2</sub>e</b> absolute total GHG emissions from our operations*</p> <p>Total reportable injury (TRI) rate of <b>0.37</b> per 100 employees</p> <p>Occupational illness occurrence rate of <b>0.05</b> per 100 employees</p> <p>Our health and safety performance continues to improve with a <b>45% reduction</b> in TRI rate since 2010</p> <p>Supported suppliers to complete <b>2,500</b> individual courses</p>

Rolls-Royce has been listed in the Dow Jones Sustainability Index for the 13th consecutive year. We achieved an overall score of 66, well above the average of 49 in the Aerospace and Defense sector.

MEMBER OF **Dow Jones Sustainability Indices**  
In Collaboration with RobecoSAM

**CDP**  
DRIVING SUSTAINABLE ECONOMIES

We have improved our CDP score to 89. This and our maintained performance band rating 'B' demonstrates our commitment to continually improving our environmental performance.

\* Regulatory GHG emissions data detailed on page 164.  
 Limited assurance engagement undertaken by KMPG LLP, using the assurance standards ISAE 3000 and ISAE 3410, over the GHG and TRI data as highlighted. More information detailed on page 164.  
 We are in the process of integrating our Power Systems business into our HS&E management system. Energy, GHG, TRI and occupational illness data from Power Systems is excluded for 2014. The figures presented have been adjusted to reflect the disposal of our Energy gas turbine and compressor business in December 2014. Entities that were part of the Energy business that were not part of the disposal have been included.



# TARGETS

Our goal is to be recognised as a leading sustainable business. We have established a dashboard of higher stretching targets to accelerate progress.

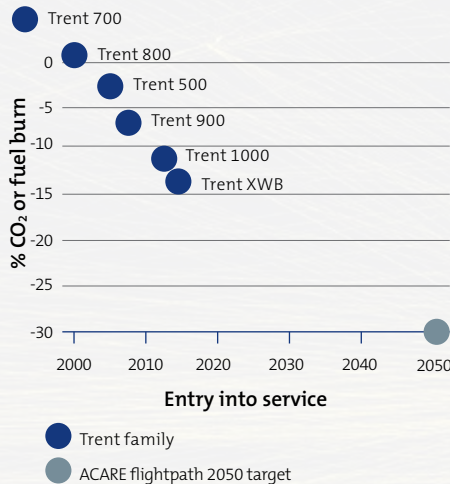
## CUSTOMER



### BETTER POWER

#### ACARE Flightpath 2050 goals

The Advisory Council for Aviation Research and Innovation in Europe (ACARE) has set challenging goals for aviation to meet by 2050. These include reducing aircraft CO<sub>2</sub> emissions by 75% (per passenger kilometre); reducing noise by 65%; and reducing oxides of nitrogen (NO<sub>x</sub>) by 90%, all relative to a typical new aircraft produced in 2000.



This chart shows the improved efficiency levels of each generation of Trent engine since the Trent 700 was introduced in 1995, and our latest large civil engine, the Trent XWB.

The Trent XWB is the most efficient turbofan aero engine flying today.

## INNOVATION



### BETTER FUTURE

Reach

**6 million people** through the Rolls-Royce STEM education programmes and activities **by 2020**



All sites to achieve Rolls-Royce employee **health and wellbeing LiveWell accreditation by 2020**



Ensure our **Sustainable Employee Engagement Index** is greater, or equal to, the Global High Performance Norm\* **by 2020**



## PROFITABLE GROWTH



### BETTER BUSINESS

All employees to complete **Global Code of Conduct certification** and mandatory ethics training **by 2020**

Reduce energy use **by 30%** normalised by revenue by 2020



Reduce greenhouse gas emissions by **50% absolute by 2025**



Reduce total solid and liquid waste by **25% normalised by revenue by 2020**



Reduce **total reportable injury (TRI) rate to 0.3 per 100 employees by 2020**, to achieve first quartile performance

**Zero waste to landfill\*\* by 2020**

**All suppliers aligned to our own ambitions**

All suppliers agree adherence to the revised Global Supplier Code of Conduct **by 2016**

Strategic suppliers supported in annual Carbon Disclosure Project submissions **by 2016**

Strategic supplier adherence to the revised Code will be monitored **by 2016**

Strategic suppliers supported to reduce their energy and waste **by 2016**




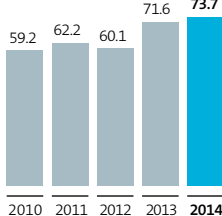
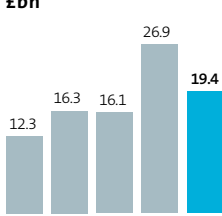
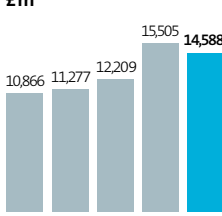
Discover more online [www.rolls-royce.com/sustainability](http://www.rolls-royce.com/sustainability)

\* Provided by Towers Watson  
\*\* Excluding hazardous waste, incineration with energy recovery only.

# KEY PERFORMANCE INDICATORS

We continue to build strong foundations for future growth in challenging economic conditions.

Financial performance indicators are shown below. The key objectives of the Board and its committees are described on pages 59 to 75, non-financial performance indicators are shown in the Sustainability section on pages 44 to 47.

CUSTOMER 															
<p><b>ORDER BOOK</b></p> <p><b>+3%</b> +5% excluding Energy</p>	<p><b>WHY WE MEASURE IT</b></p> <p>The order book provides an indicator of future business. We measure it at constant exchange rates and list prices and include both firm and announced orders. In Civil aerospace, it is common for a customer to take options for future orders in addition to firm orders placed. Such options are excluded from the order book. In Defence aerospace, long-term programmes are often ordered for only one year at a time. In such circumstances, even though there may be no alternative engine choice available to the customer, only the contracted business is included in the order book. Conservatively, we only include the first seven years' revenue of long-term aftermarket contracts.</p>	<p><b>HOW WE HAVE PERFORMED</b></p> <p>The order book grew in all businesses except Marine and Nuclear.</p> <p>The disposal of the Energy business in 2014 reduced the order book by £0.9bn.</p>	<p><b>£bn</b></p>  <table border="1"> <tr><th>Year</th><td>2010</td><td>2011</td><td>2012</td><td>2013</td><td>2014</td></tr> <tr><th>Value (£bn)</th><td>59.2</td><td>62.2</td><td>60.1</td><td>71.6</td><td>73.7</td></tr> </table>	Year	2010	2011	2012	2013	2014	Value (£bn)	59.2	62.2	60.1	71.6	73.7
Year	2010	2011	2012	2013	2014										
Value (£bn)	59.2	62.2	60.1	71.6	73.7										
<p><b>ORDER INTAKE</b></p> <p><b>-28%</b></p>	<p>Order intake is a measure of new business secured during the year and represents new firm orders, net of the movement in the announced order book between the start and end of the period. Any orders which were recorded in previous periods and which are subsequently cancelled, reducing the order book, are included as a reduction to intake. We measure order intake at constant exchange rates and list prices and, consistent with the order book policy of recording the first seven years' revenue of long-term aftermarket contracts, include the addition of the following year of revenue on long-term aftermarket contracts.</p>	<p>The reduction mainly reflects lower order intake in Civil aerospace from a high in 2013 and includes the cancellation of Emirates' A350 XWB order.</p> <p>Defence aerospace order intake increased by 55%.</p>	<p><b>£bn</b></p>  <table border="1"> <tr><th>Year</th><td>2010</td><td>2011</td><td>2012</td><td>2013</td><td>2014</td></tr> <tr><th>Value (£bn)</th><td>12.3</td><td>16.3</td><td>16.1</td><td>26.9</td><td>19.4</td></tr> </table>	Year	2010	2011	2012	2013	2014	Value (£bn)	12.3	16.3	16.1	26.9	19.4
Year	2010	2011	2012	2013	2014										
Value (£bn)	12.3	16.3	16.1	26.9	19.4										
<p><b>UNDERLYING REVENUE</b></p> <p><b>-6%</b> -3% excluding FX</p>	<p>Monitoring of revenues provides a measure of business growth. Underlying revenue is used as it reflects the impact of our FX hedging policy by valuing foreign currency revenue at the actual exchange rates achieved as a result of settling FX contracts. This provides a clearer measure of the year-on-year trend.</p>	<p>The reduction reflects an 8% fall in OE revenue and a 3% decline in services revenue.</p>	<p><b>£m</b></p>  <table border="1"> <tr><th>Year</th><td>2010</td><td>2011</td><td>2012</td><td>2013</td><td>2014</td></tr> <tr><th>Value (£m)</th><td>10,866</td><td>11,277</td><td>12,209</td><td>15,505</td><td>14,588</td></tr> </table>	Year	2010	2011	2012	2013	2014	Value (£m)	10,866	11,277	12,209	15,505	14,588
Year	2010	2011	2012	2013	2014										
Value (£m)	10,866	11,277	12,209	15,505	14,588										

## INNOVATION



<p><b>NET R&amp;D EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE</b></p> <p><b>5.8%</b></p>	<p><b>WHY WE MEASURE IT</b></p> <p>This measure reflects the need to generate current returns as well as to invest for the future. We measure R&amp;D as the self-funded expenditure before both amounts capitalised in the year and amortisation of previously-capitalised balances. We expect to spend approximately 5% of underlying revenues on R&amp;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.</p>	<p><b>HOW WE HAVE PERFORMED</b></p> <p>The increase reflects increased investment due to the phasing of major new programmes.</p>	<p><b>%</b></p> <table border="1"> <thead> <tr> <th>Year</th> <th>2010</th> <th>2011</th> <th>2012</th> <th>2013</th> <th>2014</th> </tr> </thead> <tbody> <tr> <td>Value (%)</td> <td>4.7</td> <td>4.6</td> <td>4.7</td> <td>4.8</td> <td>5.8</td> </tr> </tbody> </table>	Year	2010	2011	2012	2013	2014	Value (%)	4.7	4.6	4.7	4.8	5.8
Year	2010	2011	2012	2013	2014										
Value (%)	4.7	4.6	4.7	4.8	5.8										
<p><b>CAPITAL EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE</b></p> <p><b>4.6%</b></p>	<p>To deliver on its commitments to customers, the Group invests significant amounts in its infrastructure. 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 cost of property, plant and equipment acquired during the period and, over the medium term, expect a proportion of around 4%.</p>	<p>The level of expenditure reflects the ongoing investment in facilities and tooling as the Group prepares for increased production volumes.</p>	<p><b>%</b></p> <table border="1"> <thead> <tr> <th>Year</th> <th>2010</th> <th>2011</th> <th>2012</th> <th>2013</th> <th>2014</th> </tr> </thead> <tbody> <tr> <td>Value (%)</td> <td>3.3</td> <td>4.1</td> <td>4.0</td> <td>4.4</td> <td>4.6</td> </tr> </tbody> </table>	Year	2010	2011	2012	2013	2014	Value (%)	3.3	4.1	4.0	4.4	4.6
Year	2010	2011	2012	2013	2014										
Value (%)	3.3	4.1	4.0	4.4	4.6										

## PROFITABLE GROWTH



<p><b>UNDERLYING PROFIT BEFORE FINANCING</b></p> <p><b>-8%</b></p> <p>-5% excluding FX</p>	<p><b>WHY WE MEASURE IT</b></p> <p>We measure underlying profit before financing on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements. In particular: (a) revenues and costs denominated in US dollars and euros are presented on the basis of the exchange rates achieved during the year; (b) similar adjustments are made in respect of commodity derivatives; and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis.</p>	<p><b>HOW WE HAVE PERFORMED</b></p> <p>The reduction reflects FX changes, restructuring costs, a one-off product rectification charge and higher R&amp;D, partially offset by benefits on TotalCare contracts and lower bonus costs.</p>	<p><b>£m</b></p> <table border="1"> <thead> <tr> <th>Year</th> <th>2010</th> <th>2011</th> <th>2012</th> <th>2013</th> <th>2014</th> </tr> </thead> <tbody> <tr> <td>Value (£m)</td> <td>1,010</td> <td>1,206</td> <td>1,495</td> <td>1,831</td> <td>1,678</td> </tr> </tbody> </table>	Year	2010	2011	2012	2013	2014	Value (£m)	1,010	1,206	1,495	1,831	1,678
Year	2010	2011	2012	2013	2014										
Value (£m)	1,010	1,206	1,495	1,831	1,678										
<p><b>AVERAGE CASH/DEBT</b></p> <p><b>-£38m</b></p>	<p>We measure average cash based on the weekly balance of net funds/debt. These balances are reported at prevailing exchange rates and in recent periods, year-on-year movements in average cash balances reflect the significant acquisitions and disposals which have taken place, most notably RRPS in 2011, IAE restructuring in 2012, the purchase of the remaining 50% of RRPS and the disposal of our Energy gas turbines and compressor business in 2014. The impact on average cash balances will depend on when these transactions took place during the year.</p>	<p>The reduction reflects the impact of the purchase of the remaining 50% of Power Systems in August.</p> <p>The sale of the Energy business in December had a minimal impact.</p>	<p><b>£m</b></p> <table border="1"> <thead> <tr> <th>Year</th> <th>2010</th> <th>2011</th> <th>2012</th> <th>2013</th> <th>2014</th> </tr> </thead> <tbody> <tr> <td>Value (£m)</td> <td>960</td> <td>320</td> <td>(145)</td> <td>350</td> <td>(38)</td> </tr> </tbody> </table>	Year	2010	2011	2012	2013	2014	Value (£m)	960	320	(145)	350	(38)
Year	2010	2011	2012	2013	2014										
Value (£m)	960	320	(145)	350	(38)										
<p><b>FREE CASH FLOW</b></p> <p><b>£254m</b></p>	<p>In a business requiring significant investment, we monitor cash flow to ensure that profitability is converted into cash generation, both for future investment and as a return to shareholders. We measure free cash flow as the movement in net funds/debt during the year, before movements arising from payments to shareholders, acquisitions and disposals and FX.</p>	<p>The reduction mainly reflects lower profits and movements in customer deposits.</p>	<p><b>£m</b></p> <table border="1"> <thead> <tr> <th>Year</th> <th>2010</th> <th>2011</th> <th>2012</th> <th>2013</th> <th>2014</th> </tr> </thead> <tbody> <tr> <td>Value (£m)</td> <td>714</td> <td>581</td> <td>548</td> <td>781</td> <td>254</td> </tr> </tbody> </table>	Year	2010	2011	2012	2013	2014	Value (£m)	714	581	548	781	254
Year	2010	2011	2012	2013	2014										
Value (£m)	714	581	548	781	254										

During 2015, we intend to re-consider the dashboard of financial and non-financial KPIs against which we believe the Group should be measured.

## PRINCIPAL RISKS

# Managing our risks to deliver better power for a changing world

Rolls-Royce benefits from operating a risk management framework within a risk-conscious organisation. Risk management is built into our day-to-day activities and forms an integral part of how we work. From our engineering design, through to engine production, servicing and how we run our operations, risk management is a key enabler for delivering our brand promise: 'trusted to deliver excellence'.

Given the rapid growth of the business over the past few years and the changing risk environment that we work in, we have been reviewing how far the risk management framework continues to meet our needs across the Group. This work is now largely complete and we will be rolling out some improvements across the organisation to help ensure greater consistency across the different parts of our operations. Part of this review has looked at risk governance and how the Board assesses our principal risks and satisfies itself that these are being managed appropriately.

### RISK GOVERNANCE

The review of our risk management framework has been conducted alongside the governance review described on page 56. The Board has decided that, from January 2015, the principal risks will be reviewed by the Board or the most appropriate board committees to make sure that there is sufficient focus and independent oversight on the risks. During the year, the relevant committees will carry out 'deep dives' to review their allocated risks in detail and then report to the Board. This will ensure that we

are in a good position to assess how far controls and actions are effective.

The Executive Leadership Team (ELT) assists the Board in determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. During 2014, as part of the full and half-year results process, the ELT reviewed key risks which had been reported by the Divisions and functions. These were cross-checked with the risks that the ELT had identified from its own assessments, from which it developed a list of principal risks.

When the ELT reviews the principal risks it takes into account changes in external strategic factors such as the competitive environment, technology, cyber security and macro-economic developments as well as potential operational, financial and compliance risks. Changes in our risk profile are highlighted to the Board. The Board can regularly review and challenge whether the Group's principal risks are the right ones to focus on and have an opportunity to discuss with senior management how they are being managed. The Board is very conscious of the need to both keep the list of principal risks under active review and to consider potential risks as an explicit part of its discussions.

### OUR RISK MANAGEMENT ACTIVITIES

The Board is responsible for the Group's system of internal control and for maintaining and reviewing its effectiveness from a financial, operational and compliance perspective. This system of internal control

is designed to identify and manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss. Our risk management process is a key element of the Group's internal control system and will develop in line with our activities, and in response to the risks and uncertainties that arise.

Risk management is implemented using a Group-wide framework and software tool and a network of trained experts.

Divisions and their business units and functions are accountable for identifying and managing risk in line with Group requirements and they formally review risks at least twice yearly. Business continuity plans are put in place by the businesses to mitigate continuity risks.

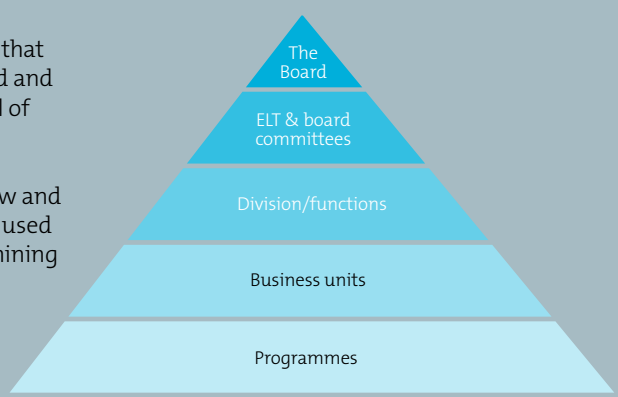
Risk thresholds are set at each level across the Group and any risks identified that meet the agreed threshold are captured in the Group risk software tool and escalated to Group level as part of a well structured reporting and review system.

This framework benefits from overall coordination by the Group's enterprise risk team, led by the director of risk, which is responsible for disseminating risk policy and processes. To help ensure full coverage and efficiency we are currently conducting a risk, control and assurance mapping exercise to give the Board and committees that have oversight responsibility a clearer picture of how the internal control and risk management framework is working in practice.

Joint ventures constitute an increasingly large part of the Group's activities. Responsibility for internal control procedures in joint ventures lies with the managers of those operations. We seek to exert influence over such joint ventures through board representation. Management and internal audit regularly review the activities of these joint ventures and the director of internal audit and the Audit Committee have been taking a close look at audit coverage in this area.

Our risk framework ensures that risks are identified, managed and communicated at every level of the Group.

Key risks are subject to review and challenge by the ELT and are used to assist the Board in determining our principal risks.



The Board is very aware that the effectiveness of risk management is highly dependent on behaviours, as a good process does not automatically lead to a good outcome. Our ethics and compliance improvement programme, aimed at securing compliance with our ethical standards, will help. The launch of the new Global Code of Conduct is reinforcing the



values and behaviours required, which in turn will strengthen our risk culture.

**PRINCIPAL RISKS**

During the year, the ELT and Board focused on the principal risks and the actions being taken to manage them. This involved: discussing changes to the risk register; considering key risk thresholds and agreeing

changes to limits; reviewing the risk indicators for principal risks; and, hearing from management how risks that exceed the revised thresholds will be managed.




The following table describes the principal risks facing the Group notwithstanding that there are other risks that may occur and may impact the achievement of the Group’s objectives.

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
<p><b>PRODUCT FAILURE</b></p> <p>Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.</p> 	<ul style="list-style-type: none"> <li>• Operating a safety first culture</li> <li>• Applying our engineering design and validation process from initial design, through production and into service</li> <li>• The Safety and Ethics Committee reviewing the scope and effectiveness of the Group’s product safety policies to ensure that they operate to the highest industry standards (see Safety and Ethics Committee on page 66)</li> <li>• Operating a safety management system (SMS), governed by the product safety review board, and subject to continual improvement based on experience and industry best practice. Product safety training is an integral part of our SMS</li> <li>• Improving our supply chain quality</li> <li>• Crisis management team chaired by the Director – Engineering and Technology or General Counsel as appropriate</li> </ul> <p><b>This principal risk is subject to review by the Safety and Ethics Committee</b></p>
<p><b>BUSINESS CONTINUITY</b></p> <p>Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, financial insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results.</p> 	<ul style="list-style-type: none"> <li>• Continuing investment in adequate capacity, and modern equipment and facilities (see Aerospace Business review on page 33)</li> <li>• Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and our people skills</li> <li>• Selecting and developing stronger suppliers</li> <li>• Developing dual sources or dual capability</li> <li>• Developing and testing incident management and business continuity plans</li> <li>• Crisis management team chaired by Director – Engineering and Technology or General Counsel as appropriate</li> <li>• Customer excellence centres providing improved response to supply chain disruption</li> </ul> <p><b>This principal risk is subject to review by the Audit Committee</b></p>



# PRINCIPAL RISKS

CONTINUED

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
<p><b>COMPETITOR ACTION</b></p> <p>The presence of large, financially strong competitors in the majority of our markets means that the Group is susceptible to significant price pressure for original equipment or services even where our markets are mature or the competitors are few. Our main competitors have access to significant government funding programmes as well as the ability to invest heavily in technology and industrial capability.</p> 	<ul style="list-style-type: none"> <li>• Accessing and developing key technologies and service offerings which differentiate us competitively (see Innovation and Technology on page 21)</li> <li>• Focusing on being responsive to our customers and improving the quality, delivery and reliability of our products and services</li> <li>• Partnering with others effectively</li> <li>• Driving down cost and improving margins (see Chief Executive's review on page 17 and Chief Financial Officer's review on pages 26 and 27)</li> <li>• Protecting credit lines</li> <li>• Investing in innovation, manufacturing and production, and continuing governance of technology programmes</li> <li>• Understanding our competitors</li> </ul> <p><b>This principal risk is subject to review by the Board</b></p>
<p><b>POLITICAL RISK</b></p> <p>Geopolitical factors that lead to an unfavourable business climate and significant tensions between major trading parties or blocs which could impact the Group's operations. For example: explicit trade protectionism, differing tax or regulatory regimes, potential for conflict, or broader political issues.</p> 	<ul style="list-style-type: none"> <li>• Where possible, locating our domestic facilities and supply chain in countries with a low level of political risk and/or ensuring that we maintain dual capability</li> <li>• Diversifying global operations to avoid excessive concentration of risks in particular areas</li> <li>• The international network of Rolls-Royce and its business units proactively monitoring local situations</li> <li>• Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base (see Chief Executive's review on pages 15 and 16 and business model on pages 24 and 25)</li> <li>• Proactively influencing regulation where it affects us (see Sustainability on page 45)</li> </ul> <p><b>This principal risk is subject to review by the Board</b></p>
<p><b>MAJOR PROGRAMME DELIVERY</b></p> <p>Failure to deliver a major programme on time, within budget to specification or technical performance falling significantly short of customer expectations, or not delivering the planned business benefits, would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation.</p> 	<ul style="list-style-type: none"> <li>• Major programmes are subject to Board approval (see Additional financial information on page 160)</li> <li>• Reviewing major programmes at levels and frequencies appropriate to their performance against key financial and non-financial deliverables and potential risks throughout the programme's life cycle (see Additional financial information on page 160)</li> <li>• Conducting technical audits at pre-defined points and performed by a team that is independent from the programme</li> <li>• Requiring programmes to address the actions arising from reviews and audits and monitoring and controlling progress through to closure</li> <li>• Applying knowledge management principles to provide benefit to current and future programmes</li> </ul> <p><b>This principal risk is subject to review by the Board</b></p>

## STRATEGIC PRIORITIES



Customer



Innovation



Profitable growth

**RISK OR UNCERTAINTY AND POTENTIAL IMPACT****COMPLIANCE**

Non-compliance by the Group with legislation or other regulatory requirements in the heavily regulated environment in which it operates (for example: export controls, use of controlled chemicals and substances, and anti-bribery and corruption legislation) compromising the ability to conduct business in certain jurisdictions and exposing the Group to potential reputational damage, financial penalties, debarment from government contracts for a period of time, and/or suspension of export privileges or export credit financing, any of which could have a material adverse effect.

**HOW WE MANAGE IT**

- Taking an uncompromising approach to compliance
- Operating an extensive compliance programme. This programme and the Global Code of Conduct are disseminated throughout the Group and are updated and reinforced from time-to-time to ensure their continued relevance, and to ensure that they are complied with both in spirit and to the letter. The Global Code of Conduct and the Group's compliance programme are supported by appropriate training (see Safety and Ethics Committee on page 67)
- A legal and compliance team is in place to manage our compliance programme and any ongoing regulatory investigations (see Safety and Ethics Committee on page 68)
- Lord Gold has reviewed the Group's current compliance procedures and the Group has continued to implement an improvement plan
- Implementing a comprehensive REACH compliance programme. This includes establishing appropriate data systems and processes, working with our suppliers, customers and trade associations and conducting research on alternative materials

**This principal risk is subject to review by the Safety and Ethics Committee**

**MARKET SHOCK**

The Group is exposed to a number of market risks, some of which are of a macro-economic nature. For example, oil price or foreign currency exchange rates, and some which are more specific to the Group, such as liquidity and credit risks, reduction in air travel or disruption to other customer operations. Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness. This would affect operational results or the outcomes of financial transactions.



- Maintaining a strong balance sheet, through healthy cash balances and a continuing low level of debt
- Providing financial flexibility by maintaining high levels of liquidity and an investment grade 'A' credit rating (see Additional financial information on page 161)
- Sustaining a balanced portfolio through earning revenue both from the sale of original equipment and aftermarket services, providing a broad product range and addressing diverse markets that have differing business cycles
- Deciding where and what currencies to source in, and where and how much credit risk is extended or taken. The Group has a number of treasury policies that are designed to hedge residual risks using financial derivatives (foreign exchange, interest rate and commodity price risk – see Additional financial information on page 160 and note 17)

**This principal risk is subject to review by the Audit Committee**

**IT VULNERABILITY**

Breach of IT security causing controlled or critical data to be lost, made inaccessible, corrupted or accessed by unauthorised users impacting the Group's operations or reputation.



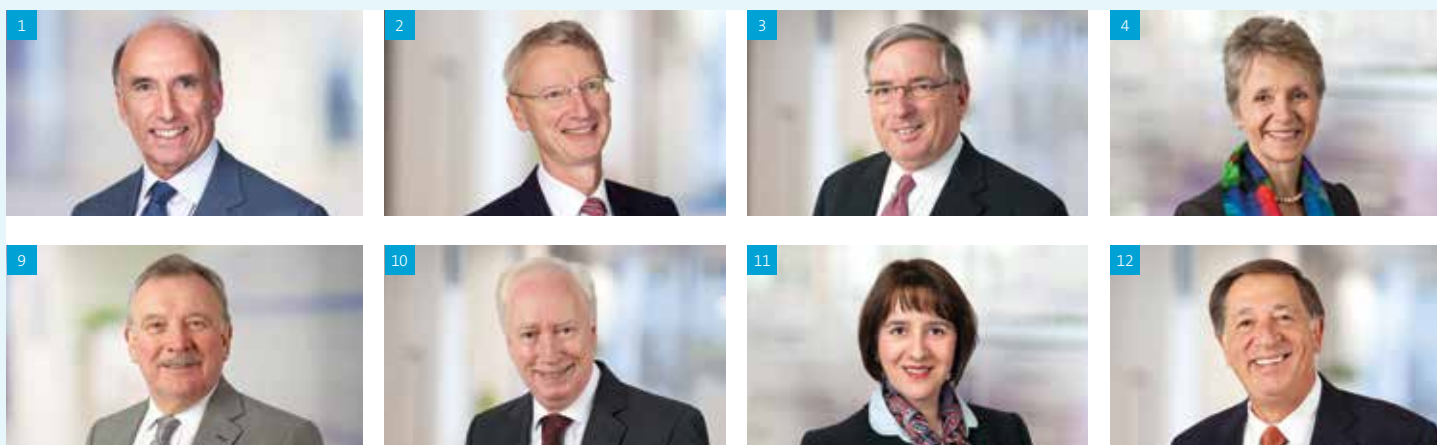
- Establishing 'defence in depth' through deployment of multiple layers of software protection and processes including web gateways, filtering, firewalls, intrusion, and advanced persistent threat detectors and integrated reporting (see Audit Committee report on pages 71 and 72)
- Running security and network operations centres
- Actively sharing IT Security information through industry, government and security forums

**This principal risk is subject to review by the Audit Committee**

The Strategic Report was approved by the Board on 12 February 2015 and signed on its behalf by

**PAMELA COLES**  
Company Secretary

# BOARD OF DIRECTORS



## 1. IAN DAVIS CHAIRMAN<sup>2</sup>

### CHAIRMAN OF THE NOMINATIONS AND GOVERNANCE COMMITTEE

Appointed to the Board March 2013 and as Chairman May 2013

**Key areas of experience:** Finance, government and overseas experience

#### Other current appointments:

- Johnson & Johnson Inc, non-executive director
- BP p.l.c., non-executive director
- UK Cabinet Office Board, non-executive member
- Apax Partners LLP, senior adviser

#### Previous relevant experience:

- McKinsey & Company 1979 – 2003
- Chairman and worldwide managing director of McKinsey 2003 – 2010
- He served as a consultant at McKinsey to a range of global organisations across the private, public and not-for-profit sectors

## 2. JOHN RISHTON CHIEF EXECUTIVE

Appointed to the Board March 2007 and as Chief Executive March 2011

**Key areas of experience:** Finance, sales and marketing, and overseas experience

#### Other current appointments:

- Unilever NV and Unilever plc, non-executive director

#### Previous relevant experience:

- Ford Motor Company, held a variety of positions in the UK and Europe 1979 – 1994
- British Airways Plc 1994 – 2001
- British Airways Plc, chief financial officer 2001 – 2005
- Royal Ahold, CFO from 2006 – 2007 and CEO from 2007 – 2011

## 3. LEWIS BOOTH CBE

### SENIOR INDEPENDENT DIRECTOR<sup>1,2,5</sup>

#### CHAIRMAN OF THE AUDIT COMMITTEE

Appointed to the Board May 2011

**Key areas of experience:** Finance, industrial and overseas experience

#### Other current appointments:

- Mondelez International Inc, director
- Gentherm Inc, director
- University of Liverpool in America Inc, director

#### Previous relevant experience:

- Ford Motor Company, senior positions in Europe, Asia, Africa and US, 1978 – 2009
- Ford Motor Company, executive vice president and CFO 2008 – 2012

He was awarded a CBE in 2012 for services to the UK automotive and manufacturing industries

## 4. DAME HELEN ALEXANDER

### NON-EXECUTIVE DIRECTOR<sup>2,3,4</sup>

#### CHAIRMAN OF THE REMUNERATION COMMITTEE

Appointed to the Board September 2007

**Key areas of experience:** Media, business and finance

#### Other current appointments:

- UBM plc, chairman
- Port of London Authority, chairman
- esure Group plc, deputy chairman
- Bain Capital, senior adviser
- EDF's UK Advisory Board, member
- University of Southampton, chancellor
- She is also involved with other not-for-profit organisations in media, the arts and education

#### Previous relevant experience:

- Economist Group, chief executive 1997 – 2008
- Economist Intelligence Unit, managing director 1993 – 1997
- BT Group plc, non-executive director 1998 – 2001
- Northern Foods plc, non-executive director 1994 – 2002
- CBI, president 2009 – 2011
- Centrica plc, non-executive director 2003 – 2011
- She was awarded a DBE in 2011 for services to business

## 5. RUTH CAIRNIE NON-EXECUTIVE DIRECTOR<sup>2,3,5</sup>

Appointed to the Board September 2014

**Key areas of experience:** International marketing and supply chain, and overseas experience

#### Other current appointments:

- Associated British Foods plc, non-executive director
- Keller Group plc, non-executive director Rotterdam School of Management, member of advisory board

#### Previous relevant experience:

- Royal Dutch Shell plc, 1976 – 2014 executive vice president strategy & planning and other senior international roles, including managing the global commercial fuels business

## 6. SIR FRANK CHAPMAN NON-EXECUTIVE DIRECTOR<sup>2,3,4</sup>

### CHAIRMAN OF THE SAFETY AND ETHICS COMMITTEE

Appointed to the Board November 2011

**Key areas of experience:** Engineering and industrial

#### Other current appointments:

- Golar LNG Limited, chairman

#### Previous relevant experience:

- Appointments within BP Pl.c., 1974 – 1978 and Royal Dutch Shell plc, 1978 – 1996
- BG Group plc, CEO 2000 – 2012
- He was knighted in 2011 for services to the oil & gas industries

## 7. WARREN EAST CBE NON-EXECUTIVE DIRECTOR<sup>1,2,5</sup>

### CHAIRMAN OF THE SCIENCE AND TECHNOLOGY COMMITTEE

Appointed to the Board January 2014

**Key areas of experience:** Technology and engineering

#### Other current appointments:

- De La Rue plc, non-executive director
- Dyson Ltd, non-executive director
- BT Group plc, non-executive director
- Micron Technology Inc., non-executive director

#### Previous relevant experience:

- ARM Holdings plc, chief executive 2001 – 2013
- ARM Holdings plc, various senior appointments 1994 – 2001

He was awarded a CBE in 2014 for services to the technology industry





#### 8. LEE HSIEN YANG NON-EXECUTIVE DIRECTOR<sup>2,4</sup>

Appointed to the Board January 2014

**Key areas of experience:** Telecommunications, government, engineering and finance

**Other current appointments:**

- General Atlantic LLC, special advisor
- Civil Aviation Authority of Singapore, chairman
- General Atlantic Singapore Fund Pte. Ltd, chairman
- The Islamic Bank of Asia Private Limited, chairman
- The Australian and New Zealand Banking Group Ltd, director
- Lee Kuan Yew School of Public Policy, member of the board of governors
- INSEAD South East Asia Council, president
- Singapore Exchange Limited, director

**Previous relevant experience:**

- Singapore Telecommunications Limited, chief executive 1995 – 2007
- Fraser and Neave Limited, chairman and non-executive director 2007 – 2013

#### 9. JOHN MCADAM NON-EXECUTIVE DIRECTOR<sup>2,3,4</sup>

Appointed to the Board February 2008

**Key areas of experience:** Retail and industrial

**Other current appointments:**

- United Utilities Group PLC, chairman
- Rentokil Initial plc, chairman
- J Sainsbury plc, senior independent director

**Previous relevant experience:**

- Unilever PLC, senior positions within Birds Eye Walls, Quest and Unichema from 1974 – 1998
- ICI Paints, chairman and CEO 1998 – 2002
- ICI plc, chief executive 2003 – 2008
- Severn Trent plc, non-executive director 2000 – 2005
- Sara Lee Corporation, non-executive director 2008 – 2012

#### 10. JOHN NEILL CBE NON-EXECUTIVE DIRECTOR<sup>1,2</sup>

Appointed to the Board November 2008

**Key areas of experience:** Engineering, industrial and finance

**Other current appointments:**

- Unipart Group of Companies, chairman and group chief executive
- Atlantis Resources Limited, chairman
- Business in the Community, council and board member
- Society of Motor Manufacturers and Trades, vice president
- BEN, the automotive industry charity, vice president
- The Institute of the Motor Industry, vice president

**Previous relevant experience:**

- Bank of England, director
  - Royal Mail, non-executive director
  - Charter International plc, non-executive director
- He was awarded a CBE in June 1994 for services to the motor industry

#### 11. JASMIN STAIBLIN NON-EXECUTIVE DIRECTOR<sup>2,5</sup>

Appointed to the Board May 2012

**Key areas of experience:** Technology, engineering and overseas experience

**Other current appointments:**

- Alpiq Holding AG, CEO
- Georg Fischer AG, non-executive director.
- Federal Institute of Technology, the ETH Domain, board member

**Previous relevant experience:**

- ABB Switzerland Ltd, CEO until 2012

#### 12. JAMES GUYETTE PRESIDENT AND CHIEF EXECUTIVE OFFICER OF ROLLS-ROYCE NORTH AMERICA INC.

Appointed to the Board January 1998

**Key areas of experience:** Sales, marketing and airline operations

**Other current appointments:**

- PrivateBancorp Inc., chairman
- priceline.com, lead independent director

**Previous relevant experience:**

- United Airlines, executive vice president marketing and planning 1969 – 1997

#### 13. DAVID SMITH CHIEF FINANCIAL OFFICER

Appointed to the Board November 2014

**Key areas of experience:** Finance

**Other current appointments:**

- Motability Operations Group plc, non-executive director
- British Motor Industry Heritage Trust, trustee

**Previous relevant experience:**

- Ford and Jaguar Land Rover, various senior positions spanning 25 years
- Jaguar Land Rover, CEO 2008 – 2010
- Edwards, chief financial officer 2010 – 2013

#### 14. COLIN P SMITH CBE DIRECTOR – ENGINEERING AND TECHNOLOGY

Appointed to the Board July 2005

**Key areas of experience:** Engineering

**Other current appointments:**

- Council for Science and Technology, member

**Previous relevant experience:**

- Rolls-Royce plc, 1974 to date. He has held a variety of key positions including Director – Research and Technology and Director of Engineering and Technology – Civil aerospace
- In June 2012 he was awarded a CBE for services to UK engineering

#### 15. PAMELA COLES COMPANY SECRETARY

Appointed Company Secretary in October 2014

**Key areas of experience:** Corporate governance and company law

**Previous relevant experience:**

- Centrica plc, head of secretariat 2008 – 2014
- Held a variety of company secretary roles including: Rank Group plc, group company secretary and a member of the executive committee
- RAC plc, company secretary and head of legal Fellow of the Institute of Chartered Secretaries and Administrators since 1997

## CHAIRMAN'S INTRODUCTION



 We benefit from a strong Board that has the requisite skills to manage an international business.”

Strong ethical standards and behaviours, supported by good governance are fundamental to a healthy company. This year we have focused on reviewing and amending our governance arrangements and structures as well as continuing to reinforce the conduct and behaviours we expect, wherever we operate.

We are very conscious that our governance must meet the demands of our business, our shareholders and other stakeholder groups. Changes in our operating and risk environment are constant, arising from developments in technology, regulation and our relative competitive position in shifting markets. Furthermore, we need to remain alert to our shareholders' points of view and ensure we are well-equipped to respond to their concerns.

During the year, the Board considered the Group's overall governance framework, including the work and composition of the board committees and the structure of reporting lines, information flow and delegation of responsibilities. We have also reviewed how we engage with shareholders and respond to their comments, particularly around the forward-looking information provided and setting out our strategy. Following this thorough review, we agreed a number of changes which took effect from 1 January 2015.

We invest over £1 billion on R&D every year. Investment in innovation and managing engineering-related risks are critical to our success and so we have established a Science and Technology Committee, under the chairmanship of Warren East. This committee will provide greater oversight of the development and implementation of our innovation strategy and provide assurance that we are concentrating our efforts in the right areas. The committee will review the direction of the Group's research, technology and development activities to ensure that significant science and technology trends are identified and incorporated into future plans.

We expanded the remit of the Nominations Committee to include the regular review of governance arrangements. We strengthened our Company Secretarial team with the recent appointment of a highly experienced Company Secretary who will be overseeing the implementation and regularly reviewing the revised governance framework. In particular, I am looking forward to benefiting from

the support she will provide to me as Chairman and to the Senior Independent Director.

In last year's Annual Report, I commented that the Safety and Ethics Committees would be combined. However, as the governance review was underway it was decided to defer this until the review was completed. These committees were combined with effect from 1 January 2015 and have assumed responsibility for sustainability as well as their other responsibilities detailed on page 66. This gives greater focus of our vision to deliver better power for a changing world ethically, safely and sustainably. We see close linkages between ethical behaviour, taking a responsible attitude towards safety and meeting our social and environmental obligations.

The Board governance structure is set out on page 59 and a full copy of the refreshed high-level governance structure is available on the Group's website.

The structure of the Group was changed in 2014 to bring greater organisational and management coherence to the work of our main two Divisions, Aerospace and Land & Sea. Through this change we are aiming to encourage better coordination across our different activities, secure benefits from greater integration and reinforce accountabilities. Each of the Divisions is described in more detail on pages 32 to 41. As part of the ongoing work looking at governance across the Group, we will continue to review our processes and structures within the Divisions and as we integrate Power Systems. As mentioned in the Audit Committee report on page 69, we are further strengthening governance at a divisional level through our sector audit committees.

Also, as part of the ongoing review, the Board is considering how internal controls and the risk management framework are operating in practice (as outlined on pages 50, 62 and 71). We view this as fundamental to understanding and discussing the main challenges to the business, both strategic and operational. The Executive Leadership Team (ELT) will continue to review all principal and emerging risks. As set out on pages 51 to 53, each identified principal risk will also be considered by the Board who will allocate certain risks to the most appropriate board committee. Those

committees will then report back to the Board with their views on how those risks are being managed and controlled.

The Audit Committee will continue to review all principal risks and the overall internal controls and risk management framework as part of its year-end activities. This will remain an area of focus in 2015, especially as we consider our approach to the changes to the UK Corporate Governance Code regarding the Board's responsibility to review, at least annually, the effectiveness of the Group's risk management and internal control systems.

In September 2014, we commissioned Independent Audit, a specialist board and governance consultancy, to carry out an evaluation of the effectiveness of the Board and its committees. I was particularly pleased with its conclusion that the Board was working off a firm base with a strong core of highly experienced and committed directors, working well together as a team in an open and supportive atmosphere. We identified a number of areas where we could do better and further details of the evaluation and its outcomes can be found on page 61 of this report.

We benefit from a strong Board that has the requisite skills to manage an international business, driven by manufacturing quality and innovation. Our Nominations and Governance Committee regularly reviews the composition and balance of the Board in terms of skills, knowledge, experience and diversity to ensure we have the right mix to manage the Group. This is particularly important as we work with the Chief Executive to ensure that, at all levels of the executive and senior management team, the right people are in place. We recruited a highly-experienced Group HR Director who will ensure that our long-term executive development and succession planning and, more generally, our resourcing and retention strategies are implemented successfully.

I am confident that the Board works well together and with the ELT. This gives us a strong platform, based on trust and confidence, on which to have rigorous discussions and hold executives accountable.

During the year we appointed Lewis Booth as the Senior Independent Director. His strong capabilities and experience, together with his contribution to the Board over several years, made him the right candidate for the role.

As I said in my review on page 13, I am delighted that David Smith has joined the Board as Chief Financial Officer. He has an exceptional track record as a financial leader and since joining Rolls-Royce has demonstrated determination, discipline and intellectual rigour.



A copy of the governance framework is available at [www.rolls-royce.com/about/whoweare/corporate\\_governance](http://www.rolls-royce.com/about/whoweare/corporate_governance)

## INTERNATIONAL ADVISORY BOARD (IAB)

The IAB, formed in 2006, advises the Board on political and economic developments around the world and alerts the Company to possible long-term opportunities, threats and risks. Its members are:

### LORD POWELL OF BAYSWATER (CHAIRMAN OF THE IAB)

Former Foreign Affairs and Defence Adviser to Prime Ministers Baroness Thatcher and Sir John Major

### VLADIMÍR DLOUHÝ

International advisor to Goldman Sachs for Central and Eastern Europe, European deputy chairman of the Trilateral Commission, president, Czech Chamber of Commerce and a former member of the Czech Government

### SIR ROD EDDINGTON

Chairman of JP Morgan (Australia & New Zealand) and former chief executive of British Airways Plc

### DR FAN GANG

Professor at China's Academy of Social Sciences and director of National Economic Research Institute, China

### MUSTAFA KOÇ

Chairman of Koç Holding, A.S., Turkey

### DR PEDRO SAMPAIO MALAN

Chairman of Itaú Unibanco's international advisory board and a member of the boards of EDP – Energias do Brasil, Souza Cruz, Brazil, Mills Engenharia, a director of Thomson Reuters Founders Share Company and a member of the Temasek international panel

### AKIO MIMURA

Senior advisor, honorary chairman Nippon Steel & Sumitomo Metal Corporation, Japan

### LUBNA OLAYAN

CEO and deputy chairperson of the Olayan Financing Company, Saudi Arabia

### RATAN TATA

Former chairman of Tata Sons Limited, India

### AMBASSADOR ROBERT B. ZOELLICK

Chairman of Goldman Sachs International Advisors, senior fellow at the Belfer Center at Harvard University, former president of World Bank Group, US Trade Representative and US Deputy Secretary of State

## THE EXECUTIVE LEADERSHIP TEAM (ELT)

The ELT is an executive forum, at which the Group's most senior business and functional leaders review, communicate and agree on issues and actions of group-wide significance. Its members are:

### JOHN RISHTON CHIEF EXECUTIVE (CHAIRS THE ELT)

MILES COWDRY  
DIRECTOR GLOBAL CORPORATE  
DEVELOPMENT

JAMES GUYETTE  
PRESIDENT AND CHIEF EXECUTIVE  
OFFICER – ROLLS-ROYCE NORTH  
AMERICA INC.

LAWRIE HAYNES  
PRESIDENT – LAND & SEA

HARRY HOLT  
GROUP OPERATIONS STRATEGY  
DIRECTOR

MARY HUMISTON  
GROUP HR DIRECTOR

COLIN SMITH  
DIRECTOR – ENGINEERING  
AND TECHNOLOGY

DAVID SMITH  
CHIEF FINANCIAL OFFICER

ROBERT WEBB  
GENERAL COUNSEL

TONY WOOD  
PRESIDENT – AEROSPACE

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## CHAIRMAN'S INTRODUCTION

CONTINUED

James Guyette will be stepping down as a Board member, at the conclusion of the AGM on 8 May 2015 and retiring from his role as President and Chief Executive Officer of Rolls-Royce North America on 31 May 2015. John Neill has also indicated that he will not put himself forward for re-election at the 2015 AGM and will therefore leave the Board having completed over six years as a Non-Executive Director.

I am delighted that Irene Dorner will be appointed as a Non-Executive Director with effect from 27 July 2015. Details of Irene's experience are included in my review on page 13.

I am pleased that we have made demonstrable progress to increase the number of women on our Board. Most recently Ruth Cairnie joined the Board as a Non-Executive Director with effect from 1 September 2014. The process for Ruth's appointment is described on page 65 of the Nominations and Governance Committee report.

Women currently represent 7% of senior management and we will continue to focus on increasing this proportion over the coming years. Historically, women have been under-represented in the engineering sector. In order to achieve our aspirations we need to increase diversity in all levels of the Group, not just the Board and we are working on programmes to achieve this. We will select future candidates based on their relevant skills, experience and knowledge and in keeping with the business needs, irrespective of gender.

Last year we began to roll-out an ethics and compliance programme where all employees were asked to certify that they had read and understood the Global Code of Conduct (Global Code) and would comply with it. This was supported by a training course. By the end of 2014, 96% of employees had provided certification in respect of the Global Code and while we are satisfied with this level of certification, we are looking to improve this figure.

The Group has continued to implement the recommendations made in Lord Gold's interim report in 2013 and has developed an ethics and compliance improvement programme to deliver the recommendations. Lord Gold has continued to work with us and reports regularly to the Board. Further details of our activities in this area are included in the Safety and Ethics Committee report on page 68.

Overall I am pleased with the progress we are making on updating and upgrading our controls and governance. We need to maintain our focus on risk management and compliance procedures. We will review our governance framework annually to ensure that we are well-positioned to provide effective oversight over a complex business and to give our shareholders a clear view of our performance and strategic direction.

**IAN DAVIS**  
Chairman

# CORPORATE GOVERNANCE

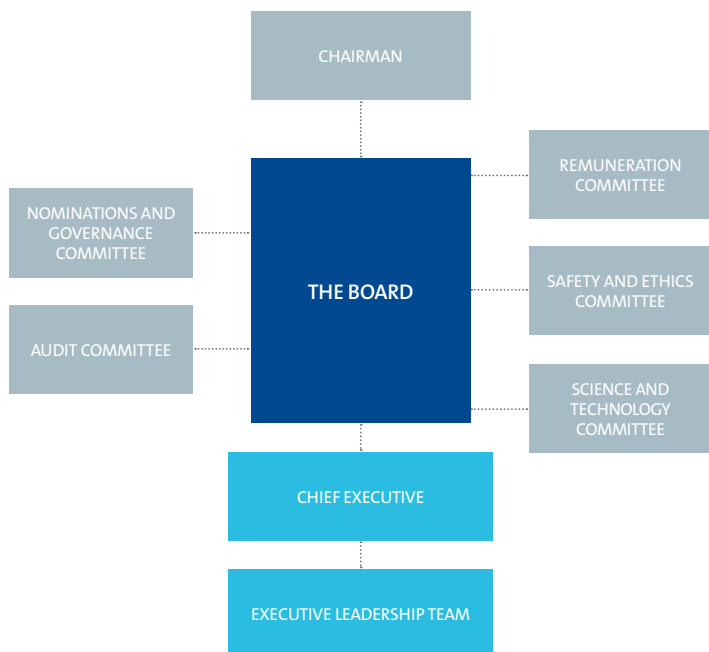
## UK CORPORATE GOVERNANCE CODE

This report sets out how the Company applied the principles of the UK Corporate Governance Code 2012 (the Code) and the extent to which the Company complied with the provisions of the Code during the year. A copy of the Code is available from the Financial Reporting Council's website [www.frc.org.uk](http://www.frc.org.uk)

The Board considers that the Company complied in all material respects with the Code for the whole of the year to 31 December 2014. The Board has agreed that arrangements by which staff may raise concerns in confidence are considered and reviewed by the Safety and Ethics Committee. Matters relating to financial reporting, the integrity of financial management or fraud are also reported to the Audit Committee.

The Audit Committee has considered the requirement to put the audit out to tender every ten years. In line with the FRC's transitional arrangements, the committee will do so during the tenure of the current lead partner which expires in 2017. More detail can be found in the Audit Committee report on page 73.

## GOVERNANCE FRAMEWORK FROM JANUARY 2015



## THE BOARD

### ROLE AND RESPONSIBILITIES

The Board believes that good corporate governance is not just a matter of compliance: it should be contributing to the Group's performance by making sure we have a clear strategic direction, manage our risks to the right level and keep the business under control. A clearly defined framework of roles and responsibilities has been agreed and this has been fully reviewed during 2014.

The powers of the directors are set out in the Company's Articles of Association (the Articles), which are available on the Group's website. The Articles may be amended by special resolution. In addition the directors have responsibilities and duties under legislation, in particular the Companies Act 2006.

The Board has a schedule of matters reserved for its approval, generally being those items which affect the shape and risk profile of the Group, as well as items such as the annual budget and performance targets, the financial statements, payments to shareholders, major capital investments, substantial changes to balance sheet management policy and the strategic plan. The schedule of reserved matters was reviewed during the year as part of the governance review and is available on the Group's website.

### BOARD MEETINGS

The Board holds regular scheduled meetings throughout the year. In 2014, the Board met 11 times, of which nine meetings were scheduled and two were unscheduled supplementary meetings.

We are very conscious of the need to provide directors with the information they need to be effective. We send out papers well in advance of meetings to help directors prepare. We keep the content and structure of papers under review to help make sure that they communicate the main issues clearly. This year's board review has highlighted some changes that would help in maintaining the Board's focus on the main strategic issues so we will be looking to develop some aspects of the board papers during 2015. The review confirmed that the directors are satisfied with the fullness of the papers and management's commitment to transparency but we recognise that more can be done to enhance the presentation of trends and key performance indicators.

Directors are expected to attend all meetings of the Board and the committees on which they sit and to devote sufficient time to the Company's affairs to enable them to fulfil their duties as directors. If directors are unable to attend a meeting, their comments on the board papers are discussed in advance with the Chairman so that their contribution can be included in the wider board discussion.

Details of attendance by directors at board meetings during 2014 are set out in the table overleaf and attendance at committee meetings is set out within the reports on pages 64, 66, 69 and 74.

# CORPORATE GOVERNANCE

CONTINUED

Members	Attendance in 2014
Ian Davis (Chairman)	9/9
John Rishton	9/9
Dame Helen Alexander	7/9
Lewis Booth CBE	9/9
Ruth Cairnie (appointed 1 September 2014)	3/3
Sir Frank Chapman	9/9
Iain Conn (retired 1 May 2014)	4/4
Warren East CBE	9/9
James Guyette	9/9
Lee Hsien Yang	8/9
John McAdam	9/9
Mark Morris (left 4 November 2014)	7/7
John Neill CBE	9/9
Colin Smith CBE	9/9
David Smith (appointed 4 November 2014)	2/2
Jasmin Staiblin	9/9

## BOARD COMPOSITION

The Board comprises a Non-Executive Chairman, four Executive Directors and nine Non-Executive Directors.

Details of the Board are set out on pages 54 and 55. Details of the Executive Directors' service contracts, or letters of appointment in the case of Non-Executive Directors, are on page 80. Details of their remuneration and share interests are set out in the Directors' Remuneration Report on pages 76 to 84.

## KEY ROLES

The roles of the Chairman, Chief Executive, Senior Independent Director and Company Secretary are set out in writing and have been agreed by the Board.

### THE CHAIRMAN

**Ian Davis**

#### Responsibilities

- effective running of the Board and its committees in accordance with the highest standards of corporate governance
- setting the Board agenda
- managing the Board to ensure adequate time for discussion of all agenda items
- ensuring the Board receives accurate, timely and clear information

### THE CHIEF EXECUTIVE

**John Rishton**

#### Responsibilities

- overseeing the day-to-day operation of the Company's business
- developing and implementing the Company's strategy as approved by the Board
- establishing and maintaining formal and appropriate delegations of authority
- maintaining a close working relationship with the Chairman

### THE SENIOR INDEPENDENT DIRECTOR

**Lewis Booth CBE**

#### Responsibilities

- providing a sounding board for the Chairman
- being available to major shareholders if they have concerns which have not been resolved through the normal channels of the Chairman, Chief Executive or other Executive Directors
- conducting an annual review of the performance of the Chairman

### THE COMPANY SECRETARY

**Pamela Coles**

All directors have access to the advice and services of the Company Secretary. She acts as Secretary to the Board and its committees.

#### Responsibilities

- ensuring compliance with board procedures and corporate governance
- administering the process for directors to access external independent advice at the Company's expense
- assisting the Nominations and Governance Committee with plans for directors' induction and ongoing training
- ensuring the Board receives accurate, timely and clear information

The guiding principles, agreed by the Board, to govern the relationship between the Chairman and the Chief Executive are contained within the governance framework available on the Group's website.

## INDEPENDENCE OF NON-EXECUTIVE DIRECTORS

The Board conducts a rigorous review of the independence of the Non-Executive Directors every year, based on the criteria in the Code. This review was undertaken in November 2014 and the Board concluded that all the Non-Executive Directors remained independent in character and judgement.

The Code does not consider the test of independence to be appropriate to the chairman of a company. However, Ian Davis did meet the Code's independence criteria upon his appointment as Chairman in May 2013. His other external commitments are described on page 54.

## CONFLICTS OF INTEREST

Directors have a duty to avoid a situation in which they have, or can have, a direct or indirect interest which conflicts, or possibly may conflict, with the interests of the Company unless that situational conflict has been authorised by the Board. The Nominations Committee reviewed and authorised all directors' situational conflicts and has agreed, that while directors are required to keep confidential all Company information, they shall not be required to share with the Company confidential information received by them from a third party which is the subject of the situational conflict.

### APPOINTMENTS AND RE-APPOINTMENTS

A formal, rigorous and transparent process is followed during the selection and subsequent appointment of new directors. Each director stands for re-appointment at each AGM. Non-Executive Directors' terms of office will be terminated without compensation if they fail to be re-elected (see page 91 for further information). Non-Executive Directors are appointed for an initial term of three years, which may be extended with the agreement of the Board, although re-appointment is not automatic. A rigorous review is undertaken, taking account of their performance and ability to contribute to the Board in the light of the knowledge, skills, experience and diversity required, when considering extending a term for a Non-Executive Director beyond six years. For 2014, this has consisted of face-to-face discussions between the Chairman and each director, taking into account observations arising from the external board review.

### EXECUTIVE LEADERSHIP TEAM (ELT)

The ELT is the senior decision-making executive committee and is chaired by the Chief Executive. Its membership is shown on page 57. During the year it developed detailed strategic options for the Board to consider. It also reviewed HS&E performance, customer relations, governance, principal risks, financial and operational performance as well as acquisitions and disposals during the year.

The ELT assists the Board in determining the nature and extent of the principal risks as described on page 50.

### DIRECTORS' INDEMNITIES AND INSURANCE

In accordance with the Articles, and to the extent permitted by law, the Company has entered into separate deeds of indemnity with its directors, which were in force during the financial year and remain in force at the date of this report. The Company also maintains directors' and officers' liability insurance cover for its directors and officers. This cover also extends to directors of subsidiary companies.

### THE WORK OF THE BOARD

At each scheduled meeting, Executive Directors supplied reports on business and financial performance including the approval of financial statements and budgets. The Board also received regular updates on HS&E, employee and legal issues and conducted a review of its governance arrangements. The chairman of each of the board committees provided verbal reports on matters discussed by that committee since the previous board meeting.

In September 2014, the Board held its annual strategy meeting. We focused on areas of particular importance and immediacy including our human resource strategy and our approach to strengthening our technology infrastructure and exploiting technological developments.

In addition to its routine business, matters considered by the Board in 2014 included:

- an update by Lord Gold on his interim report on ethical issues;
- the proposed acquisition of Wärtsilä;
- discussions with FRC over accounting for risk and revenue sharing arrangements (RRSAs);
- our relationship and strategy with major airframe customers;
- the sale of our Energy gas turbines and compressor business to Siemens;
- the £1 billion share buyback;
- a proposal to provide engines for the Airbus A330neo;
- feedback from investor days held during the year;
- renewal of £2.75 billion Euro Medium Term Note programme;
- the Board external evaluation report and actions to be taken;
- the revised corporate governance framework;
- management succession issues; and
- the integration of Power Systems.

### BOARD EVALUATION

The Board and its committees undertake an annual evaluation of their performance, which is conducted by external consultants at least once every three years. In 2014, the evaluation was conducted by Independent Audit who do not have any other connection to the Company.

Independent Audit reviewed a year's worth of board and committee papers and interviewed all directors and others who have significant interaction with the Board and its committees including the external auditors and our remuneration advisors. They also observed meetings of the Board and committees. The final report was discussed in detail by the Board at a board dinner and with Independent Audit during a full discussion at a board meeting. Follow-up meetings with individual committee chairmen, the Company Secretary and other senior management are underway.

The review concluded that we benefit from a strong Board which works well as a team of directors and enjoys a constructive and open relationship with management. Numerous positive points were noted and particular emphasis was put on the changes that have already been made to introduce new directors who bring fresh perspectives and different experience to the Board, and to encourage lively debate at meetings.

# CORPORATE GOVERNANCE

CONTINUED

There is always scope for improvement so we have taken into account Independent Audit's recommendations and during 2015 will be implementing a number of changes in emphasis, which include:

- reaffirming our strategy and business model for the Land & Sea Division;
- making sure our agendas are managed actively to reflect our priorities;
- enhancing the board information to make sure it is more explicitly tied into our strategic priorities and objectives;
- monitoring and guiding management's programme for enhancing our management information;
- ensuring that our investor communications are at the right level;
- driving through the human resource and executive development programmes; and
- making sure that our risk management and internal control frameworks are meeting our business and governance needs.

The committees' work was reviewed and this confirmed that all committees are providing effective support to the Board. Areas for further development are noted in the individual committee reports.

The evaluation of the Chairman was carried out by Lewis Booth, Senior Independent Director, who sought the individual views of each of the Executive and Non-Executive Directors, particularly given that this was the Chairman's first full year in the role. All the directors, with the exception of the Chairman, then met in December 2014 to discuss the feedback and Lewis Booth subsequently met with the Chairman to discuss the outcome.

The Board unanimously agreed that the Chairman's performance had been very strong and that he had established himself in the role very effectively. The Chairman's engagement across the entire spectrum of the Group was notable, and he has developed strong working relationships with both the Non-Executive and Executive Directors while being very effective in introducing new directors onto the Board.

## BOARD DEVELOPMENT

Newly appointed directors participate in a structured induction programme, facilitated by the Company Secretary, and receive a comprehensive data pack providing detailed information on the Group.

We recognised last year that our induction programme needed further development and we were pleased to note that the new directors informed the external reviewers that they were very satisfied with the support they received.

This thorough introduction for new directors includes meetings with a range of management. Visits by board members to our operating sites are also an important part of both induction and continuing education, to ensure that directors understand our business through direct experience of operating processes and discussions with employees at different levels throughout the

business. During the year, some of the Non-Executive Directors visited sites in the UK at Derby and Bristol, Ålesund in Norway and our Crosspointe facility in the US. We are reviewing the programme for 2015 to make sure that all directors have opportunities to visit our operations.

Further training is available for all the directors, including presentations by the executive team on particular aspects of the business. In addition, there is a procedure for directors to take independent professional advice at the Company's expense and every director has access to the Company Secretary.

## FINANCIAL REPORTING

The Group has a comprehensive budgeting system with an annual budget approved by the Board. Revised forecasts for the year are reported at least quarterly. Actual results, at both a business and Group level, are reported monthly against budget and variances are kept under scrutiny. The new Chief Financial Officer is undertaking an in-depth review of our management reporting and budgeting processes to ensure that they fully provide what we need, taking into account the size and shape of the Group and the structure of our operations.

Financial managers are required to acknowledge in writing that their routine financial reporting is based on reliable data and that results are properly stated in accordance with Group requirements. In addition, for annual reporting, business presidents and finance directors are required to confirm that their business has complied with the Group's finance manual.

## INTERNAL CONTROL AND RISK MANAGEMENT

The Group's system of internal controls is designed to manage, rather than eliminate, the risk of failure to achieve business objectives for the Group's subsidiaries (not including joint ventures and associates) and can only provide reasonable and not absolute assurance against material misstatement or loss.

The Board will continue routinely to challenge management in order to ensure that the system of internal control is constantly improving and remains fit for purpose. A major review of our risk management framework has been conducted over the past year and implementation is now underway. The Board, with the advice of the Audit Committee, has reviewed the effectiveness of the systems of internal control for the year under review and to the date of this report. Further information can be found in the Audit Committee report on page 71.

The Board confirms that the Group continues to be compliant with the Turnbull Guidance. Details of the Group's approach to risk management are set out on pages 50 to 53. We are working on our approach to meeting the new standards introduced in September 2014 by the FRC's changes to the UK Corporate Governance Code.



## RELATIONS WITH SHAREHOLDERS

### INVESTOR RELATIONS

The Board recognises and values the importance of maintaining an effective investor communication programme. It is proactive in obtaining an understanding of shareholder views on a number of key matters affecting the Group. We recognise that, at certain points over the past year, our communications might have been more effective and so we are now undertaking a full review of the processes underpinning our investor communications and relations.

A dedicated Investor Relations department, that reports to the Chief Financial Officer, conducts an investor relations programme with institutional investors which includes formal events during the year, as well as a regular series of one-to-one and group meetings. The purpose of these events is to highlight particular issues, themes or announcements that the Group believes warrant further explanation or clarification. The events also provide opportunities for shareholders to meet members of the senior management team to discuss topics of interest. Examples of these events in 2014 were: the full and half-year results announcements; the AGM; a capital markets day held in June to discuss our strategy and contract accounting; visits to the Group's sites; a Marine capital markets day in Ålesund; and industry conferences. The one-to-one and group meetings provide additional context around the Group's business strategy and financial performance such that shareholders are able to consistently and fairly value the Group's businesses.

Lewis Booth, the Senior Independent Director, is available to major shareholders if they have concerns that contact through the normal channels has either failed to resolve or is deemed inappropriate. Since his appointment as Senior Independent Director in May 2014, Lewis Booth attended the June capital markets day in London and the October Marine capital markets day in Ålesund, both of which allowed him to engage directly with investors and analysts.

The Group's website contains up-to-date information for shareholders which includes an online version of the Annual Report, share price information, news releases, presentations to the investment community and information on shareholder services. It also contains factual data about the Group's businesses, products and services.

### ANNUAL GENERAL MEETING (AGM)

All holders of ordinary shares may attend the Company's AGM at which the Chairman and Chief Executive present a review of the key business developments during the year. This year's AGM will be held at 11.00am on Friday, 8 May 2015 at the Queen Elizabeth II Centre, Broad Sanctuary, Westminster, London SW1P 3EE.

Shareholders can ask questions of the Board on the matters put to the meeting, including the Annual Report and the running of the Company generally. All directors are invited to attend each AGM. Unless unforeseen circumstances arise, all committee chairmen will be present to take questions at the AGM.

The Company intends to send the AGM notice and any relevant related papers to shareholders at least 20 working days before the meeting. The AGM notice will be available to view on the Group's website.

A poll is conducted on each resolution at all Company general meetings. All shareholders have the opportunity to cast their votes in respect of proposed resolutions by proxy, either electronically or by post. Following the AGM, the voting results for each resolution are published and are available on our website.

Shareholders unable to attend the AGM can vote on the business of the meeting either by post or online.

At the 2015 AGM, a special resolution is being proposed to amend the Articles by increasing the directors' powers to incur borrowings as set out in Article 130 from £3 billion to £5 billion. The current fixed limit was introduced in 2004. The Company has grown very significantly over the last decade in terms of market capitalisation, revenue, order book and global operational scale. The Board considers it commercially prudent and timely to refresh the borrowing limit. This will create additional flexibility for the Company to respond to any future needs of the business. The Company's external borrowing is already limited by existing internal controls, the need to maintain a favourable credit rating, the limits contained in the financial covenants in the Group's committed borrowing facilities and the principles of sound corporate governance. The adoption of the higher limit will not materially change the Company's borrowing policy and the Board believes it to be in the best commercial interests of the Group.

### INFORMATION INCLUDED IN THE DIRECTORS' REPORT

Certain additional information that fulfils the requirements of the Corporate Governance Statement can be found in the section headed Other Statutory Information on page 162 and is incorporated into this Corporate Governance Report by reference.

## NOMINATIONS AND GOVERNANCE COMMITTEE

The role of the Nominations and Governance Committee is to lead the process for appointments to the Board, ensuring there is a formal and appropriate procedure for the appointment and induction of new directors. As part of the governance review conducted in the year, the Board agreed that corporate governance would become the responsibility of the Nominations Committee. As a result, the committee's remit has been widened so that it is responsible for reviewing the governance framework going forward.

The committee reviews the composition and balance of the Board and senior executive team on a regular basis to ensure that the Group has the right structure, knowledge, skills, and experience in place to ensure effective management of the Group.

### COMMITTEE MEMBERS AND ATTENDANCE

The committee, which met four times during 2014 as the Nominations Committee, consists of all of the Non-Executive Directors.

Members	Attendance in 2014
Ian Davis (Chairman)	4/4
Dame Helen Alexander	4/4
Lewis Booth CBE	4/4
Ruth Cairnie (appointed 1 September 2014)	1/1
Sir Frank Chapman	4/4
Iain Conn (retired 1 May 2014)	2/2
Warren East CBE	4/4
Lee Hsien Yang	3/4
John McAdam	4/4
John Neill CBE	4/4
Jasmin Staiblin	4/4

### Responsibilities:

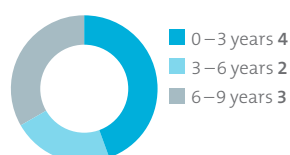
- reviewing the structure, size and composition (including skills, knowledge, experience and diversity) of the Board and its committees and make recommendations to the Board
- giving consideration and formulating plans for succession planning for directors and senior executives
- evaluating any conflicts of interest that the directors may have
- reviewing the Board's diversity policy
- reporting to the Board on the Company's corporate governance practices and procedures to ensure they, and their development and implementation, remain appropriate for a group of the size and complexity of Rolls-Royce and reflect best practice principles
- overseeing induction plans for directors
- reviewing the results of the annual board performance evaluation
- reviewing the independence of the Non-Executive Directors
- conducting an annual evaluation of the Chief Executive

The terms of reference for the committee were reviewed during the year and can be accessed on the website.

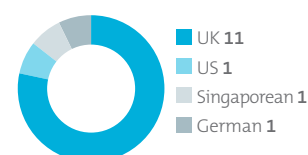
### BOARD BALANCE AND COMPOSITION

During the year, the committee reviewed the balance and composition of the Board taking into account skills, knowledge, experience and diversity. The review highlighted the skills and attributes required in order to determine and identify new Board members.

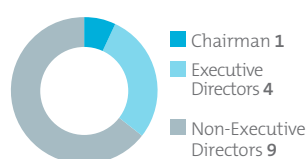
#### TENURE OF NON-EXECUTIVES



#### NATIONALITIES OF THE BOARD



#### BALANCE OF BOARD



We are confident that we now have the right mix of skills, experience and diversity. Across the board membership we benefit from extensive experience of working in global and complex businesses operating in diverse geographical and product markets. Our Non-Executive Directors have extensive experience of working at the most senior levels within complex multi-national companies and organisations and our Audit Committee chairman was CFO of a global company. They have had direct experience of a range of significant factors in common with Rolls-Royce including product quality and customer service across a diverse range of engineering, manufacturing and extractive environments, innovative technology and long-term product development. Our Non-Executive Directors also have extensive listed company experience with a good understanding of investor relations, financing, reporting and regulatory issues.

The appointment of Irene Dorner, who has extensive risk management and international experience, will be a strong addition to our Board. We are particularly pleased that she will be joining our Safety and Ethics Committee, as well as the Nominations and Governance Committee, from the date of her appointment.

We are satisfied with the current composition of the Board although the Chairman and the committee will, of course, regularly review membership of the Board and ensure we continue to have the requisite skills and experience as our markets and product mix develop.

The recruitment processes are formal, rigorous and transparent. Job specifications are drawn up for all new appointments against which potential candidates are considered. Recommendations are made to the Board who consider and approve appointments. We were pleased to note Independent Audit's findings: the directors feel that the recruitment processes have been sufficiently transparent, inclusive, and that the director succession plans are well-structured and are discussed openly with the Board.

The committee discusses with the Chief Executive the senior executive positions and succession plans and this will continue to be a particular point of focus during 2015.

Ruth Cairnie joined the Board as a Non-Executive Director with effect from 1 September 2014. Her strategic and international experience and her roles in addressing technology and environmental challenges will enable her to make a significant contribution to Rolls-Royce. MWM Consulting was engaged as the search consultants for a new Non-Executive Director with the particular skills required as set out in its brief, which resulted in Ruth Cairnie's appointment. MWM Consulting does not provide any other services to the Company.

David Smith joined the Board as Chief Financial Officer with effect from 4 November 2014. He was previously chief financial officer for the Aerospace Division and has an exceptional track record as a financial leader having held a number of senior positions at Ford and Jaguar Land Rover, and more recently as chief financial officer at the technology group, Edwards.

The committee is also responsible for nominating appropriate individuals for membership of the Board's committees. A number of changes were considered, recommended to the Board and implemented as part of the governance review.

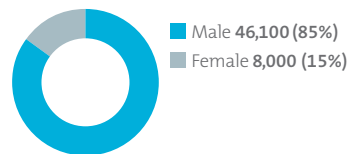
#### DIVERSITY

Increasing diversity is an important element of the changing culture in Rolls-Royce. The Board fully recognises and embraces the benefits of diversity throughout the Group at both Board and senior management levels as it brings a broader and more rounded perspective to decision making. Increasing diversity is an important element of the changing culture in Rolls-Royce.

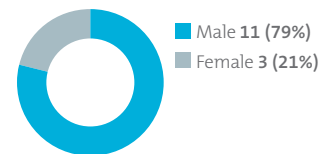
A diverse workforce will help ensure our continued success as a global business and contribute towards a better future. We face challenges in increasing diversity throughout the Group but we are working with our leadership teams, championed by the ELT, to raise awareness and to create a more inclusive workplace.

We have seen increased levels of diversity in both our early career and high potential pool and, as I detailed in my introduction on page 12, graduate intake for women has increased.

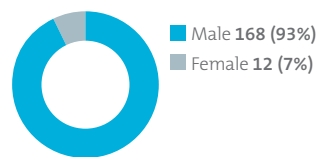
#### EMPLOYEE HEADCOUNT BY GENDER



#### BOARD MEMBERS BY GENDER



#### SENIOR MANAGERS BY GENDER



With the appointment of Ruth Cairnie, the proportion of female Non-Executive Directors exceeds 25% (33%) and in total 21% of the Board are female. Although we have not set a fixed target we are committed to maintaining the current level of women on the Board. We continue to participate in the FTSE 100 Cross-Company Mentoring Programme which aims to increase the number of eligible female candidates for UK board positions and we have comprehensive programmes in place to increase the diversity in our talent pipeline.

We will continue to consider candidates for future Board appointments from the widest possible pool and will only engage executive search firms that have signed up to the Voluntary Code of Conduct for Executive Search Firms in relation to gender diversity on corporate boards.

In addition to the work described above, the committee also carried out the following:

- recommended the appointment of a new Senior Independent Director;
- renewed terms of office for Lewis Booth, Sir Frank Chapman and John Neill;
- considered the independence of the Non-Executive Directors;
- considered the schedule of directors' conflicts of interests and recommended that the schedule be approved by the Board;
- considered the proposal for a revised governance framework and recommended to the Board that it should be approved;
- reviewed and revised the Non-Executive Directors induction programme; and
- reviewed its own terms of reference.

# SAFETY AND ETHICS COMMITTEE REPORT



During the year, it was agreed that the Group's Safety and Ethics Committees would be combined with effect from 1 January 2015 and, to that end, I assumed the chairmanship of both committees, taking over from Iain Conn as Chairman of the Ethics Committee in May 2014. I would like to express my thanks to Iain Conn for his support.

### COMMITTEE MEMBERS AND ATTENDANCE

The combined committee comprises four Non-Executive Directors, Sir Frank Chapman (Chairman), Dame Helen Alexander, Lee Hsien Yang and John McAdam, and will meet at least four times a year.

Working with the other members over the course of the year, I have very much valued the way they apply their personal experience and am convinced that we have the right combination of skills for securing rigorous independent review of our safety and ethics practices.

Responsibilities
• maintaining an understanding of, and keeping under review, the Group's frameworks for the effective governance of safety and ethics
• overseeing and reviewing annually safety and ethics policies
• reviewing progress reports on implementation of annual plans and programmes
• reviewing compliance with relevant legislation and regulation in relation to safety and ethics and the environment
• reviewing key performance indicators in relation to safety and ethics
• ensuring appropriate training is provided for all employees in relation to safety and ethics

The new terms of reference for the combined committee are available on the Group's website.

The role of the committee is to assist the Board in fulfilling its oversight responsibilities in respect of all aspects of safety and ethics as detailed in the following sections.

The attendance at the separate Safety and Ethics Committee meetings during the year is shown below:

### SAFETY

Members	Attendance in 2014
Sir Frank Chapman (Chairman)	2/2
Iain Conn (retired 1 May 2014)	n/a
Lee Hsien Yang	2/2
John McAdam	1/2

### ETHICS

Members	Attendance in 2014
Sir Frank Chapman (Chairman)	2/2
Dame Helen Alexander	3/3
Lewis Booth CBE	3/3
Iain Conn* (retired 1 May 2014)	1/1
Lee Hsien Yang	2/3
Jasmin Staiblin	3/3

\* Committee Chairman until 1 May 2014

### SAFETY

#### PRODUCT SAFETY

Our Aerospace and Land & Sea Divisions supply high-value products that people's lives depend upon. These products have to meet our own internal standards and strict regulatory requirements with regards to safety. The Product Safety policy describes five principles that govern our approach: leadership commitment and accountability; level of product safety; maintaining and improving product safety; conforming product; and, safety awareness and competence. The safety management system (SMS) links these to our operational processes. An overview of the key elements is shown below and this provides a framework for our product safety governance work.

### SAFETY MANAGEMENT SYSTEM (SMS) OVERVIEW

<b>COMPANY OBJECTIVE</b>			
Provide products and services that meet or exceed regulatory requirements, achieving the high standard of safety we require and our customers expect. Continuously pursue opportunities to improve the safety of our products.			
<b>STRATEGIES – PRODUCT SAFETY POLICY PRINCIPLES</b>			
Clear leadership and management accountabilities and commitment.			
Continuously improve product safety in design.			
Raise the level of product safety by setting higher standards, correcting issues and learning from experience.			
Improve product quality to support product safety.			
Safety awareness and competence for all our people.			
<b>KEY ENABLERS</b>			
<b>CAPABILITY</b> Competence and capacity	<b>ROLLS-ROYCE MANAGEMENT SYSTEM</b> High consequence group processes	<b>METHODS AND STANDARDS</b> Rolls-Royce specific and external	<b>ORGANISATIONAL STRUCTURES</b> Product Safety Boards Quality Boards Process Councils

The Safety Committee conducted a thorough review of our product safety approach during 2014 including receiving detailed briefings on the SMS and the safety assurance framework. In part the objective was to make sure all committee members are fully familiar with our process framework. Also we used this 'walk through' as an opportunity for management to ensure that the processes can be readily understood and communicated, and for sharing our experience of similar processes from companies we have worked with. This detailed review will continue during 2015.

In respect of the policy of continuous improvement, the committee reviewed progress with a significant product safety programme aimed at improvements to our parts classification process. In addition we extended the committee's understanding of product safety risks outside of the Aerospace activities, focusing on Marine activities. We kept under review the product safety metrics emanating from management's safety boards and management's response to significant product safety events. Important highlights were brought to the attention of the Board.

#### HEALTH, SAFETY AND ENVIRONMENT

The committee received reports on the HS&E risk profile, improvements currently being implemented in the HS&E management system, periodic performance trends and a new balanced scorecard together with major incident investigation reports. The committee reviewed the insights from serious chemical incidents which occurred during the year at our Crosspointe and Indianapolis facilities in the US. Common themes were identified from the investigations that were carried out and improvements were identified that will help to strengthen controls across the Group.

We agreed to a rolling agenda of HS&E topics for future discussion and reviewed the Group level HS&E risk profile to assess levels of control and current improvement and assurance priorities and programmes. In 2015, the committee will continue oversight of Group HS&E across the three strategic areas of people and culture, management systems and risk based improvement programmes.

In both areas of product safety and HS&E, we have been very pleased with the open-minded and constructive approach management have exhibited in looking for opportunities to learn from the committee's experience of practice elsewhere. I was pleased to note that the external review of the Board's work highlighted the efforts made by both management and the committee to undertake a rigorous review and to work together to consider any opportunities for strengthening our approach.

The committee discussed HS&E and process safety leadership and culture, and creating the right environment for effective management systems and risk control. We also considered progress with significant programmes, most notably the Group-wide electrical safety enhancement initiative. Further information on HS&E performance can be found in Sustainability on pages 45 to 47.

## GLOBAL CODE OF CONDUCT (GLOBAL CODE)

We reviewed updates on the Global Code roll-out and training programmes. By the end of 2014, 96% of all employees had provided certification in respect of the Global Code. The roll-out of the Global Code in Power Systems commenced in 2014. Whilst we are satisfied with this level of completion, the committee is looking at the reasons behind the outstanding gaps.

The Red Flag Group, a US company that provides consulting and governance training to help companies manage risk, has ranked Rolls-Royce third amongst the FTSE 100 companies that had their code of conduct assessed.



#### Discover more online

[www.rolls-royce.com/sustainability/better\\_business/ethics/](http://www.rolls-royce.com/sustainability/better_business/ethics/)

**A high-performance safety culture with sound and ethical business practices wherever we operate is being embedded in everything that we do.”**

# SAFETY AND ETHICS COMMITTEE REPORT

CONTINUED

## SECURITY

The committee received a briefing on personnel security matters for employees travelling to higher-risk regions and how the Group reviews operational security for those regions. International travellers complete mandatory in-house e-learning courses before travelling to regions where specific security risks have been identified.

## ETHICS

### REGULATORY INVESTIGATIONS

We reported last year that the Serious Fraud Office (SFO) had begun a formal investigation. The committee received regular updates on the regulatory investigations. The Group is continuing to cooperate fully with the authorities in the UK, US and elsewhere. As the investigation is still ongoing we are unable to give any further details or a timescale when the investigation will conclude.

### LORD GOLD'S REVIEW

The Group has continued to implement the recommendations made in Lord Gold's interim report in 2013 and has developed an ethics and compliance improvement programme to deliver the recommendations. In December 2014, Lord Gold issued a second interim report and the recommendations made in that report have been accepted by the Company and incorporated into the improvement plan.

During the year, we received updates on this improvement programme and the Group has made good progress. Throughout the year, Lord Gold and the director of risk have held focus groups made up of employees throughout our domestic and international operations to obtain feedback on the Group's ethics and compliance improvement programmes.

### ANTI-BRIBERY AND CORRUPTION POLICIES (ABC)

We reviewed progress made by the ABC compliance team who completed a review of all of the Group's current advisers, reducing the overall number significantly. All advisers must comply with the Group's new adviser policy.

During 2014, the ABC compliance team reviewed, issued and updated a suite of new Group-wide mandated policies including: a new Group ABC policy; advisers; confidential information; gifts and hospitality; and facilitation payments. The majority of the revised ABC policies were issued in 2014 with the balance issued in January 2015. A further ABC training programme will be rolled out to all staff in 2015. The size, structure and skills of the ethics and ABC compliance team were reviewed to ensure that the composition of the team is appropriate for the demands placed upon it.

### ETHICS LINE

We reviewed effectiveness of the Company's 24/7 confidential reporting line 'the Ethics Line' which, since its relaunch last year, has seen calls rise significantly from the 2013 level of 588 to the 2014 level of 850. This is thought to be mainly due to improving awareness and engagement across the Group following the Global Code roll-out and mandatory ethics training. The oversight group,

formed in 2014, review all high-risk cases, analyse the contact trends and provide updates to the committee highlighting any high-risk cases. Where appropriate we share cases with the Audit Committee.

The committee fully recognises the importance of the Board showing leadership around ethical and behavioural standards. We have committed significant board time to the issue during the year and have taken steps to send clear messages, including all directors completing the ethics training course. Lord Gold has regularly discussed his work with both the Board and the committee. As part of the review of the Board's effectiveness, our approach was considered by Independent Audit who recognised the structured and committed approach taken by the Board over the course of the year. We are now turning our attention to working out the most effective way of monitoring policy and process implementation and gauging behaviour and attitudes so that the Board can be confident that the right values and attitudes are being consistently reflected in the way we work.

### CONCLUSION

Safety in Rolls-Royce is given the highest priority for our customers, those affected by the operation of our products, our people and the communities in which we work. Overall, product safety and HS&E performance is improving, but as we strive for continuously improving standards there is still more we can and will do.

The Board has been explicit that improper business conduct will not be tolerated and disciplinary action will be taken against anyone not adhering to the ethics and compliance policies. We are making excellent progress with our ethics programme.

A high-performance safety culture with sound and ethical business practices wherever we operate is being embedded in everything that we do in order to underpin long-term sustainability and to deliver to all stakeholders our brand promise of 'trusted to deliver excellence'.

### SIR FRANK CHAPMAN

Chairman of the Safety and Ethics Committee

# AUDIT COMMITTEE REPORT



I am pleased to present the 2014 report of the Audit Committee.

Our key aim is to review and report to the Board on financial reporting, internal control and internal audit, and to ensure the relationship with the external auditors is open and effective. Our work to deliver this objective during 2014 is summarised later in this report. I would like to thank the members of the committee, the executive management team and KPMG for the open discussions that take place at our meetings and the importance they all attach to its work.

The terms of reference for the committee were reviewed during the year as part of the wider governance review. This has clarified some aspects of the committee's responsibilities, primarily around oversight of risk management. From 2015, we will be working to this revised version, which is available on the Group's website.

## Responsibilities

### Financial reporting

- reviewing the financial results announcements and financial statements and monitoring compliance with relevant regulations
- reviewing the appropriateness of accounting policies and the supporting key judgements and estimates

### Internal control and internal audit

- assessing the scope and effectiveness of the systems to identify, manage and monitor financial and non-financial risks
- reviewing the procedures for detecting, monitoring and managing the risk of fraud
- reviewing the scope, resources, results and effectiveness of internal audit

### External audit

- overseeing the relationship with the external auditor, reviewing the effectiveness of the external audit process and making recommendations to the Board regarding the external auditor's appointment

The Audit Committee consists of Non-Executive Directors and met five times in 2014.

Members	Attendance in 2014
Lewis Booth CBE (Chairman)*	5/5
Iain Conn (retired 1 May 2014)	3/3
Warren East CBE	3/5
John Neill CBE	5/5

\* Lewis Booth has recent and relevant financial experience. His biography is on page 54.

## SECTOR AUDIT COMMITTEES

In support of the committee's work, each of the Group's businesses now has its own sector audit committee. We felt that this would be helpful in building in a level of detailed executive oversight which would strengthen further accountability for the quality of financial reporting and internal control at the divisional and sector level. All the sector committees are chaired by the director of internal audit to introduce a degree of independence from management and to support their effective organisation and operation.

The sector committees meet twice a year to consider the accounting policies, judgements and estimates and the internal control environment of each business. We receive formal reports and discuss the results of these meetings. This gives us further insight into the extent of management control and accountability, broadens our reach within the Group and informs areas for further consideration at our meetings. Over the next year, their focus on internal control and risk management systems will develop further.

## OUR WORK DURING 2014

### FINANCIAL REPORTING

In meeting our responsibilities over the past year, we have devoted a lot of time to discussing accounting policies and judgements and our work and conclusions are discussed in detail below. Coming out of these discussions, we fully recognise the need for the Group to communicate clearly to shareholders and to give them confidence that our accounting policies are sound and subject to thorough review by the committee as well as the auditors and management.

We review financial announcements and financial statements with both management and KPMG. In 2014, we focused on:

- compliance with financial reporting standards and governance reporting requirements;
- the appropriateness of accounting policies, focusing on areas requiring significant judgements;
- the procedures and controls around estimates that are key in applying accounting policies;
- the response of senior executives to their perception of the increased risk relating to the pressure on, and incentives for, management to achieve financial targets;
- whether the Annual Report and Financial Statements, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's position and performance, business model and strategy; and
- any relevant correspondence from regulators.

# AUDIT COMMITTEE REPORT

CONTINUED

We place considerable emphasis on making sure that the accounting policies are appropriate so that the financial statements faithfully represent the results and financial position of the Group and its underlying contractual arrangements. This is particularly so for the Civil aerospace business, where our business model includes a number of unique features.

As described in the business model on page 24, the development of gas turbine engines for use in civil aircraft applications involves large upfront investments, which may be shared with suppliers, and which are expected to be recovered over long periods from the sale of OE; and subsequently from the aftermarket from the sale of spare parts and engine maintenance work. Much of the aftermarket repair and overhaul is provided through long-term service agreements. Given this long exposure, which may extend for decades from the initial concept, the amount of revenue and profit recognised during any period requires a significant number of accounting judgements and estimates. Consequently, one of our primary responsibilities is to ensure that the bases for these judgements and estimates are robust.

As reported last year, we monitored the enquiry from the FRC's Conduct Committee on the accounting for risk and revenue sharing arrangements (RRSAs). I joined management and KPMG in meeting with the Conduct Committee to hear first-hand and to participate in the debate. We considered carefully the Conduct Committee's views and possible alternative approaches. The Audit Committee concurred with management's view that the revised policy adopted in 2013 best reflects the nature of the transactions.

We also monitored an enquiry from the Conduct Committee regarding the accounting for long-term contractual arrangements in Civil aerospace. No adjustments resulted from this. However, the discussions did lead us to conclude that we had been insufficiently clear in explaining how the different ways we do business with our Civil aerospace customers lead to our accounting policies. In response to this and the views of investors, the Group has taken two principal steps. Firstly, an investor day was held in June, at which management explained the different commercial arrangements that apply and how we account for each. Secondly we have made enhancements to this year's Annual Report, primarily:

## ACCOUNTING POLICIES: SIGNIFICANT JUDGEMENTS AND ESTIMATES

Given the long-term nature of the Group's businesses it is inevitable that most of the accounting policies subject to significant accounting judgement will remain the same from year to year, though the facts and circumstances on which those judgements are based will vary. In 2014, our discussions were principally on whether:

Key issue	Activity
<ul style="list-style-type: none"> <li>the key accounting judgements set out on pages 101 to 103 are appropriate.</li> </ul>	The Group finance department presented to the committee the key accounting judgements and the reasons why these judgements had been made. We were satisfied that these are the appropriate key judgements. For 2014, two new areas of judgement were identified. The first related to the disposal of the Energy business — see below. The second related to whether the leaseback of spare engines that the Group has sold to joint ventures should be classified as operating leases (when the profit on sale is recognised immediately) or finance leases (when it is spread over the lease term). We concluded that certain arrangements should be treated as finance leases and, accordingly, the profit has been deferred.
<ul style="list-style-type: none"> <li>there are any indications of impairment of the carrying values of the intangible assets in Civil aerospace.</li> </ul>	We considered the business plans for the relevant engine programmes, including the key assumptions on which they are based, and which support the value in use assessments for the intangible assets. We were satisfied that no impairments were required. For 2014, we focused particularly on the intangible assets related to the Trent 900 programme.
<ul style="list-style-type: none"> <li>the estimates used in accounting for long-term contractual arrangements in Civil aerospace are appropriate.</li> </ul>	We reviewed the forecasts of future contract performance on which the accounting is based. We also considered performance to date against these forecasts and the results of a detailed review of certain aspects of the processes supporting these forecasts. Where the accounting results in a contract asset, we assessed the recoverability of the asset against agreed criteria. We were satisfied that the forecasts have been prepared on an appropriate and consistent basis.
<ul style="list-style-type: none"> <li>the provisions for customer financing liabilities in Civil aerospace are adequate.</li> </ul>	We considered the likelihood of the liabilities crystallising, based on an assessment of customers' fleet plans and their creditworthiness. We also considered the value of any security held, based on third-party valuations. We were satisfied that provisions have been made on an appropriate basis. For 2014, we considered in particular the release of previously established provisions relating to unexpired guarantees under which the Group's obligations are judged to have been terminated.
<ul style="list-style-type: none"> <li>the disposal of the Energy business has been appropriately accounted for.</li> </ul>	We considered the estimates made in determining the amounts of the proceeds deferred in respect of the Group's continuing obligations for transitional commitments to provide future goods and services to Siemens. We were satisfied that the disposal has been accounted for appropriately.
<ul style="list-style-type: none"> <li>the disclosures of contingent liabilities, in particular those in respect of the possible outcome of the SFO enquiries are adequate.</li> </ul>	We considered legal advice in respect of the SFO enquiries. We were satisfied that the disclosures appropriately reflect the current position.



- The description of the Civil aerospace business now emphasises that whenever we sell engines, we secure contractual rights to profitable aftermarket business even where there is no TotalCare agreement. Consequently, the description of the resulting intangible asset previously referred to as 'recoverable engine costs' has been changed to 'contractual aftermarket rights'.
- The accounting policies include a plain English description of the rationale for the accounting we apply and the detailed descriptions have been enhanced (see page 101).

 We place considerable emphasis on making sure that the Group's accounting policies are appropriate."

Following these two enquiries, we instigated a review of all the Group's significant accounting policies as described in note 1 of the Financial Statements and the key judgements and estimates supporting them.

These reviews were undertaken by management and involved analysis of the relevant accounting standards and guidance, comparative analysis with other companies with similar or analogous transactions to the extent available, consideration of the pros and cons of options in the context of achieving the most faithful representation of the transactions in the Group's accounts, and informal discussions with accounting firms other than KPMG. KPMG also provided the committee with its views.

We were satisfied with the results of these reviews, which concluded that the accounting policies adopted by the Group were the most appropriate available and that enhancements and revisions in note 1 should be made to add clarity to the accounting policies and the rationale on which they are based.

Since the year end, we have reviewed the form and content of the Group's 2014 Annual Report together with the production process used to develop and verify the report. We have reported to the Board that, taken as a whole, we consider the Annual Report to be fair, balanced and understandable.

#### INTERNAL CONTROL AND RISK MANAGEMENT

To support the Board in carrying out its review of internal controls and risk management, we reviewed the process by which the Board reaches its conclusion. This involved consideration of the key findings from the ongoing oversight, monitoring and reporting processes, management representations and independent assurance reports.

We are currently assessing how we will develop our approach to meeting the revised Code standards requiring the monitoring of internal control and risk management as an ongoing process as well as evaluating effectiveness at least annually.

From 2015 onwards, as a result of a broad ranging review of our risk governance approach, our overall assessment will combine oversight of the principal risks management activities undertaken by each board committee or the Board (as explained in the Chairman's Introduction on page 56); the Audit Committee will consider financial control and reporting, fraud and IT risks together with an assessment of the integrated control and risk management approach covering all financial and non-financial risks. In this way we aim to make sure that the Board's oversight of risks and risk management is rigorous in its coverage and depth, making sure that principal risks are assessed in detail and that one committee has an integrated review of how the internal control framework is operating.

In line with this, during 2014, we carried out an assessment of financial controls, primarily based on a self-assessment of these controls by each of the businesses. A priority for 2015 is to standardise and, where necessary, enhance the Group's financial internal control framework, against which this assessment is made. This will create greater consistency, particularly in the Group's small operations, and reinforce ownership and accountability for effective internal control throughout the organisation.

We also schedule detailed reviews with the management of each of the Group's businesses and with key functions. The objective of these reviews is to have the opportunity to discuss and challenge key accounting judgements and estimates, and to assess the internal control and risk management systems. They also provide the committee members with the opportunity to meet and evaluate the financial and risk management personnel deeper in the Group.

At our meetings during 2014, we received presentations from:

- The **Civil aerospace** business — we discussed: the key business risks (including possible competitor actions, ensuring profitable delivery of the increased engine volumes, ensuring on-time delivery of new programmes, business continuity risks including supply chain disruption and market shock due to external events or factors reducing air travel); accounting policies; key accounting judgements, estimates and controls; credit risks associated with customers; and, CorporateCare and TotalCare accounting.
- The **Marine** business — we discussed: key challenges for the business (slower than anticipated recovery of the business's markets, cost reduction initiatives, and delivering critical systems changes); key business risks (competitor actions linked with failure to address our own cost base, market shock to which the offshore sector is particularly vulnerable, failure to invest in the right technologies, and failure to maintain customer satisfaction through poor quality or late delivery); the control environment in a widely dispersed business; ERP systems; and key accounting policies and judgements including warranty/reliability issues, with a focus on an emerging product quality issue.
- The **chief information officer** — we discussed: current trends in cyber security including inherent risks and vulnerabilities and the current landscape; the Group's 'defence in depth' approach to cyber security; the Group's recent experience of attacks; and plans

# AUDIT COMMITTEE REPORT

CONTINUED

for the future. The committee asked for KPMG's views on the Group's approach. We agreed that committee members would visit the Group's key cyber-security centre in 2015 to see the approach being applied in practice.

- The **director of tax** — we discussed: the approach to managing the Group's tax affairs; the role of the tax function and its interaction with other areas of finance and external suppliers; key tax risks and how they are managed; the profile of tax payments over the last five years; the effective tax rate; the UK tax position (in particular the impact of R&D expenditure, pension contributions and the timing of tax payments on TotalCare profits); and key tax-related accounting policies and judgements (including accounting for advance corporation tax).

These reviews provide the committee with invaluable insights into the risks facing the Group and the management of them, and the application of key accounting policies, judgements and estimates.

We were also notified of any matters raised through the Group's whistle-blowing arrangements or otherwise that related to financial reporting, the integrity of financial management or fraud. There were no cases of fraud that were significant or that demonstrated weaknesses in internal controls. Additionally we monitor compliance with the Group's policies in respect of expenses incurred by the directors and other senior executives; no significant issues were identified.

## INTERNAL AUDIT

The new director of internal audit has been working closely with the committee in undertaking a full review of our audit structure and approach. This has given us an opportunity to review internal audit's effectiveness. The discussions on his conclusions and suggestions for changes have formed the basis of the committee's review of internal audit effectiveness over the course of 2014.

We are very pleased with the progress that has been made. A number of changes have been made to improve the structure of audit reports and we are satisfied that the approach to reporting to the committee is now working well. A process for mapping risks, controls and assurance is underway and this will help ensure that our audit coverage is sound.

Twice a year, we review detailed updates on significant findings and audit operations. In particular, we review the nature and number of issues raised by internal audit and the time to complete the related actions, which during 2014 we considered to be reasonable. We were pleased to see that the responsiveness of management across all areas of the business to audit findings has improved and we consider that audit findings are being followed through effectively and promptly. Between these six-monthly updates, we review a dashboard which identifies key trends.

I meet the director of internal audit in private before each meeting and on an ad-hoc basis throughout the year, and the committee as a whole has a private meeting with him at least once a year. These discussions cover the activities, findings, resolution of control weaknesses, progress against the agreed plan and the resourcing of the department.

We were satisfied that the scope, extent and effectiveness of internal audit work are appropriate for the Group and that the director of internal audit has a sound plan for ensuring that this continues to be the case as our business progresses and the risks we face change.

## EXTERNAL AUDITOR

The audit cycle is continuous. In April, following the completion of the 2013 audit, the lead audit partner presented the audit strategy for 2014, identifying KPMG's assessment of the key audit risks and the proposed scope of audit work. In addition to those described in the auditor's report (pages 154 to 159), these risks were: valuation of derivatives; accounting for RRSAs; warranties and guarantees; valuation of derivative financial instruments; valuation of pension liabilities; recoverability of tax assets and adequacy of tax provisions; litigation and claims; and the form and content of the Annual Report.

As part of the reporting of the half and full-year results, in July 2014 and February 2015, KPMG reported to the committee on their assessment of the Group's judgements and estimates in respect of these risks and the adequacy of the reporting.

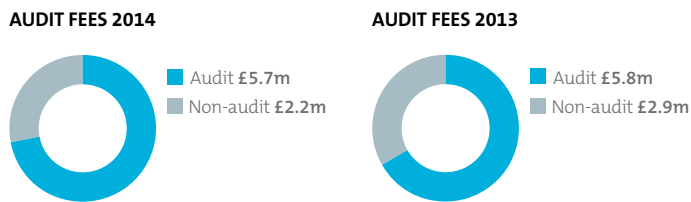
The 2013 Annual Report included, for the first time, an extended auditor's report under new auditing standards. We agreed to assist KPMG in their trialling of a report that went beyond the minimum requirements. We were pleased to note the positive comment that this report generated and have agreed to continue with this approach.

I meet the lead audit partner before each meeting and the whole committee meets with KPMG in private at least once a year. In 2014, I met senior members of the KPMG team to discuss key accounting policies, judgements and estimates in depth and, upon his appointment to the committee, Warren East was briefed by KPMG. In addition, I met with a small group of KPMG's senior partners to discuss emerging and leading audit committee practices in comparable UK listed companies as well as other topical matters.

## NON-AUDIT SERVICES PROVIDED BY KPMG

In order to safeguard auditors' independence and objectivity, we do not engage KPMG for any non-audit services except where it is work that they must, or are clearly best suited to, perform. Fees paid to KPMG for audit, audit related and other services are set out in note 8 to the Financial Statements.

All proposed services must be pre-approved in accordance with an agreed policy which is approved annually. We also review the non-audit fees charged by KPMG quarterly.



Non-audit related fees paid to KPMG during the year were 39% of the audit fee, principally in respect of assurance work requested by Siemens in respect of the disposal of the Energy business, grant claims and tax compliance. The nature and level of all services provided by the external auditor is a factor taken into account by the Audit Committee in its annual review of the external auditor.

As described in last year's Annual Report, we took the decision to allow Power Systems to complete engagements already in progress. Non-audit related services provided to Power Systems in 2014 amounted to £0.9 million, a reduction of 57% compared to 2013.

Based on our review of the services provided by KPMG and discussion with the lead audit partner we concluded that neither the nature nor the scale of these services gave any concerns regarding the objectivity or independence of KPMG.

#### RE-APPOINTMENT OF AUDITOR AND AUDIT TENDERING

Following the completion of the audit, we reviewed the effectiveness and performance of KPMG with feedback from committee members, senior finance personnel and internal audit. A wide range of factors were considered including: independence and objectivity; business understanding; technical knowledge; quality, continuity and experience of the audit personnel, in particular the lead audit partner; responsiveness; planning and risk identification; working with management; the quality of reporting to, and discussions with, the committee; cost effectiveness; and the quality of the report to shareholders. We also considered the reports on KPMG by the FRC's audit quality review team. The audit of Rolls-Royce was not subject to their review in 2014. We also reviewed the fees of the external auditor.

Our conclusions were that the external audit was carried out effectively, efficiently and with the necessary objectivity and independence. The committee and the Board have recommended their re-appointment at the 2015 AGM.

KPMG were appointed as auditors in 1990 and this appointment has not been subject to a tender process since that date. No contractual obligations restrict our choice of external auditors. The lead audit partner is required to rotate every five years and other key audit partners are required to rotate every seven years. Jimmy Daboo took over as lead audit partner in 2013.

The new EU Directive requires that audits be tendered at least every ten years and that an incumbent auditor can only be re-appointed once. Under the transitional arrangements, we will be required to appoint a different auditor no later than the audit of the 2020 financial statements.

The Group is a complex and technologically advanced business with a long cycle from the development of an engine to its eventual retirement. We believe that KPMG's knowledge of this, built up over a number of years, enhances the effectiveness of the audit and that the existing professional requirements, such as the rotation of audit personnel, maintain independence.

In accordance with the requirements of the EU Directive, we plan to recommend a tender of the audit during the tenure of the current lead partner which, subject to KPMG's annual re-appointment, would end following the 2017 audit. Before we make such a recommendation, we will satisfy ourselves that: (i) it will not be unnecessarily disruptive, taking account of any other activities; and (ii) appropriate plans are in place to ensure audit effectiveness is maintained. We do not propose to tender the audit in 2015.

#### LOOKING FORWARD

The work of an audit committee is increasingly broad and complex. We are very conscious of the need to keep on top of developments in financial accounting and reporting and to stay alert to regulatory changes around external audit. There is also considerable change in our responsibilities to make sure that the internal control framework is working well and to give the Board confidence that the business is under control and risks are appropriately mitigated.

The external review undertaken in 2014 gave particular attention to the committee's work and how, as a Board and committee, we are approaching internal control and risk management. This risk governance assessment, along with the wider governance review conducted by the Board, has helped me consider how we will develop further the committee's work.

The reviews have highlighted areas where oversight and risk management need more structured review by the committee so that we receive an integrated picture of the effectiveness of the control framework in addition to our usual active oversight of financial controls. As described in this report, we have made good progress during the course of this year, very ably and actively supported by the management team. I look forward to seeing that progress continue with the implementation of the new risk management framework and other initiatives during 2015.

#### LEWIS BOOTH CBE

Chairman of the Audit Committee

# REMUNERATION COMMITTEE REPORT



On behalf of the Board, I am pleased to present our Directors' Remuneration Report for 2014.

## THE WORK OF THE COMMITTEE

During the year, the committee continued to perform its responsibilities and, in particular, we kept under review the performance against incentive plans and the appropriateness of metrics. On a longer-term basis, the committee initiated a review of the Group's remuneration principles to ensure that they remain aligned with our strategic objectives. A project is now underway to develop an integrated reward strategy which also aligns with our overall people strategy.

During 2014, the committee:

- endorsed the out-turn of the 2013 annual bonus and 2011 PSP;
- established new rules for the PSP, including malus and clawback provisions;
- considered the requirements of the new remuneration reporting regulations in formulating the remuneration report and recommended the approval of the 2013 report to the Board;
- reviewed Executive Directors' base salary levels;
- established new minimum shareholding requirements for Executive Directors;
- set 2014 annual bonus targets and performance targets for the PSP 2014 – 2016;
- considered a benchmarking report on executive benefits;
- considered a benchmarking report for the executive salary review in 2015;
- approved mid-year PSP grants to certain senior executives;
- considered the projected out-turns for the 2014 annual bonus, All Employee Bonus Scheme and the 2012 PSP;
- agreed termination terms for the former Chief Financial Officer;
- agreed the remuneration terms for David Smith who was appointed as Chief Financial Officer;
- reviewed our terms of reference;
- reviewed our reward principles;
- considered provisional targets for 2015; and
- considered the structure of the annual bonus for 2015.

I am confident that we have covered our responsibilities effectively.

 Our remuneration policy is aligned with our strategy to generate the funds we need to invest in future growth."

As part of the 2014 board review, the effectiveness of the committee was considered by the external reviewers, Independent Audit. I was pleased to note its view that the make-up of the committee is sound, with members bringing a good knowledge of remuneration issues and all making an informed contribution. Our processes ensure the right issues are considered in a timely way and with robust discussion. Suggestions were put forward to strengthen further the way management works with the committee and we will follow through on these in 2015.

## COMMITTEE MEMBERS, ATTENDANCE AND RESPONSIBILITIES

The Remuneration Committee comprises four independent Non-Executive Directors and met five times in 2014.

Members	Attendance in 2014
Dame Helen Alexander	5/5
Ruth Cairnie (appointed 1 September 2014)	3/3
Sir Frank Chapman	5/5
John McAdam	5/5

The Chairman, the Chief Executive, the Group HR Director, the HR director reward and pensions, the Company Secretary and the Chief Financial Officer were invited to attend meetings. None of them was present during any discussion of their own remuneration packages.

When considering remuneration for our senior executives, the Remuneration Committee has used the policy framework approved by shareholders at the AGM in May 2014.

Our remuneration policy aligns the interests of our directors and senior executives with that of our shareholders by linking incentives to the performance of the business on both short and long-term measures. Our performance was not as strong as targeted during 2014 and therefore we will not be making an annual bonus payment as a result.

The Performance Share Plan (PSP), granted in 2012, was measured over a three-year performance period that ended at the end of 2014. The three measures for performance, earnings per share (EPS), cash flow per share (CPS) and total shareholder return (TSR) have exceeded the base threshold which has resulted in the 2012 grant vesting in March 2015, but at a lower level than in previous years.

We continue to believe our incentive programmes support our business strategy. Our short-term incentive is based on cash and profit, which are key objectives; it is also linked to personal performance which includes longer-term strategic objectives. Our long-term incentive is primarily based on cash flow per share which continues to be critical for our growth and success. Part of the annual bonus is deferred into shares and executives have an ongoing shareholding requirement which aligns them to the interests of shareholders.

#### Responsibilities

- considering and making recommendations to the Board on the strategy and policy for the remuneration of the Executive Directors, the Chairman and members of the ELT
- determining the design, conditions and coverage of annual and long-term incentive plans for senior executives and approving total and individual payments under the plans
- determining targets for any performance-related pay plans
- determining the issue and terms of all share-based plans available to all employees
- determining compensation (if any) in the event of termination of service contracts of Executive Directors or ELT members

#### ANNUAL BONUS OUTCOME

Group underlying profit and cash flow were below the base level targets of performance set by the Remuneration Committee and therefore there will be no bonus paid for 2014.

#### PSP OUTCOME

Over the three-year performance period for the 2012 PSP grant, earnings per share growth was 16%, which exceeded the OECD index of consumer prices of 5%, and cash flow per share was 63p. This resulted in 49% of the shares conditionally granted being released. The Company's total shareholder return (TSR) performance was 39th in the FTSE 100 over the three-year performance period which resulted in a 37% increase in the shares released to Executive Directors.

#### 2015 SALARY REVIEW

The committee has reviewed the salary levels of the Executive Directors in accordance with our approved remuneration policy. The Executive Directors did not receive an increase in 2014 and again in 2015 John Rishton and James Guyette will not receive a salary increase. Colin Smith and David Smith will receive salary increases based on their individual business circumstances and their positioning within the external market range. The details of the increases are on page 77.

#### LOSS OF OFFICE PAYMENTS

The committee gave careful consideration to remuneration matters relating to the departure of Mark Morris, the former Chief Financial Officer, in accordance with the remuneration policy agreed by the Board and approved by shareholders at the 2014 AGM. The details of the payments are on page 80.

Overall, our remuneration policy is aligned with our strategy to generate the funds we need to invest in future growth. Our overarching aim is to ensure the long-term health of the Company. Therefore we need to ensure and continually monitor that our incentives are market-competitive and are designed to attract, retain and develop the best talent which will drive long-term value and future business success.

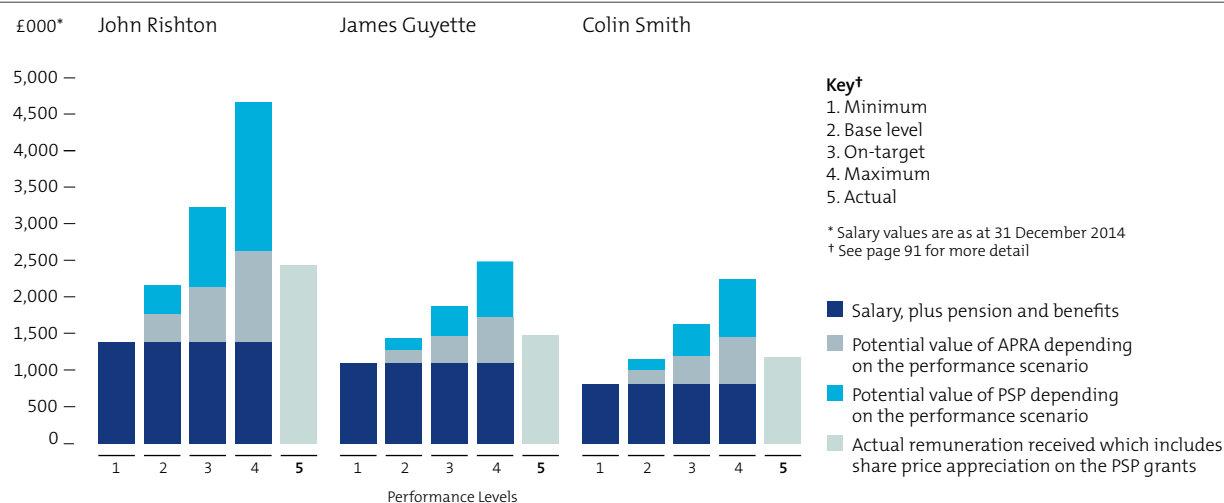
#### DAME HELEN ALEXANDER

Chairman of the Remuneration Committee

# DIRECTORS' REMUNERATION REPORT

This section gives information on directors' remuneration and incentive out-turns, and details how the remuneration policy, set out on pages 86 to 92, will be applied in 2015.

The bar chart below shows the total remuneration received for current Executive Directors, except David Smith who was only appointed on 4 November 2014.



## SINGLE FIGURE OF REMUNERATION (SUBJECT TO AUDIT)

	Salary/fees (a) £000		Benefits (b) £000		Bonus (c) £000		LTIP (d) £000		Other (e) £000		Sub-total £000		Pension (f) £000		Total £000	
	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013
<b>Executive Directors</b>																
John Rishton	925	921	151	125	–	824	1,007	3,478	–	–	2,083	5,348	303	303	2,386	5,651
James Guyette	510	535	108	114	–	423	373	1,256	–	–	991	2,328	462	532	1,453	2,860
Mark Morris <sup>1</sup>	429	506	149	159	–	383	–	318	–	6	578	1,372	137	162	715	1,534
Colin Smith CBE	525	523	138	128	–	394	364	1,140	–	–	1,027	2,185	131	531	1,158	2,716
David Smith <sup>2</sup>	84	–	2	–	–	–	–	–	–	–	86	–	27	–	113	–
<b>Sub-total</b>	<b>2,473</b>	<b>2,485</b>	<b>548</b>	<b>526</b>	<b>–</b>	<b>2,024</b>	<b>1,744</b>	<b>6,192</b>	<b>–</b>	<b>6</b>	<b>4,765</b>	<b>11,233</b>	<b>1,060</b>	<b>1,528</b>	<b>5,825</b>	<b>12,761</b>
<b>Chairman and Non-Executive Directors</b>																
Ian Davis <sup>3</sup>	425	292	3	2	–	–	–	–	–	–	428	294	–	–	428	294
Dame Helen Alexander	85	75	1	–	–	–	–	–	–	–	86	75	–	–	86	75
Lewis Booth CBE	100	80	6	10	–	–	–	–	–	–	106	90	–	–	106	90
Ruth Cairnie <sup>4</sup>	23	–	–	–	–	–	–	–	–	–	23	–	–	–	23	–
Sir Frank Chapman	85	75	3	3	–	–	–	–	–	–	88	78	–	–	88	78
Iain Conn <sup>5</sup>	29	82	–	–	–	–	–	–	–	–	29	82	–	–	29	82
Warren East CBE <sup>6</sup>	67	–	–	–	–	–	–	–	–	–	67	–	–	–	67	–
Lee Hsien Yang <sup>7</sup>	67	–	2	–	–	–	–	–	–	–	69	–	–	–	69	–
John McAdam	67	60	–	–	–	–	–	–	–	–	67	60	–	–	67	60
John Neill CBE	67	60	2	2	–	–	–	–	–	–	69	62	–	–	69	62
Jasmin Staiblin	67	60	1	2	–	–	–	–	–	–	68	62	–	–	68	62
<b>Sub-total</b>	<b>1,082</b>	<b>784</b>	<b>18</b>	<b>19</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>1,100</b>	<b>803</b>	<b>–</b>	<b>–</b>	<b>1,100</b>	<b>803</b>
<b>Total</b>	<b>3,555</b>	<b>3,269</b>	<b>566</b>	<b>545</b>	<b>–</b>	<b>2,024</b>	<b>1,744</b>	<b>6,192</b>	<b>–</b>	<b>6</b>	<b>5,865</b>	<b>12,036</b>	<b>1,060</b>	<b>1,528</b>	<b>6,925</b>	<b>13,564</b>

<sup>1</sup> Mark Morris left the Company on 4 November 2014.

<sup>2</sup> David Smith was appointed as an Executive Director on 4 November 2014.

<sup>3</sup> Ian Davis was appointed Chairman on 2 May 2013.

<sup>4</sup> Ruth Cairnie was appointed as a Non-Executive Director on 1 September 2014.

<sup>5</sup> Iain Conn retired as a Non-Executive Director on 1 May 2014.

<sup>6</sup> Warren East CBE was appointed as a Non-Executive Director on 1 January 2014.

<sup>7</sup> Lee Hsien Yang was appointed as a Non-Executive Director on 1 January 2014.

**Notes to the table**

- (a) Salary/fees – cash paid in the year. James Guyette was paid in US dollars translated at £1 = US\$1.6477 (2013 US\$1.565).  
 (b) Benefits – taxable value of all benefits paid in the year. The benefits for the Non-Executive Directors relate to travel and subsistence associated with attending board meetings.

	John Rishton £000		James Guyette £000		Mark Morris £000		Colin Smith CBE £000		David Smith £000	
	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013
Benefits										
Car or car allowance including fuel allowance	21	18	11	11	21	24	24	21	2	–
Chauffeur services	14	13	–	–	–	–	–	–	–	–
Financial planning	5	–	18	19	5	–	5	–	–	–
Medical insurance	2	1	7	7	1	1	2	1	–	–
Life assurance	–	–	33	38	–	–	–	–	–	–
Club membership fees	–	–	24	23	–	–	–	–	–	–
Travel and subsistence	3	–	–	–	23	30	3	3	–	–
Housing costs	106	93	15	16	99	104	104	103	–	–
<b>Total</b>	<b>151</b>	<b>125</b>	<b>108</b>	<b>114</b>	<b>149</b>	<b>159</b>	<b>138</b>	<b>128</b>	<b>2</b>	<b>–</b>

- (c) Bonus. Group profit and cash performance were below the base level targets set by the committee and therefore no bonus was awarded for 2014.  
 (d) Long-term incentive plan (LTIP). This is the estimated value of the PSP shares that are due to vest in March 2015 (2014 being the final year of the performance period) and for John Rishton, as well as his PSP shares, the performance related shares he received on joining the Company. It is based on the number of shares that will vest multiplied by the average share price of 863.65p over the quarter ending 31 December 2014 (as the vesting price is not known at the date of approval of the Directors' Remuneration Report). The performance against targets for 2014 has been determined for these awards as detailed on page 79 and 67% of the original award, which includes the TSR kicker, will vest. The LTIP amounts for 2013 relating to shares that vested in 2014 have been recalculated using the vesting price of 1015.81p per share. The original calculation used a share price of 1184.52p per share, as the vesting price was not known at the time.  
 (e) Value of the gain made on the exercise of ShareSave options is the difference between the exercise price of 387p and the mid-market price of 1062p on the date of exercise relating to the ShareSave option exercised in 2013.  
 (f) Pensions. For defined benefit plans, this is the increase in pension benefit net of inflation for the current year and applying the HMRC methodology multiplier of 20. Cash in lieu of pension accrual is also included. David Smith opted not to join the UK defined contribution pension scheme and receives a cash allowance. The pension figure shown in the single figure table is his benefits accrued from 4 November 2014.

**BASE SALARY**

The committee has reviewed the salary levels of Executive Directors and the result of the review is shown below. Executive Directors did not receive an increase in 2014 and there will be no increase to the salaries for John Rishton and James Guyette in 2015. David Smith's increase reflects that his salary on appointment was positioned to allow scope for progression in the role. The increase for Colin Smith reflects the importance of the role to the business, along with the current modest positioning compared to the external market range.

Name	Base salary as at 1 March 2015	Base salary as at 1 March 2014	Base salary as at 1 March 2013
John Rishton	£925,000	£925,000	£925,000
James Guyette	\$840,000	\$840,000	\$840,000
Colin Smith CBE	£550,000	£525,000	£525,000
David Smith*	£540,000	£510,000	n/a

\* David Smith's salary level was set at the date of his appointment on 4 November 2014.

**ANNUAL BONUS**

The annual bonus pool is delivered under the Annual Performance Related Award plan (APRA) and in 2014, Executive Directors were eligible for award levels detailed in the remuneration policy.

**APRA 2014 PERFORMANCE MEASURES**

The APRA bonus is determined by Group financial performance and personal performance and for 2014, the Group financial measures were cash flow performance and profit. Levels for both measures were set as follows:

	Profit element %	Cash element %	% of maximum bonus
Base	15	15	30
Target	30	30	60
Maximum	50	50	100

The Group financial performance is the addition of the cash and profit out-turns, provided a specified minimum level is achieved on both, after deduction of the cost of bonus from profit, otherwise no bonus is payable.

# DIRECTORS' REMUNERATION REPORT

CONTINUED

The 2014 financial performance resulted in no APRA bonus out-turn:

Group underlying profit	Group underlying profit* was £1,649 million which was below the base level of £1,800 million and therefore no bonus was payable for 2014.
Cash flow	Cash flow* for the year was an outflow of £232 million which was below the hurdle of zero inflow/outflow which was required to activate any bonus payments.
Overall award	No bonus is payable for 2014.

\* Group underlying profit and cash flow, after deduction of the cost of bonus, and excludes the impact of acquisitions and disposals in the year and unbudgeted foreign exchange translation effects where material.

The extent of this disclosure reflects the Board's view that APRA profit and cash targets are commercially sensitive and this will be kept under review.

## DEFERRED APRA AWARDS IN MARCH 2014 (SUBJECT TO AUDIT)

Executive Directors receive 40% of any annual bonus in deferred shares. For 2013 APRA, the following deferred share awards were made in March 2014. Ordinary shares held as deferred shares may receive a bonus issue of C Shares during the deferral period.

Name	Number of shares	Face value £000	Vesting date
John Rishton	33,490	330	03/03/2016
James Guyette	16,307	161	03/03/2016
Mark Morris*	15,543	153	n/a
Colin Smith CBE	16,000	158	03/03/2016

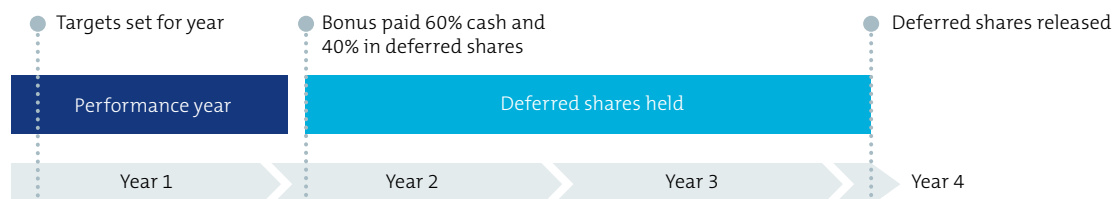
\* Mark Morris forfeited the above award when he left the Company.

## APRA 2015

The committee has determined that the bonus in respect of 2015 will be operated on similar terms to 2014. There will be no change to the maximum bonus opportunities for Executive Directors.

## APRA TIMELINE

The chart below provides an illustration of the annual bonus resulting from performance in year 1. This is usually delivered in March of year 2, partially in cash and partially in deferred shares. The deferred shares are held in trust for two years and are then released in March of year 4, subject to the recipient being still employed by the Group. Malus and clawback provisions apply.



## PERFORMANCE SHARE PLAN (PSP) TIMELINE

The chart below provides an illustration of PSP awards, which are conditional share awards, entitling senior executives to a number of shares determined by reference to corporate performance over a three-year performance period. PSP awards are usually made in March of year 1 and released in March of year 4, subject to the performance criteria being met. Malus and clawback provisions apply.



\* For details of the share retention policy, see page 82.



**LONG-TERM INCENTIVES – PSP**

The PSP is designed to reward and incentivise selected senior executives who can influence the long-term performance of the Group.

**PSP 2014 AWARD TARGETS (SUBJECT TO AUDIT)**

The targets were as follows and straight line vesting will apply between these points.

Aggregate cash flow per share (CPS) over the three-year period	% of maximum award released
Less than 125p	0%
125p	30%
155p	100%

**PSP AWARDS MADE IN MARCH 2014**

In 2014, Executive Directors received PSP grants in line with the remuneration policy as follows:

	Number of shares awarded	% of salary	Face value (at maximum vesting) £000	Minimum % vesting (as a % of maximum)	Performance period end date
John Rishton	112,768	120	1,665	20	31/12/2016
James Guyette	51,770	100	764	20	31/12/2016
Mark Morris*	51,812	100	765	20	n/a
Colin Smith CBE	53,336	100	788	20	31/12/2016

\* Mark Morris forfeited the above award when he left the Company on 4 November 2014.

All awards are made as performance shares based on a percentage of salary and the value is divided by the average share price over a three-day period which was 984.33p before to the date of grant. The face value is the maximum number of shares that would vest (150% of the award) multiplied by the share price at the date of grant. If the EPS or base CPS targets are not achieved, no shares vest.

**PSP AWARDS VESTING IN MARCH 2015**

The following sets out details in respect of the March 2012 PSP award, for which the final year of performance was the 2014 financial year.

	Targets for 2012 – 2014 period	Performance against targets
EPS growth (hurdle)	Awards may vest if EPS growth exceeds the OECD index of consumer prices. Awards will lapse if hurdle not met.	EPS growth of 16% over the three-year period exceeded the hurdle which was 5%.
Aggregate CPS (100% of award)	Aggregate CPS over three-year period of less than 56p – zero vesting. Aggregate CPS over three-year period of 56p – 30% vesting. Aggregate CPS over three-year period of 83p – 100% vesting. Straight-line vesting between these points.	Aggregate CPS performance over three years of 63p. 49% vesting.
TSR performance (multiplier of up to 50%)	TSR below median of FTSE 100 – no additional vesting. TSR above median of FTSE 100 – 25% increase. TSR at upper quartile of FTSE 100 – 50% increase. Straight-line basis between these points.	TSR performance was 39th best amongst the FTSE 100. 37% increase.
Total		67% of shares will vest during March 2015.

**PSP AWARDS TO BE MADE IN MARCH 2015**

The performance targets in respect of the 2015 to 2017 performance period under the aggregate CPS measure will be as follows:

Aggregate CPS over the three-year period	% of maximum award released
Less than 60p	0%
60p	30%
100p	100%

CPS is calculated as reported cash flow before the cost of business acquisitions or proceeds of disposals, foreign exchange translation effects, special payments into pension schemes and payments to shareholders, divided by the weighted average number of shares in issue. CPS is cumulative over a three-year period.

# DIRECTORS' REMUNERATION REPORT

CONTINUED

We believe that the combination of EPS, CPS and TSR targets are challenging and that the performance necessary to achieve awards towards the upper end of the range is stretching. They should not, therefore, be interpreted as providing guidance on the Group's performance over the relevant period.

## EXECUTIVE DIRECTORS' SERVICE CONTRACTS

The table below summarises the notice periods contained in the Executive Directors' service contracts.

	Date of contract	Notice period Company	Notice period individual
John Rishton	10 Mar 2011	12 months	6 months
James Guyette	29 Sep 1997	30 days	30 days
Colin Smith CBE	1 July 2005	12 months	6 months
David Smith	19 Nov 2014	12 months	6 months

## NON-EXECUTIVE DIRECTORS' LETTERS OF APPOINTMENT

The Chairman and Non-Executive Directors have letters of appointment rather than service contracts.

	Appointment date	Current letter of appointment end date
Ian Davis	1 Mar 2013	29 Feb 2016
Dame Helen Alexander	1 Sep 2007	31 Aug 2016
Lewis Booth CBE	25 May 2011	24 May 2017
Ruth Cairnie	1 Sep 2014	31 Aug 2017
Sir Frank Chapman	10 Nov 2011	9 Nov 2017
Warren East CBE	1 Jan 2014	31 Dec 2016
Lee Hsien Yang	1 Jan 2014	31 Dec 2016
John McAdam	19 Jan 2008	18 Feb 2017
John Neill CBE	13 Nov 2008	12 Nov 2015
Jasmin Staiblin	21 May 2012	20 May 2015

## PAYMENTS TO PAST DIRECTORS (NOT SUBJECT TO AUDIT)

Dr Mike Howse retired from the Board on 30 June 2005. Following his retirement, he has continued to be retained by the Company for his expertise in engineering and was paid £27,720 in 2014 (2013 £23,310).

## LOSS OF OFFICE PAYMENTS (SUBJECT TO AUDIT)

Mark Morris left the Company on 4 November 2014. It was agreed to pay him 12 months' salary and benefits, in equal monthly payments, in lieu of his notice period totalling £717,150 gross (base salary £510,000 and benefits comprising a cash payment in respect of pension of £163,200 and other benefits of £43,950 which included: car and fuel allowance, tax planning, medical and life insurance) and a payment for unused leave of £15,632. The total paid to him after leaving the Company up to 31 December 2014 was £133,443 which includes the unused leave payment. The contractual payments were made in accordance with his service agreement. He received his 2013 APRA deferred shares of 18,591 shares in accordance with the rules of the plan. His 2014 APRA deferred shares and his ShareSave option lapsed, and he forfeited his PSP awards. He was offered up to £48,000, including VAT, in respect of career transition support which the Company will pay. No further payments were made to Mark Morris in respect of his loss of office. If he commences alternative employment within 12 months following his departure, the committee will consider reducing the amount due to be paid.

## EXTERNAL DIRECTORSHIPS

The directors retained the payments detailed below from serving on the boards of these companies:

	Directorships held	Payments received £000
John Rishton <sup>1</sup>	Unilever PLC and Unilever N.V.	86
James Guyette <sup>2,3</sup>	PrivateBancorp Inc. and priceline.com	135
David Smith	Motability Operations Group plc	43

<sup>1</sup> John Rishton's fee was partly paid in euros translated at £1 = EUR 1.24.

<sup>2</sup> James Guyette received 1,881 Restricted Stock Units (RSUs) at US\$26.59 per share in PrivateBank and 187 RSUs at US\$1,338.24 per share in priceline.com, in addition to his annual fees.

<sup>3</sup> James Guyette was paid in US dollars translated at £1=US\$1.6477.

**NON-EXECUTIVE DIRECTORS' FEES PAID**

The Chairman and Non-Executive Directors are not eligible to participate in any of the Group's share schemes, incentive arrangements or pension schemes. A facility is in place which enables Non-Executive Directors to use some or all of their fees, after the appropriate statutory deductions, to make market purchases of shares in the Company on a monthly basis. The base fees were increased with effect from 1 May 2014 following shareholder approval.

**NON-EXECUTIVE DIRECTORS' BASE FEES**

	2014 £000	2013 £000
Chairman	425	425
Other Non-Executive Directors	70	60
Chairman of Audit Committee	25	20
Chairman of Safety and Ethics Committee	20	15
Chairman of Remuneration Committee	20	15
Senior Independent Director	15	12

The Chairman of the Science and Technology Committee will be paid £20,000 with effect from 1 January 2015.

**PENSION ENTITLEMENTS (SUBJECT TO AUDIT)**

The Group's UK pension schemes are funded, registered schemes and were approved under the regime applying until 6 April 2006. They include both defined contribution and defined benefit schemes. Normal retirement age for the defined benefit schemes is 62.

John Rishton is a member of one of the Group's UK defined contribution pension schemes and received employer contributions restricted to the annual allowance limits with any excess paid as a cash allowance. The cash allowance is calculated as equivalent to the cost of the pension contributions allowing for National Insurance costs.

Mark Morris, who left the Company on 4 November 2014, had opted out of future pension accrual with effect from 16 August 2012 and received a cash allowance in lieu of future pension accrual.

Colin Smith CBE opted out of future pension accrual with effect from 1 April 2006 and receives a cash allowance in lieu of future pension accrual.

David Smith receives a cash allowance in lieu of a defined contribution pension.

James Guyette participates in pension plans sponsored by Rolls-Royce North America Inc. He is a member of two defined benefit plans in the US, one qualified and one non-qualified. He accrues a retirement lump sum benefit in both of these plans. In addition, James Guyette is a member of two 401(k) Savings Plans in the US, one qualified and one non-qualified, to which both he and his employer, Rolls-Royce North America Inc., contribute. He is also a member of an unfunded non-qualified deferred compensation plan in the US, to which his employer makes notional contributions. Under the defined benefit plans, 65 was the earliest age at which benefits could have been taken without consent and without actuarial reduction.

Details of the defined benefits of the Executive Directors as at 31 December 2014, in the Group's UK and US pensions schemes are given below:

	Total accrued annual pension entitlement at 31 December 2014 £000
Mark Morris*	172
Colin Smith	393

\* The accrued pension for Mark Morris is as at 4 November 2014 when he left the Company.

	Total accrued retirement lump sum entitlement at 31 December 2014 £000
James Guyette <sup>1</sup>	1,380

<sup>1</sup> Benefits are translated at £1 = US\$1.5877 (2013 US\$1.6542).

# DIRECTORS' REMUNERATION REPORT

CONTINUED

Details of defined contribution pension contributions paid by the Group on behalf of the following Executive Directors are given below:

	2014 £000	2013 £000
John Rishton	42	50
James Guyette <sup>1</sup>	349	395

<sup>1</sup> Benefits are translated at £1=US\$1.6477 (2013 US\$1.565).

## SHARE RETENTION POLICY (SUBJECT TO AUDIT)

We believe it is important that the interests of the Executive Directors should be closely aligned with those of shareholders. The deferred APRA award and the PSP provide considerable alignment. However, participants in the PSP are also required to retain at least one half of the number of after-tax shares released from the PSP, until the value of their shareholding reaches the percentage of salary shown in the table below. When this level is reached it must be maintained until retirement or departure from the Group. The Executive Director's total shareholding, for the purposes of comparing it with the minimum shareholding requirement, includes shares held: by their connected persons; in the SIP; and PSP shares that have vested, but does not include unvested PSP awards. The shareholding requirement increased in 2014 to 250% of salary for the Chief Executive and 200% of salary for the other Executive Directors. APRA deferred shares do not count towards their minimum shareholding requirement.

Except for David Smith, who was appointed on 4 November 2014, and has not had an opportunity to build up his shareholding, the Executive Directors each complied with the 2014 minimum shareholding requirement as detailed in the table below.

	Base salary £000	Total shareholding	Minimum shareholding requirement as % of salary	Minimum shareholding requirement <sup>1</sup>	Actual shareholding as % of minimum requirement
John Rishton	925	411,061	250	234,931	175
James Guyette <sup>2</sup>	529	384,898	200	107,484	358
Colin Smith CBE	525	202,369	200	106,671	190
David Smith	510	116	200	103,623	0.11

<sup>1</sup> Salary divided by the March 2014 PSP grant price of 984.33p multiplied by percentage of salary.

<sup>2</sup> Translated at £1 = US\$1.5877.

## DIRECTORS' INTERESTS IN SHARES (SUBJECT TO AUDIT)

The directors and their connected persons had the following interests in the ordinary shares and C Shares<sup>1</sup> of the Company at 31 December 2014, or at date of leaving or retirement, if earlier, are shown in the table below:

	Ordinary shares	C Shares	Unvested awards			Vested awards
			Conditional shares not subject to performance conditions (APRA)	Conditional shares subject to performance conditions (PSP)	Options over shares subject to savings contracts (ShareSave)	Vested shares and options exercised in year
<b>Executive Directors</b>						
John Rishton	411,061	–	81,740	354,621	1,745	388,459
James Guyette	384,863	–	42,077	167,869	–	152,824
Mark Morris (left on 4 November 2014)	82,736	–	33,600	161,549	541	37,674
Colin Smith CBE	202,369	–	39,207	167,627	–	140,216
David Smith (appointed 1 November 2014)	116	–	–	18,287	–	–
<b>Chairman and Non-Executive Directors</b>						
Ian Davis	19,027	–	–	–	–	–
Dame Helen Alexander	3,566	–	–	–	–	–
Lewis Booth CBE	30,000	1,675,000	–	–	–	–
Ruth Cairnie (appointed 1 September 2014)	4,540	–	–	–	–	–
Sir Frank Chapman	9,137	1,515,481	–	–	–	–
Iain Conn (retired 1 May 2014)	28,401	11,178	–	–	–	–
Warren East CBE	999	–	–	–	–	–
Lee Hsien Yang	702	–	–	–	–	–
Dr John McAdam	2,452	–	–	–	–	–
John Neill CBE	44,919	–	–	–	–	–
Jasmin Staiblin	–	–	–	–	–	–

<sup>1</sup> Non-cumulative redeemable preference shares of 0.1p each.

**CHANGES IN INTERESTS (SUBJECT TO AUDIT)**

	Ordinary shares		C Shares	
	31 December 2014	Changes from 31 December 2014 to 12 February 2015	31 December 2014	Changes from 31 December 2014 to 12 February 2015
<b>Executive Directors</b>				
John Rishton	411,061	4,255	–	–
James Guyette	384,863	3,983	–	–
Colin Smith CBE	202,369	2,053	–	–
David Smith	116	17	–	–
<b>Chairman and Non-Executive Directors</b>				
Ian Davis	19,027	641	–	–
Dame Helen Alexander	3,566	236	–	–
Lewis Booth CBE	30,000	–	1,675,000	(1,675,000)
Ruth Cairnie	4,540	443	–	–
Sir Frank Chapman	9,137	900	1,515,481	741,960
Warren East CBE	999	–	–	–
Lee Hsien Yang	702	229	–	–
Dr John McAdam	2,452	54	–	–
John Neill CBE	44,919	723	–	–

**DIRECTORS' INTERESTS IN UNVESTED AND VESTED AWARDS****JOHN RISHTON**

	31 December 2013	Granted during year	TSR uplift/dividend enhancement	Vested awards	31 December 2014	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2011	164,866	–	82,433	247,299	–	601.50	09/03/2011	09/03/2014	1015.81
PSP 2012	133,383	–	–	–	133,383	809.70	01/03/2012	01/03/2015	–
PSP 2013	108,470	–	–	–	108,470	1023.33	01/03/2013	01/03/2016	–
PSP 2014	–	112,768	–	–	112,768	984.33	07/05/2014	03/03/2017	–
	<b>406,719</b>	<b>112,768</b>	<b>82,433</b>	<b>247,299</b>	<b>354,621</b>				
Performance related shares	63,397	–	31,699	95,096	–	601.50	09/03/2011	01/03/2014	1015.81
Performance related shares	40,565	–	–	–	40,565	601.50	09/03/2011	01/03/2015	–
	<b>103,962</b>	<b>–</b>	<b>31,699</b>	<b>95,096</b>	<b>40,565</b>				
APRA 2011	44,400	–	1,664	46,064	–	808.80	01/03/2012	01/03/2014	1015.81
APRA 2012	48,250	–	–	–	48,250	1023.33	01/03/2013	01/03/2015	–
APRA 2013	–	33,490	–	–	33,490	984.40	07/05/2014	03/03/2016	–
	<b>92,650</b>	<b>33,490</b>	<b>1,664</b>	<b>46,064</b>	<b>81,740</b>				
ShareSave (options)	1,450	–	–	–	1,450	525.00*	01/02/2012	01/02/2017	–
ShareSave (options)	–	295	–	–	295	961.60*	01/02/2014	01/02/2017	–

\* For ShareSave, the share price shown is the exercise price which was 85% of the market price at the date of the award. The performance related shares were awarded as part of a special grant of shares to John Rishton on joining the Company and were intended to mirror the fair value and vesting profile of incentives he forfeited on leaving his previous employer.

**JAMES GUYETTE**

	31 December 2013	Granted during year	TSR uplift/dividend enhancement	Vested awards	31 December 2014	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2011	82,404	–	41,204	123,608	–	601.50	09/03/2011	09/03/2014	1015.81
PSP 2012	64,385	–	–	–	64,385	809.70	01/03/2012	01/03/2015	–
PSP 2013	51,714	–	–	–	51,714	1023.33	01/03/2013	01/03/2016	–
PSP 2014	–	51,770	–	–	51,770	984.33	07/05/2014	03/03/2017	–
	<b>198,503</b>	<b>51,770</b>	<b>41,204</b>	<b>123,608</b>	<b>167,869</b>				
APRA 2011	28,161	–	1,055	29,216	–	808.80	01/03/2012	01/03/2014	1015.81
APRA 2012	25,770	–	–	–	25,770	1023.33	01/03/2013	01/03/2015	–
APRA 2013	–	16,307	–	–	16,307	984.40	07/05/2014	03/03/2016	–
	<b>53,931</b>	<b>16,307</b>	<b>1,055</b>	<b>29,216</b>	<b>42,077</b>				

# DIRECTORS' REMUNERATION REPORT

CONTINUED

## MARK MORRIS

	31 December 2013	Granted during year	TSR uplift/ dividend enhancement	Vested awards	4 November 2014 <sup>1</sup>	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2011	25,039	–	6,260	31,299	–	601.50	09/03/2011	09/03/2014	1015.81
PSP 2012	59,899	–	–	–	<b>59,899</b>	809.70	01/03/2012	n/a	–
PSP 2013	49,838	–	–	–	<b>49,838</b>	1023.33	01/03/2013	n/a	–
PSP 2014	–	51,812	–	–	<b>51,812</b>	984.33	07/05/2014	n/a	–
	<b>134,776</b>	51,812	6,260	31,299	<b>161,549</b>				
APRA 2011	6,145	–	230	6,375	–	808.80	01/03/2012	01/03/2014	1015.81
APRA 2012	18,057	–	–	–	<b>18,057</b>	1023.33	01/03/2013	01/03/2015	–
APRA 2013	–	15,543	–	–	<b>15,543</b>	984.40	07/05/2014	n/a	–
	<b>24,202</b>	15,543	230	6,375	<b>33,600</b>				
ShareSave (options)	541	–	–	–	<b>541</b>	525.00	01/02/2012	n/a	–

\* The TSR uplift applied was 25% of the original grant.

<sup>1</sup> All the above awards except the APRA 2012, granted in 2013, were forfeited on leaving the Company.

## COLIN SMITH CBE

	31 December 2013	Granted during year	TSR uplift/ dividend enhancement	Vested awards	31 December 2014	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2011	74,813	–	37,407	112,220	–	601.50	09/03/2011	09/03/2014	1015.81
PSP 2012	62,987	–	–	–	<b>62,987</b>	809.70	01/03/2012	01/03/2015	–
PSP 2013	51,304	–	–	–	<b>51,304</b>	1023.33	01/03/2013	01/03/2016	–
PSP 2014	–	53,336	–	–	<b>53,336</b>	984.33	07/05/2014	03/03/2017	–
	<b>189,104</b>	53,336	37,407	112,220	<b>167,627</b>				
APRA 2011	26,985	–	1,011	27,996	–	808.80	01/03/2012	01/03/2014	1015.81
APRA 2012	23,207	–	–	–	<b>23,207</b>	1023.33	01/03/2013	01/03/2015	–
APRA 2013	–	16,000	–	–	<b>16,000</b>	984.40	07/05/2014	03/03/2016	–
	<b>50,192</b>	16,000	1,011	27,996	<b>39,207</b>				

## DAVID SMITH

	4 November 2014	Granted during year	TSR uplift at vesting/ dividend enhancement	Vested awards	31 December 2014	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2014	18,287	–	–	–	<b>18,287</b>	984.33	03/03/2014	03/03/2017	–

## CHIEF EXECUTIVE PAY, TSR AND ALL-EMPLOYEE PAY

This section of the report enables our remuneration arrangements to be seen in context by providing:

- a five-year history of our Chief Executive's remuneration;
- our TSR performance over the same period;
- a comparison of the year-on-year change in our Chief Executive's remuneration with the change in average remuneration across the Group; and
- a year-on-year comparison of the total amount spent on employment costs across the Group and shareholder payments.

## CHIEF EXECUTIVE PAY

Year	Chief Executive <sup>1,2</sup>	Single figure of total remuneration £000	Annual bonus as a % of maximum	PSP as a % of maximum
2014	John Rishton	2,386	–	45
2013	John Rishton	6,228	55	100
2012	John Rishton	4,577	85	–
2011	John Rishton	3,677	63	–
2011	Sir John Rose	3,832	–	75
2010	Sir John Rose	3,914	100	100

<sup>1</sup> On 31 March 2011, Sir John Rose retired as Chief Executive and John Rishton was appointed.

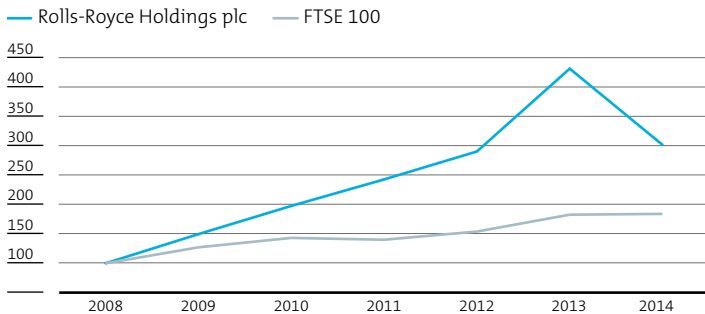
<sup>2</sup> The remuneration for Sir John Rose does not include any pension accrual or contribution as he was receiving his pension from 1 February 2008. John Rishton received a special grant of shares on joining the Company on 1 March 2011 to mirror the shares he forfeited on resigning from his previous employer. The share price has increased from 483.50p at the time this grant was made to 870p at the end of 2014. These are the main reasons why John Rishton's remuneration in 2012 and 2013 exceeds that of his predecessor.

## TSR PERFORMANCE

The Company's TSR performance over the previous six years compared to a broad equity market index is shown in the graph below. The FTSE 100 has been chosen as the comparator because it contains a broad range of other UK listed companies.

The graph shows the growth in value of a hypothetical £100 holding in the Company's ordinary shares over six years, relative to the FTSE 100 index. The values of the hypothetical £100 holdings at the end of the six-year period were £302.23 and £184.40 respectively.

### ROLLS-ROYCE – SIX YEAR REBASED TSR



## PERCENTAGE CHANGE IN CHIEF EXECUTIVE REMUNERATION

The following table compares the percentage change in the Chief Executive's salary, bonus and benefits to the average percentage change in salary, bonus and benefits for all UK employees from 2013 to 2014.

	Salary	Benefits	Annual bonus
Chief Executive	0%	21%	-100%
UK employees average	3%	-0.1%	-98.5%

UK employees were chosen as a comparator group in order to avoid the impact of exchange rate movements over the year. UK employees make up approximately 45% of the total employee population.

## RELATIVE SPEND ON PAY

The following chart sets out the percentage change in payments to shareholders and overall expenditure on pay across the Group.

### PAYMENTS TO SHAREHOLDERS (note 17 – financial statements)



### GROUP EMPLOYMENT COSTS (note 7 – financial statements)



## STATEMENT OF SHAREHOLDER VOTING

	For	Against	Votes withheld
Approval of 2013 remuneration report			
Percentage of votes (%)	94.16	5.84	
Number of votes cast	1,242,179,846	77,016,965	14,049,941

We monitor carefully shareholder voting on our remuneration policy and implementation. We recognise the importance of ensuring that our shareholders continue to support our remuneration arrangements.

## ADVISERS TO THE COMMITTEE

During the year, the committee had access to advice from Deloitte LLP's executive compensation advisory practice. Total fees for advice provided to the committee during the year by Deloitte were £81,432. Deloitte also advised the Company on tax, assurance, pensions and corporate finance and Deloitte MCS Limited provides consulting services.

Deloitte is a founding member of the Remuneration Consultants Group and adheres to its code in relation to executive remuneration consulting. The committee requests Deloitte to attend meetings periodically during the year. The committee is satisfied that the advice it has received has been objective and independent.

## STATUTORY REQUIREMENTS

The Directors' Remuneration Report has been prepared on behalf of the Board by the Remuneration Committee.

We adopt the principles of good governance as set out in the UK Corporate Governance Code 2012 and comply with the regulations contained in the Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, the Listing Rules of the Financial Conduct Authority and the relevant schedules of the Companies Act 2006.

The Companies Act 2006 and the Listing Rules require the Company's auditor to report on the audited information in their report on page 159 and to state that this section has been properly prepared in accordance with these regulations. The Directors' Remuneration Report is subject to shareholder approval at the AGM on 8 May 2015.

The Directors' Remuneration Report was approved by the Board on 12 February 2015 and signed on its behalf.

## DAME HELEN ALEXANDER

Chairman of the Remuneration Committee

## DIRECTORS' REMUNERATION POLICY

The policy was approved by shareholders at the 2014 AGM and is reproduced here for information only.

### REMUNERATION POLICY FRAMEWORK

The Group is committed to achieving sustained improvements in performance and this depends crucially on the individual contributions made by the executive team and by employees at all levels. The Board believes that an effective remuneration strategy plays an essential part in the future success of the Group.

Accordingly, the remuneration policy will continue to reflect the following broad principles:

- the remuneration of Executive Directors and other senior executives should reflect their responsibilities and contain incentives to deliver the Group's performance objectives without encouraging excessive risk taking;
- remuneration must be capable of attracting and retaining the individuals necessary for business success;
- remuneration policy must be sufficiently flexible to take account of changes in the Group's business environment and market practices;
- total remuneration should be based on Group and individual performance, both in the short and long term;

- the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the senior executives to acquire shares in the Company. Therefore a significant proportion of senior executive remuneration will comprise share-based long-term incentives; and
- when determining remuneration, the committee will take into account pay and employment conditions elsewhere in the Group.

### POLICY REPORT

The policy became effective from 1 May 2014.

#### EXECUTIVE DIRECTORS' REMUNERATION POLICY

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
Salary	It is essential that the Company provides competitive salaries, suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.	<p>Salary levels are set using careful judgement, taking into account the scope of the role and responsibilities, performance, experience, potential, retention issues and salaries elsewhere in the Group. Judgement will be informed, but not led, by reference to companies of a similar size, complexity and internationality.</p> <p>Salaries are reviewed annually and normally fixed for 12 months from 1 March each year. However, salary increases are not automatic. Exceptionally, salaries may be increased on other dates in the year.</p> <p>Executive Directors may be appointed at salaries below the target level to enable pay progression commensurate with growth in the new role.</p>	<p>Annual salary increases will not normally exceed average increases for employees in other appropriate parts of the Group.</p> <p>On occasion, increases may be larger where the committee considers this to be necessary. Circumstances where this may apply include: growth into a role; to reflect a change in scope of role and responsibilities; where market conditions indicate a level of under competitiveness and the committee judges that there is a risk in relation to attracting or retaining executives.</p> <p>Where the committee exercises its discretion to award increases above the average for other employees, the resulting salary will not exceed the competitive market range.</p>	None, although individual performance is the primary consideration in setting salary alongside overall Company affordability and market competitiveness.



## EXECUTIVE DIRECTORS' REMUNERATION POLICY

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
<b>Benefits</b>	To provide market competitive benefits sufficient to recruit and retain, and to support the executive to give maximum attention to their role.	<p>Benefits provided include a car or car allowance, contribution to the cost of fuel, use of a driver, financial planning assistance, life assurance and medical insurance. Other appropriate benefits may be provided from time-to-time at the discretion of the committee.</p> <p>Certain benefits, such as accommodation or use of a driver, are to enable an executive to devote maximum time and attention to their role. Club membership fees may also be provided. The Group may pay any tax due on these benefits.</p> <p>The Group offers relocation for executives to be located within reasonable reach of their place of work. Where relocation is not practical or a preferred option, or where work is mainly split between two locations, support for accommodation and travel may be provided.</p> <p>Relocation support may include items such as transaction and legal fees, removals, disturbance allowance and temporary travel and subsistence costs. International relocation support may include items such as school fees, tax equalisation and home visits.</p>	<p>Benefits will be market competitive taking into account the role and the local market.</p> <p>Benefits excluding any accommodation, relocation and associated tax costs will not exceed £100,000 per annum.</p> <p>The value of benefits provided for international and domestic relocation and any ongoing accommodation and travel support will be appropriate to the individual circumstances of the executive and only expenses that the committee considers necessary and appropriate will be supported.</p>	None.
<b>Pension</b>	To provide market-competitive pensions sufficient to recruit and retain.	<p>New executives to the Company are offered membership of a defined contribution pension plan. Pension contributions are based on base salary only.</p> <p>There are a number of legacy pension arrangements, including defined benefit plans, which were in place before 27 June 2012 and have not been changed since. Commitments to these arrangements will be honoured.</p> <p>Executives may opt to receive a cash allowance in lieu of pension.</p>	<p>The maximum employer contribution to defined contribution pension arrangements is 38% of base salary.</p> <p>Under the Group's legacy defined benefit arrangements, the pension due is the higher of a pension based on the executive's final salary, with a maximum annual accrual rate of 2.5%, or based on career average salary with a maximum annual accrual rate of 3.3%. The resulting pension is limited so that the maximum pension at normal retirement age is two thirds of the executive's final remuneration. The benefits under these arrangements include a lump sum payable on death in service and pensions for surviving spouses, civil partners and certain dependants.</p> <p>Executives may opt to receive a cash allowance in lieu of pension. The cash allowance is calculated to be equivalent to the employer's defined contribution pension contributions, reduced to allow for the additional National Insurance cost incurred by the employer.</p> <p>James Guyette participates in qualified and non-qualified defined benefit and defined contribution pension arrangements in the US. Under these various arrangements combined it is expected that the benefits provided by the Company will be equivalent in value to a pension of two thirds of salary, with post retirement increases similar to those required by statute in the UK.</p>	None.

# DIRECTORS' REMUNERATION POLICY

CONTINUED

## EXECUTIVE DIRECTORS' REMUNERATION POLICY

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
<b>Annual bonus</b>	<p>To incentivise and reward execution of the business strategy, delivery of financial performance targets and achievement of personal objectives.</p> <p>Compulsory deferral of part of any bonus encourages retention and provides alignment with shareholders.</p>	<p>The committee sets Group financial targets and agrees personal objectives for each executive director at the start of the financial year. At the end of the year, business performance determines the Company bonus payout level and the committee considers whether any adjustment to the payout level is appropriate. Each Executive Director's bonus is also dependent on the achievement of their personal objectives and wider contribution to the Group. The committee may apply an uplift of up to 20% or a reduction, potentially to zero, as appropriate.</p> <p>A portion of the bonus paid, in a range 30% to 50%, is compulsorily deferred into the Company's shares for a period of two years and is subject to continued employment (with early release in certain circumstances). There are no further performance conditions.</p> <p>Deferred shares may receive a bonus issue of C Shares or equivalent during the deferral period.</p> <p>The bonus plan is non-contractual and may be offered on a year-by-year basis. The committee has the right to apply the malus provision on an individual or group basis and amend or withdraw the bonus before payment. From 2014, the same right over deferred shares will apply as will the right to clawback bonuses paid or vested shares on an individual basis if it can be demonstrated that individuals have acted in an improper manner. Malus and/or clawback provisions may apply in exceptional cases such as: material misstatement of results; a material failure of risk management; serious reputational damage; serious individual wrongdoing such as non-compliance with the Company's Code of Conduct; or gross misconduct.</p>	<p>The current maximum annual bonus, linked to business performance, is 135% of salary for the Chief Executive and 125% for other Executive Directors. This is based on achieving the highest targets set for business performance. However, the committee may adjust the bonus to reflect personal performance as described in the previous column, giving an overall maximum of 162% and 150% respectively.</p> <p>The committee has the discretion to increase the overall maximum bonus level to 200% of salary for the Chief Executive and 175% for other Executive Directors, subject to this not being above the competitive market range.</p>	<p>The bonus payout level is determined primarily by Group financial performance but the committee may introduce non-financial metrics and/or adjust the payout level to reflect other factors as appropriate. The final bonus awarded to each director is also linked to their personal performance.</p> <p>Any non-financial metrics used in the annual bonus plan will be linked to the Group's strategy and will not be weighted more than 50% of the whole bonus. A principle applies that no bonus is payable unless the base financial targets are achieved and this also applies if non-financial measures are introduced.</p> <p>Based on the current bonus opportunity:</p> <p><b>Chief Executive:</b> Bonus generated by business performance is 40% of salary for achieving the base level targets and 135% of salary for achieving the highest level of targets. Bonus may then be adjusted for personal performance in a range 0-120% at committee discretion with 100% typically applying for good performance and a 20% uplift available for outstanding personal performance.</p> <p><b>Other Executive Directors:</b> Bonus generated by business performance is 37% of salary for achieving the base level targets and 125% of salary for achieving the highest level of targets. Bonus may then be adjusted for personal performance as above.</p>

**EXECUTIVE DIRECTORS' REMUNERATION POLICY**

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
<b>Performance Share Plan (PSP)</b> <b>Post 2014 AGM onwards</b>	<p>To incentivise and reward development and execution of the business strategy over the longer term.</p> <p>The plan provides alignment with shareholder interests through the performance measures chosen and a retention element through the plan timescale.</p> <p>A shareholding requirement is linked to the PSP in order to further provide alignment with shareholders.</p> <p>The link between the performance measures and the Company's strategy is explained in the notes to this table on page 90.</p>	<p>Executive Directors are granted awards over shares annually at the start of a three-year performance period. The proportion of those awards that vest is determined at the end of the period according to a set of Company performance measures.</p> <p>Vesting of awards is subject to continued employment until vesting date with the exception of certain leaver circumstances, in which case vesting is subject to Company performance and pro-rating for service.</p> <p>The plan rules contain malus and clawback provisions. The committee has the right to amend and withdraw share grants before vesting for individuals and groups and the right to reclaim vested shares or their proceeds from individuals where it has been demonstrated that they acted in an improper manner. Situations where the provisions will apply are as described in the bonus section on page 88.</p> <p>Executive Directors are required to hold a level of shareholding.</p>	<p>The Chief Executive is granted awards each year over shares to the value of 120% of salary. Other Executive Directors are granted 100% of salary. Subject to the earnings per share (EPS) condition being met, these shares vest at the end of the performance period if the Company has achieved the maximum target set for cash flow per share (CPS). The number of shares vesting can be increased by 25% for above median TSR ranking rising to 50% increase for upper quartile TSR ranking.</p> <p>Maximum face values of annual awards are therefore 180% of salary for the Chief Executive and 150% of salary for other Executive Directors.</p>	<p>The three corporate performance measures are:</p> <ol style="list-style-type: none"> <li>1. EPS – condition. The increase in EPS over the three-year period must exceed an appropriate index of consumer prices for the same period. If this condition is not met share vesting is zero.</li> <li>2. CPS – prime measure. The aggregate CPS over the performance period will determine the number of shares which vest. Achieving a base target of CPS will result in 30% of the shares vesting and achieving a maximum CPS target will cause 100% of the shares to vest. The number of shares which may vest is determined on a straight-line basis between the 30% and 100% level.</li> <li>3. Total shareholder return (TSR) relative to FTSE 100 or other appropriate index. The number of shares vesting will be increased by 25% if the Company's TSR is ranked above the median of the FTSE 100, or other appropriate index, over the same periods and by 50% if ranked at or above the upper quartile of the same group. Intermediate TSR ranking will increase the number of shares released on a straight-line basis.</li> </ol>
<b>Performance Share Plan (PSP)</b> <b>Legacy awards – 2004 plan</b>	<p>The purpose of the 2004 share plan is fully consistent with the purpose of the 2014 plan described above.</p>	<p>The operation of the 2004 plan is as described above with the exception of malus and clawback elements which will apply for 2014 grants.</p>	<p>As above.</p>	<p>As above.</p>
<b>ShareSave Plan</b>	<p>This savings-related share option plan provides all employees worldwide an interest in the performance of Rolls-Royce shares.</p>	<p>Executive Directors may participate on the same terms as other employees. The option price may be discounted by up to 20%.</p> <p>Accumulated savings may be used to exercise an option to acquire shares.</p>	<p>The maximum savings amount is currently £250 per month over a three- or five-year period. This may be increased in accordance with changes to UK legislation.</p>	<p>No performance measures are permitted by UK legislation applicable to this type of plan.</p>
<b>Share Incentive Plan (SIP)</b>	<p>UK employees may elect to receive part of any annual bonus in shares.</p> <p>UK employees may elect to make regular monthly purchases of shares from pre-tax income.</p>	<p>UK-based Executive Directors may participate on the same terms as all other UK employees. Shares held in the SIP for five years will vest free from income tax and National Insurance contributions.</p>	<p>Currently, up to £3,000 of the annual cash bonus can be applied to purchase shares.</p> <p>The maximum monthly amount of £125 may be used to purchase shares.</p> <p>The above limits may be increased in accordance with changes to UK legislation.</p>	<p>The award of any bonus will depend on performance conditions (see page 88) but no further conditions apply once the employee elects to participate in the SIP.</p>

# DIRECTORS' REMUNERATION POLICY

CONTINUED

## NON-EXECUTIVE DIRECTORS' REMUNERATION POLICY

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
<b>Fees</b>	To reward individuals for fulfilling the relevant role and to attract individuals of the skills and calibre required.	<p>The committee makes recommendations to the Board on the remuneration of the Chairman. The Chairman and the Executive Directors determine the remuneration for the Non-Executive Directors. The level of remuneration is set within a limit approved from time-to-time by shareholders.</p> <p>The Chairman is paid a single consolidated fee. Other Non-Executive Directors are paid a base fee covering Board and committee membership. Committee chairmen and the Senior Independent Director receive an additional fee.</p>	<p>The Articles of Association require the Company to set a maximum ceiling on the total remuneration payable to Non-Executive Directors including the Non-Executive Chairman. A resolution to increase this to £1,400,000 was proposed at the 2014 AGM.</p> <p>Fees are set at a level appropriate for the role and are reviewed regularly, taking into account fees payable to Non-Executive Directors of companies of a similar size and complexity.</p>	None
<b>Benefits</b>	To devote maximum time and attention to the requirements of the role.	<p>The Chairman has occasional use of chauffeur services.</p> <p>Travel, hotel and subsistence expenses incurred in attending Board meetings and committee meetings or otherwise required to attend the Company's offices are reimbursed by the Company. The Group may pay any tax due on such benefits.</p> <p>Where a Non-Executive Director is based outside the UK and has to file a UK tax return, the Company may pay towards tax advice and filing.</p>	<p>The maximum value for chauffeur services will not exceed £25,000 per annum.</p> <p>The maximum contribution towards tax advice and filing is £5,000 per annum.</p>	None

### PERFORMANCE MEASURES AND TARGETS

The annual bonus measures are primarily based on Group financial performance but may contain non-financial measures as detailed in the above table.

The committee will set the Group financial targets with reference to the prior year and to the budgets and business plans for the coming year, ensuring the levels to achieve base, on-target and maximum bonus payout are appropriately challenging.

The PSP performance measures set out in the policy table support the Group's strategy as follows:

- the EPS growth hurdle ensures any payout is supported by sound profitability;
- the aggregate CPS measure incentivises the generation of cash flow in line with the Group's strategy. This measure is set in line with the principles described for the annual bonus; and
- the TSR performance measure aligns interests with shareholders by rewarding TSR out-performance. The TSR is measured with reference to constituents of an appropriate index such as the FTSE 100.

In accordance with the rules of the PSP, the performance conditions may be replaced or varied if an event occurs or circumstances arise which cause the committee to determine that the performance conditions have ceased to be appropriate. If the performance conditions are varied or replaced, the amended performance conditions must, in the opinion of the committee, be fair,

reasonable and materially no more or less difficult than the original condition when set.

### SHAREHOLDERS' VIEWS

This statement of remuneration policy is largely a consolidation of policies which have enjoyed the support of shareholders for many years. We considered the guidance provided by the GC 100 and shareholder advisory groups in preparing this policy and have followed this insofar as it is appropriate in the context of our business. Prior to finalising the policy, we shared it with a selection of major shareholders. Looking ahead, we welcome an open dialogue with shareholders and intend to continue to consult with major shareholders before implementing any significant change.

### GROUP EMPLOYEE CONSIDERATIONS

When setting remuneration for Executive Directors the committee takes into account contextual information about pay and conditions within the Group, including the following:

- salary increases for the all-employee population;
- bonus awards for the all-employee population; and
- pay ratios between Executive Directors and other employees.

Rolls-Royce employs over 54,000 people in more than 50 countries. Inevitably remuneration arrangements differ to reflect local markets, but some common themes apply to employees at all levels worldwide:

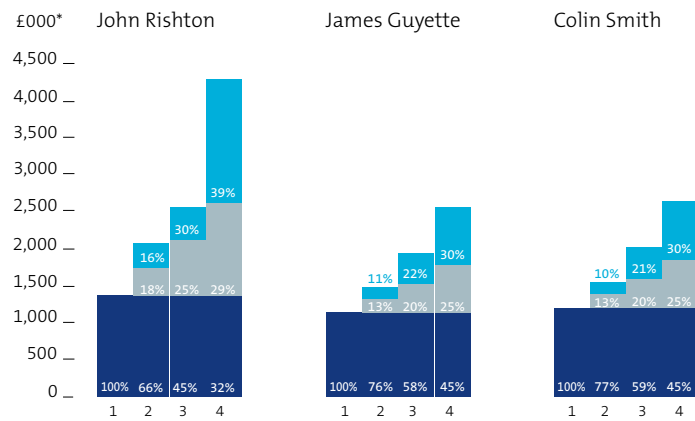
- we aim to offer competitive levels of remuneration, benefits and incentives to attract and retain employees;
- all employees participate in bonus arrangements where the bonus is determined by the same financial measures as that applicable to Executive Directors; and
- all employees have the opportunity to participate in a savings related share option plan.

At more senior levels, remuneration is increasingly long term and larger proportions are dependent on both Group and individual performance and paid in the form of shares.

Given the scale of the employee population, the committee considered that it would be impractical to consult all employees when drawing up the policy.

**ILLUSTRATIONS OF REMUNERATION POLICY APPLICATION**

The bar chart below illustrates projected executive remuneration for 2014 at four different levels of performance showing payments from minimum to maximum. The table below the chart explains performance levels one to four and the associated remuneration.



\* Salary values are as at 31 December 2013

- Salary, plus pension and benefits
- Potential value of bonus depending on the performance scenario
- Potential value of PSP depending on the performance scenario

Remuneration achieved for key levels of performance are:	
<b>1. Minimum</b>	Fixed remuneration only. No bonus or PSP paid.
<b>2. Base level</b>	Bonus and PSP resulting from base level of business performance. Bonus at 30% of maximum payment assuming no adjustment for personal performance. PSP vesting at 30% of maximum from achieving base CPS target with no TSR multiplier.
<b>3. On-target</b>	Bonus and PSP resulting from performance in line with Company expectations. Bonus at 60% of maximum assuming no adjustment for personal performance. PSP vesting mid-way between base and maximum levels with 25% TSR multiplier.
<b>4. Maximum</b>	Maximum annual bonus based on achieving the highest targets set for business performance and outstanding individual performance: PSP vesting from achieving maximum CPS target and with maximum 50% TSR multiplier.

**SERVICE CONTRACTS**

UK-based Executive Directors' contracts include the following provisions:

- 12 months' notice of termination from Rolls-Royce;
- 6 months' notice of termination from the executive; and
- reimbursement of reasonable business expenses.

The committee recognises that in the case of appointments to the Board from outside the Group, it may be necessary to offer a longer initial notice period, which would subsequently reduce to 12 months after that initial period.

James Guyette has a contract with Rolls-Royce North America Inc., drawn up under the laws of the State of Virginia, US. This provides that, on termination without cause, he is entitled to 12 months' severance pay without mitigation and, in addition, appropriate costs incurred in relocating household and personal effects. The contract also provides for the payment of club membership fees and for tax and financial planning up to a maximum of US\$15,000 per annum and the Group will gross up any amounts to cover any applicable taxes arising.

All contracts also include the entitlement to paid holidays, sick pay and other standard employee terms.

The Chairman and the Non-Executive Directors have letters of appointment rather than service contracts. No compensation is payable to the Chairman or to any Non-Executive Director if the appointment is terminated early or if they fail to be re-elected at an AGM.

**POLICY ON EXIT PAYMENTS**

The notice period the Company is required to give to Executive Directors under their contracts of employment is 12 months. Payment in lieu of notice will not exceed the value of 12 months' salary, benefits and pension contributions. Both mitigation and the staggering of payments through the notice period will be considered by the committee where appropriate, as will the funding of reasonable outplacement and other professional fees. Should

# DIRECTORS' REMUNERATION POLICY

CONTINUED

additional compensation matters arise, such as a settlement or compromise agreement, the committee will exercise judgement and will take into account the specific commercial circumstances.

Pension benefits on early retirement should be payable in accordance with the normal rules of the relevant pension plan. Under legacy UK defined benefit pension arrangements, accrued pension is reduced to reflect early receipt in accordance with factors set by the trustees from time-to-time and is limited to a maximum pension of two thirds of the executive's final remuneration, pro-rated by actual service to potential service.

The committee has the discretion to preserve incentive awards pro-rated to service and to release deferred shares. In exercising this discretion, the committee will have regard to performance and the circumstances of leaving. For deferred shares these are usually released in cases such as retirement, death, injury, ill-health and redundancy.

For PSP, the rules state that unvested awards may be preserved at the committee's discretion according to the circumstances. In such cases vesting will be at the normal date, subject to the established performance conditions, and pro rata to employment in the performance period. In cases such as death and terminal illness, the committee also has the discretion to vest the awards immediately using an estimate of future out-turn.

The treatment of leavers in the Company's ShareSave and SIP plans is governed by the plan rules. The UK rules are HMRC approved. An Executive Director who has ShareSave options who retires or who leaves the Company through ill-health, disability or redundancy will be entitled to exercise their options, pro rata to the savings made, within six months of leaving the Company. An Executive Director who leaves in any other manner such as dismissal would only be entitled to have their savings returned to them. Participants in the SIP who leave the Company for the same reasons listed above will have their shares released to them free of tax and National Insurance contributions.

In the event of a change of control of the Company, PSP awards will vest based on the extent to which the committee determines the performance conditions have been or would have been met. Pro-rating for service in the performance period will apply. Deferred shares earned under APRA would vest in full. ShareSave options would immediately be exercisable pro rata to savings made. Consideration received as shares would be held in the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.

If awards are made on recruitment (such as buy-outs) the treatment on leaving would be determined at the time at the committee's discretion.

## POLICY ON NEW APPOINTMENTS

The committee will normally award newly appointed Executive Directors with a remuneration package which is consistent with the policy and principles as set out in this report. Base salary may be set at a level higher or lower than previous incumbents and in certain circumstances, to facilitate the recruitment of individuals of the required calibre, the committee may use its discretion to make individual additional incentive awards up to a maximum of 100% of annual salary. Incentive levels may also be increased by up to 30% of salary per annum for incentives commencing within two years of joining. This level of discretion is considered appropriate given the current conservative market positioning of Rolls-Royce and our potential need to recruit from other market sectors or countries outside of the UK.

In addition, remuneration forfeited on resignation from a previous employer may be compensated. The form of this compensation would be considered on a case-by-case basis and may comprise either cash or shares. Generally:

- if such remuneration was in the form of shares, compensation will be in the Company's shares;
- if remuneration was subject to achievement of performance conditions, compensation will be subject to Rolls-Royce performance conditions; and
- the timing of any compensation will, where practicable, match the vesting schedule of the remuneration forfeited.

A newly appointed Executive Director may be provided with reasonable relocation support as set out in the policy table. Internal appointments would receive a remuneration package that is consistent with the remuneration policy. Legacy terms and conditions would be honoured, including pension entitlements and any outstanding incentive awards.

If an Executive Director is appointed following a merger or an acquisition of a company by Rolls-Royce, of which the Executive Director was employed, legacy terms and conditions may be honoured.

## LEGACY COMMITMENTS

Contractual commitments made before 27 June 2012 and before the policy came into effect will be honoured. This will include grants made under the old PSP arrangement which will vest, subject to the performance criteria being achieved after the adoption of this policy, as well as previous contractual provisions relating to the defined benefit pension scheme.

The committee may make minor amendments to the policy set out above (for regulatory, exchange control, tax, administrative purposes or to take account of a change in legislation) without obtaining shareholder approval for that amendment.

# RESPONSIBILITY STATEMENTS

## RESPONSIBILITY STATEMENTS

### STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

The directors, as listed on pages 54 and 55, are responsible for preparing the Annual Report and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRS as adopted by the EU and applicable law and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards and applicable law.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of their profit or loss for that period.

In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent and Group's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and Corporate Governance Statement that complies with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

## RESPONSIBILITY STATEMENTS UNDER THE DISCLOSURE AND TRANSPARENCY RULES

Each of the persons who is a director at the date of approval of this report confirms that to the best of his or her knowledge:

- i) each of the Group and parent company financial statements, prepared in accordance with IFRS and UK Accounting Standards respectively, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole;
- ii) the Strategic Report on pages 1 to 53 and Directors' Report on pages 54 to 92 and pages 162 to 165 includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face; and
- iii) the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's position and performance, business model and strategy.

By order of the Board

**PAMELA COLES**

Company Secretary

12 February 2015

## CONSOLIDATED FINANCIAL STATEMENTS

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# CONSOLIDATED INCOME STATEMENT

For the year ended 31 December 2014

	Notes	2014 £m	Re-presented * 2013 £m
<b>Continuing operations</b>			
Revenue	2	13,736	14,642
Cost of sales		(10,533)	(11,482)
<b>Gross profit</b>		<b>3,203</b>	3,160
Other operating income	3	10	65
Commercial and administrative costs		(1,124)	(1,237)
Research and development costs	3	(793)	(658)
Share of results of joint ventures and associates	11	94	149
<b>Operating profit</b>		<b>1,390</b>	1,479
Profit on acquisition/reclassification of joint ventures		2	119
Profit on disposal of businesses	25	6	216
<b>Profit before financing and taxation</b>	2	<b>1,398</b>	1,814
Financing income	4	121	327
Financing costs	4	(1,452)	(441)
<b>Net financing</b>		<b>(1,331)</b>	(114)
<b>Profit before taxation</b> <sup>1</sup>		<b>67</b>	1,700
Taxation	5	(151)	(377)
<b>Profit for the year from continuing operations</b>		<b>(84)</b>	1,323
<b>Discontinued operations</b>			
Profit for the year from ordinary activities	2	4	56
Profit on disposal	25	138	–
<b>Profit for the year from discontinued operations</b>		<b>142</b>	56
<b>Profit for the year</b>		<b>58</b>	1,379
<b>Attributable to:</b>			
Ordinary shareholders		69	1,367
Non-controlling interests		(11)	12
<b>Profit for the year</b>		<b>58</b>	1,379
<b>Earnings per ordinary share attributable to ordinary shareholders:</b>			
From continuing operations	6		
Basic		(3.90)p	70.26p
Diluted		(3.90)p	69.48p
From continuing and discontinued operations			
Basic		3.68p	73.26p
Diluted		3.68p	72.44p
<b>Payments to ordinary shareholders in respect of the year</b>			
Per share	17	23.1p	22.0p
Total		435	414
<sup>1</sup> Underlying profit before taxation	2	1,617	1,759

\* Re-presented to reflect the Energy business as a discontinued operation. The relevant notes have also been re-presented.

# CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2014

	Notes	2014 £m	2013 £m
<b>Profit for the year</b>		<b>58</b>	<b>1,379</b>
<b>Other comprehensive income</b>			
<b>Items that will not be reclassified to profit or loss</b>			
Movements in post-retirement schemes	19	1,192	48
Related tax movements	5	(431)	10
		<b>761</b>	<b>58</b>
<b>Items that may be reclassified to profit or loss</b>			
Foreign exchange translation differences on foreign operations		(158)	(64)
Reclassified to income statement on disposal of businesses		(29)	–
Share of other comprehensive income of joint ventures and associates	11	(13)	(6)
Related tax movements	5	(2)	1
		<b>(202)</b>	<b>(69)</b>
<b>Total comprehensive income for the year</b>		<b>617</b>	<b>1,368</b>
<b>Attributable to:</b>			
Ordinary shareholders		650	1,356
Non-controlling interests		(33)	12
<b>Total comprehensive income for the year</b>		<b>617</b>	<b>1,368</b>

# CONSOLIDATED BALANCE SHEET

At 31 December 2014

	Notes	2014 £m	2013 £m
<b>ASSETS</b>			
<b>Non-current assets</b>			
Intangible assets	9	4,804	4,987
Property, plant and equipment	10	3,446	3,392
Investments – joint ventures and associates	11	539	601
Investments – other	11	31	27
Other financial assets	17	107	674
Deferred tax assets	5	369	316
Post-retirement scheme surpluses	19	1,740	248
		<b>11,036</b>	10,245
<b>Current assets</b>			
Inventories	12	2,768	3,319
Trade and other receivables	13	5,509	5,092
Taxation recoverable		19	16
Other financial assets	17	22	74
Short-term investments		7	321
Cash and cash equivalents	14	2,862	3,990
Assets held for sale		1	6
		<b>11,188</b>	12,818
<b>Total assets</b>		<b>22,224</b>	23,063
<b>LIABILITIES</b>			
<b>Current liabilities</b>			
Borrowings	15	(68)	(207)
Other financial liabilities	17	(209)	(1,976)
Trade and other payables	16	(6,791)	(7,045)
Current tax liabilities		(184)	(204)
Provisions for liabilities and charges	18	(433)	(348)
		<b>(7,685)</b>	(9,780)
<b>Non-current liabilities</b>			
Borrowings	15	(2,193)	(2,164)
Other financial liabilities	17	(717)	(360)
Trade and other payables	16	(2,445)	(2,138)
Non-current tax liabilities		(10)	(10)
Deferred tax liabilities	5	(1,228)	(882)
Provisions for liabilities and charges	18	(374)	(385)
Post-retirement scheme deficits	19	(1,185)	(1,041)
		<b>(8,152)</b>	(6,980)
<b>Total liabilities</b>		<b>(15,837)</b>	(16,760)
<b>Net assets</b>		<b>6,387</b>	6,303
<b>EQUITY</b>			
<b>Equity attributable to ordinary shareholders</b>			
Called-up share capital	20	376	376
Share premium account		179	80
Capital redemption reserve		159	163
Cash flow hedging reserve		(81)	(68)
Other reserves		78	250
Retained earnings		5,671	4,804
		<b>6,382</b>	5,605
Non-controlling interests	11	5	698
<b>Total equity</b>		<b>6,387</b>	6,303

The financial statements on pages 95 to 148 were approved by the Board on 12 February 2015 and signed on its behalf by:

JOHN RISHTON Chief Executive

DAVID SMITH Chief Financial Officer

# CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2014

	Notes	2014 £m	2013 £m
<b>Reconciliation of cash flows from operating activities</b>			
Operating profit from continuing operations		1,390	1,479
Operating (loss)/profit from discontinued operations		(1)	56
<b>Operating profit</b>		<b>1,389</b>	<b>1,535</b>
(Profit)/loss on disposal of property, plant and equipment		(3)	7
Share of results of joint ventures and associates	11	(94)	(160)
Dividends received from joint ventures and associates	11	73	99
Return of capital from joint ventures	11	3	–
Gain on consolidation of previously non-consolidated subsidiary		(3)	–
Amortisation and impairment of intangible assets	9	367	428
Depreciation and impairment of property, plant and equipment	10	375	372
Increase/(decrease) in provisions		129	(17)
Decrease in inventories		166	119
Increase in trade and other receivables		(878)	(533)
Increase in trade and other payables		214	376
Cash flows on other financial assets and liabilities held for operating purposes		(30)	9
Net defined benefit post-retirement cost recognised in profit before financing		170	279
Cash funding of defined benefit post retirement schemes		(322)	(315)
Share-based payments	21	21	79
Net cash inflow from operating activities before taxation		1,577	2,278
Taxation paid		(276)	(238)
<b>Net cash inflow from operating activities</b>		<b>1,301</b>	<b>2,040</b>
<b>Cash flows from investing activities</b>			
Additions of unlisted investments		(11)	(1)
Disposals of unlisted investments		–	1
Additions of intangible assets		(477)	(503)
Purchases of property, plant and equipment		(648)	(669)
Government grants received		11	21
Disposals of property, plant and equipment		65	7
Acquisitions of businesses	25	(3)	(37)
Acquisition of non-controlling interest		(1,937)	–
Reclassification of joint ventures to subsidiaries		–	245
Acquisition of preference shares in subsidiary		–	(34)
Disposal of discontinued operations	25	1,027	–
Disposals of other businesses	25	24	273
Investments in joint ventures and associates		(17)	(43)
<b>Net cash outflow from investing activities</b>		<b>(1,966)</b>	<b>(740)</b>
<b>Cash flows from financing activities</b>			
Repayment of loans		(233)	(133)
Proceeds from increase in loans and finance leases		49	1,013
<b>Net cash flow from decrease in borrowings and finance leases</b>		<b>(184)</b>	<b>880</b>
Interest received		18	15
Interest paid		(63)	(58)
Decrease/(increase) in short-term investments		313	(313)
Issue of ordinary shares (net of expenses)		1	32
Purchase of ordinary shares – share buyback		(69)	–
Purchase of ordinary shares – other		(2)	(3)
Dividend paid to non-controlling interest		(76)	(60)
Redemption of C Shares		(406)	(357)
<b>Net cash (outflow)/inflow from financing activities</b>		<b>(468)</b>	<b>136</b>
<b>Change in cash and cash equivalents</b>		<b>(1,133)</b>	<b>1,436</b>
<b>Cash and cash equivalents at 1 January</b>		<b>3,987</b>	<b>2,585</b>
Exchange gains/(losses) on cash and cash equivalents		8	(34)
<b>Cash and cash equivalents at 31 December</b>		<b>2,862</b>	<b>3,987</b>

	2014 £m	2013 £m
<b>Reconciliation of movements in cash and cash equivalents to movements in net funds</b>		
Change in cash and cash equivalents	(1,133)	1,436
Cash flow from decrease/(increase) in borrowings and finance leases	184	(880)
Cash flow from (decrease)/increase in short-term investments	(313)	313
<b>Change in net funds resulting from cash flows</b>	<b>(1,262)</b>	869
Net funds (excluding cash and cash equivalents) of businesses acquired	(30)	(204)
Exchange gains/(losses) on net funds	19	(43)
Fair value adjustments	(59)	105
<b>Movement in net funds</b>	<b>(1,332)</b>	727
Net funds at 1 January excluding the fair value of swaps	1,940	1,213
<b>Net funds at 31 December excluding the fair value of swaps</b>	<b>608</b>	1,940
Fair value of swaps hedging fixed rate borrowings	58	(1)
<b>Net funds at 31 December</b>	<b>666</b>	1,939

The movement in net funds (defined by the Group as including the items shown below) is as follows:

	At 1 January 2014 £m	Funds flow £m	Net funds of businesses acquired £m	Exchange differences £m	Fair value adjustments £m	Reclassifications £m	At 31 December 2014 £m
Cash at bank and in hand	982	(228)		(15)	–	–	739
Money market funds	1,157	(470)		5	–	–	692
Short-term deposits	1,851	(438)		18	–	–	1,431
Overdrafts	(3)	3		–	–	–	–
<b>Cash and cash equivalents</b>	<b>3,987</b>	<b>(1,133)</b>		<b>8</b>	<b>–</b>	<b>–</b>	<b>2,862</b>
Short-term investments	321	(313)	–	(1)	–	–	7
Other current borrowings	(204)	229	(30)	–	(2)	(60)	(67)
Non-current borrowings	(2,163)	(3)	–	14	(57)	60	(2,149)
Finance leases	(1)	(42)	–	(2)	–	–	(45)
<b>Net funds excluding fair value of swaps</b>	<b>1,940</b>	<b>(1,262)</b>	<b>(30)</b>	<b>19</b>	<b>(59)</b>	<b>–</b>	<b>608</b>
Fair value of swaps hedging fixed rate borrowings	(1)				59		58
<b>Net funds</b>	<b>1,939</b>	<b>(1,262)</b>	<b>(30)</b>	<b>19</b>	<b>–</b>	<b>–</b>	<b>666</b>

# CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the year ended 31 December 2014

Notes	Attributable to ordinary shareholders							Non-controlling interests (NCI) £m	Total equity £m	
	Share capital £m	Share premium £m	Capital redemption reserve £m	Cash flow hedging reserve <sup>1</sup> £m	Other reserves <sup>2</sup> £m	Retained earnings <sup>3</sup> £m	Total £m			
At 1 January 2013	374	–	169	(63)	314	5,185	5,979	17	5,996	
Profit for the year	–	–	–	–	–	1,367	1,367	12	1,379	
Foreign exchange translation differences on foreign operations	–	–	–	–	(64)	–	(64)	–	(64)	
Movement on post-retirement schemes	19	–	–	–	–	48	48	–	48	
Share of other comprehensive income of joint ventures and associates	11	–	–	(5)	(1)	–	(6)	–	(6)	
Related tax movements	5	–	–	–	1	10	11	–	11	
<b>Total comprehensive income for the year</b>				(5)	(64)	1,425	1,356	12	1,368	
Arising on issues of ordinary shares	20	2	80	–	–	(81)	1	–	1	
Issue of C Shares	17	–	–	(366)	–	3	(363)	–	(363)	
Redemption of C Shares	17	–	–	360	–	(360)	–	–	–	
Ordinary shares purchased		–	–	–	–	(3)	(3)	–	(3)	
Share-based payments – direct to equity <sup>4</sup>		–	–	–	–	99	99	–	99	
Reclassification of Rolls-Royce Power Systems AG <sup>5</sup>		–	–	–	–	–	–	669	669	
Transactions with NCI (including dividend of £60m)		–	–	–	–	–	–	(45)	(45)	
Initial recognition of put option on NCI <sup>6</sup>		–	–	–	–	(1,477)	(1,477)	45	(1,432)	
Related tax movements	5	–	–	–	–	13	13	–	13	
<b>Other changes in equity in the year</b>		2	80	(6)	–	(1,806)	(1,730)	669	(1,061)	
<b>At 1 January 2014</b>		<b>376</b>	<b>80</b>	<b>163</b>	<b>(68)</b>	<b>250</b>	<b>4,804</b>	<b>698</b>	<b>6,303</b>	
Profit for the year		–	–	–	–	69	69	(11)	58	
Foreign exchange translation differences on foreign operations		–	–	–	–	(141)	(141)	(17)	(158)	
Reclassified to income statement on disposal of businesses	25	–	–	–	(29)	–	(29)	–	(29)	
Movement on post-retirement schemes	19	–	–	–	–	1,199	1,199	(7)	1,192	
Share of other comprehensive income of joint ventures and associates	11	–	–	–	(13)	–	(13)	–	(13)	
Related tax movements	5	–	–	–	(2)	(433)	(435)	2	(433)	
<b>Total comprehensive income for the year</b>				(13)	(172)	835	650	(33)	617	
Arising on issues of ordinary shares	20	2	99	–	–	(100)	1	–	1	
Issue of C Shares	17	–	–	(414)	–	2	(412)	–	(412)	
Redemption of C Shares	17	–	–	408	–	(408)	–	–	–	
Ordinary shares purchased – share buyback <sup>7</sup>		–	–	–	–	(69)	(69)	–	(69)	
Ordinary shares cancelled <sup>7</sup>	20	(2)	–	2	–	–	–	–	–	
Ordinary shares purchased – other		–	–	–	–	(2)	(2)	–	(2)	
Share-based payments – direct to equity <sup>4</sup>		–	–	–	–	29	29	–	29	
Transactions with NCI – acquisition of NCI shares		–	–	–	–	584	584	(584)	–	
Dividend paid to NCI		–	–	–	–	–	–	(76)	(76)	
Related tax movements	5	–	–	–	–	(4)	(4)	–	(4)	
<b>Other changes in equity in the year</b>			99	(4)	–	32	127	(660)	(533)	
<b>At 31 December 2014</b>		<b>376</b>	<b>179</b>	<b>159</b>	<b>(81)</b>	<b>78</b>	<b>5,671</b>	<b>6,382</b>	<b>5</b>	<b>6,387</b>

<sup>1</sup> See accounting policies note 1.

<sup>2</sup> Other reserves include a merger reserve of £3m (2013 £3m, 2012 £3m) and a translation reserve of £75m (2013 £247m, 2012 £311m).

<sup>3</sup> At 31 December 2014, 14,561,097 ordinary shares with a net book value of £129m (2013 11,960,535, 2012 20,365,787 ordinary shares with net book values of £91m and £125m respectively) were held for the purpose of share-based payment plans and included in retained earnings. During the year, 7,770,113 ordinary shares with a net book value of £64m (2013 16,603,840 shares with a net book value of £118m) vested in share-based payment plans. During the year the Company acquired 169,404 (2013 298,588) of its ordinary shares via reinvestment of dividends received on its own shares. In addition, the Company issued 10,200,000 (2013 7,900,000) new ordinary shares to the Group's share trust for its employees share-based payment plans with a net book value of £100m (2013 £81m).

<sup>4</sup> Share-based payments – direct to equity is the net of the credit to equity in respect of the share-based payment charge to the income statement and the actual cost of shares vesting, excluding those vesting from own shares.

<sup>5</sup> On 1 January 2013, the Group exercised rights that resulted in Rolls-Royce Power Systems AG (RRPS) being classified as a subsidiary and consolidated.

<sup>6</sup> As part of the Rolls-Royce Power Systems Holding GmbH (RRPSH) shareholders' agreement, Daimler had the option to sell its shares in RRPSH to Rolls-Royce for a period of six years from 1 January 2013. The initial fair value of the exercise price of this option in respect of Bergen Engines AS (£166m) was recognised in 2012 and the amount in respect of RRPS was recognised in 2013 and charged to retained earnings. In addition, £45m of the initial recognition of the put option on NCI relating to Bergen Engines AS, recognised in 2012, was reclassified from NCI to retained earnings. Subsequent movements in the value of the liability are included in the income statement but excluded from the underlying results.

<sup>7</sup> Following the completion of the sale of the Energy business to Siemens on 1 December 2014 and further to the announcement on 19 June 2014 of a £1bn share buyback, on 10 December 2014 the Company put in place a £250m programme to enable the purchase of its ordinary shares. The aim of the buyback is to reduce the issued share capital of the Company, helping enhance returns for shareholders. In the period to 31 December 2014, 8,215,000 shares were purchased at an average price of 840p. These shares were cancelled.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 1 ACCOUNTING POLICIES

### THE COMPANY

Rolls-Royce Holdings plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended 31 December 2014 consist of the consolidation of the financial statements of the Company and its subsidiaries (together referred to as the 'Group') and include the Group's interest in jointly controlled and associated entities.

### BASIS OF PREPARATION AND STATEMENT OF COMPLIANCE

In accordance with European Union (EU) regulations, these financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), as adopted for use in the EU effective at 31 December 2014 (Adopted IFRS).

The Company has elected to prepare its parent company financial statements under UK Generally Accepted Accounting Practices. These are set out on pages 149 to 151 and the accounting policies in respect of Company financial statements are set out on page 150.

These consolidated financial statements have been prepared on the historical cost basis except where Adopted IFRS requires the revaluation of financial instruments to fair value and certain other assets and liabilities on an alternative basis – most significantly post-retirement scheme obligations are valued on the basis required by IAS 19 *Employee Benefits* – and on a going concern basis as described on page 164.

The consolidated financial statements are presented in sterling which is the Company's functional currency.

The preparation of financial statements in conformity with Adopted IFRS requires management to make judgements and estimates that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### KEY AREAS OF JUDGEMENT

#### INTRODUCTION

The Group generates a significant portion of its revenues and profit on aftermarket arrangements arising from the installed original equipment (OE) fleet. As a consequence, the Group will often agree contractual prices for OE deliveries that take into account the anticipated aftermarket arrangements. Accounting policies reflect this aspect of the business model, in particular the policies for the recognition of contractual aftermarket rights and the linkage of OE and aftermarket arrangements.

When a civil large engine is sold, the economic benefits received usually far exceed the cash receivable under the contract, due to the rights to valuable aftermarket spare parts business. However, because the value of this right cannot be estimated with enough precision, accounting standards require that the revenue recognised in the accounts on sale of the engine is restricted to a total amount that results in a break even position. The amount of the revenue recognised in excess of cash receivable is recognised as an intangible asset, which is called a 'contractual aftermarket right' (previously referred to as a 'recoverable engine cost'; this change has been made to reflect better the nature of the asset).

There is only one circumstance where accounting standards require the recognition of more of the value of the aftermarket rights when an engine is sold. This occurs where a long-term aftermarket contract (generally a TotalCare agreement – TCA) and an engine sale contract have been negotiated together. In this circumstance, the part of the aftermarket rights covered by the TCA can be valued much more precisely and is recognised at the time of the engine sale through accounting for the engine sale and TCA as a single contract. Nevertheless, the accounting profit recognised is still less than the economic benefits on the sale as there will be other valuable aftermarket rights (for instance for the period beyond the TCA term or for the sale of parts which are outside the scope of the TCA) which cannot be recognised.

The Group enters into arrangements with long-term suppliers to share the risks and rewards of major programmes – risk and revenue sharing arrangements (RRSAs). The accounting policy for these arrangements has been chosen, consistent with Adopted IFRS, to reflect their commercial effect.

The key judgements in determining these accounting policies are described below.

#### CONTRACTUAL AFTERMARKET RIGHTS (CARs)

On delivery of Civil aerospace engines, the Group has contractual rights to supply aftermarket parts to the customers and its intellectual rights, warranty arrangements and, where relevant, statutory airworthiness or other regulatory requirements provide reasonable control over this supply. The directors consider that these rights meet the definition of an intangible asset in IAS 38 *Intangible Assets*. However, the directors do not consider that it is possible to determine a reliable fair value for this intangible asset. Accordingly, an intangible asset (CAR) is only recognised on the occasions where the contractual price of the engine is below the cost of manufacture and then only to the extent of this deficit, as this amount is reliably measurable. An equal amount of revenue is recognised at the same point. Where a long-term aftermarket contract is linked to the OE contract (see below), the contractual price of the engine (including amounts allocated from the aftermarket contract) is above its cost of manufacture; consequently no CAR is recognised.

#### MEASURE OF PERFORMANCE ON LONG-TERM AFTERMARKET CONTRACTS

A large proportion of the Group's activities relate to long-term aftermarket contracts, in particular TotalCare and similar arrangements in the Aerospace Division. Under these contracts, the Group's primary obligation is to maintain customers' equipment in an operational condition and achieves this by undertaking various activities, such as engine monitoring, line maintenance and repair and overhaul, over

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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### 1 ACCOUNTING POLICIES CONTINUED

the period of the contract. In general, the directors consider that the stage of performance of the contract should be by reference to the obligation to maintain an operational fleet and that this is best measured by the operation of the fleet. Accordingly, stage of performance is measured by reference to flying hours of each fleet under contract.

#### LINKAGE OF ORIGINAL AND LONG-TERM AFTERMARKET CONTRACTS

Where the key terms of a long-term aftermarket contract are substantively agreed (eg in a term sheet) at the same time as an OE contract with the operator, the directors consider these to be linked for accounting purposes and they are treated as a single contract, as this best reflects the overall commercial effect. Where the OE contract is not with the operator, eg where it is with an OE manufacturer or a lessor, the contracts are not linked as they were not negotiated on a unified basis.

#### RISK AND REVENUE SHARING ARRANGEMENTS (RRSAs)

RRSAs with key suppliers (workshare partners) are a feature of our Civil aerospace business. Under these contractual arrangements the key commercial objectives are that: (i) during the development phase the workshare partner shares in the risks of developing an engine by performing its own development work, providing development parts and paying a non-refundable cash entry fee; and (ii) during the production phase it supplies components in return for a share of the programme revenues as a 'life of type' supplier (ie as long as the engine remains in service). The share of development costs borne by the workshare partner and of the revenues it receives reflect the partner's proportionate cost of providing its production parts compared to the overall manufacturing cost of the engine. The share is based on a jointly agreed forecast at the commencement of the arrangement.

These arrangements are complex and have features that could be indicative of: a collaboration agreement, including sharing of risk and cost in a development programme; a long-term supply agreement; sharing of intellectual property; or a combination of these. In summary, and as described below, the directors' view is that the development and production phases of the contract should be considered separately in accounting for the RRSA, which results in the entry fee being matched against the non-recurring costs incurred by the Group.

Having considered the features above, the directors considered that there is no directly applicable IFRS to determine an accounting policy for the recognition of entry fees of this nature in the income statement. Consequently, in developing an accounting treatment for such entry fees that best reflects the commercial objectives of the contractual arrangement, the directors have analysed these features in the context of relevant accounting pronouncements (including those of other standard setters where these do not conflict with IFRS) and have weighed the importance of each feature in faithfully representing the overall commercial effect. The most important considerations that need to be balanced are: the transfer of development risk; the workshare partner receiving little standalone value from the payment of the entry fee; and the overall effect being collaboration between the parties which falls short of being a joint venture as the Group controls the programme. Also important in the analysis is the fact that, whilst the Group and the workshare partner share risks and rewards through the life of the contract, these risks and rewards are very different during the development and production phases.

In this context, the entry fee might be considered to represent: an amount paid as an equalisation of development costs; a payment to secure a long-term supply arrangement; a purchase of intellectual property; or some combination thereof. The accounting under these different scenarios could include: recognition of the entry fee to match the associated costs in the income statement; being spread over the life of the programme as a reduction in the cost of supply during production; or being spread over the time period of the access to the intellectual property by the workshare partner.

The directors consider that the most important features of the arrangement are the risk sharing and that the entry fee represents a contribution to the development costs that the Group incurs in excess of its proportionate programme share. The key judgements taken in reaching this view are: the entry fee is determined by the parties on that basis and the contract specifies that, in the event that a derivative engine is to be developed, additional entry fees will also be calculated on this basis; the workshare partners describe the entry fee in this way; although the workshare partner receives little stand-alone value from paying the entry fee, the entry fee together with its own development activities represent its aggregate investment in the collaboration; the amount of the entry fee does not include any amount in excess of that necessary to equalise forecast development costs; the Group is not 'on risk' for the full development costs it incurs but for that amount less the entry fees received; and, as far as can be determined, this appears to be common industry accounting for arrangements of this type, under both Adopted IFRS and US accounting standards (which the directors do not believe conflicts with IFRS in this regard).

The resulting accounting policy (described on page 105) represents the commercial effect of the contractual arrangements in that the Group recognises only those development costs to which it is exposed (and thus reflects the significant transfer of development risk to the workshare partner) and the costs of supply of parts during the production phase is measured at the workshare partner's share of programme revenues (which we consider to be a commercial fair value). The directors do not consider that accounting which would result in entry fees only being recognised in the production phase would appropriately reflect the sharing of development risk. Accordingly, the directors believe that the policy adopted best reflects the commercial objectives of the arrangements, the nature of the relationship with the workshare partner and is in accordance with Adopted IFRS.

As described in the 2013 Annual Report, an alternative view is that the RRSA contract cannot be divided into separate development and production phases, as the fees and development components received by the Group during the development phase are exchanged for the obligation to pay the supplier a predetermined share of any sales receipts during the production phase. On this basis the entry fees received would be deferred in their entirety and recognised over the period of production. The size of the difference between the two



## 1 ACCOUNTING POLICIES CONTINUED

approaches is monitored and is not currently expected to become material in the foreseeable future. The impact of the different approaches on profit before tax and net assets, which is not considered to be material, is as follows:

	2014			2013		
	Reported profit before tax £m	Underlying profit before tax £m	Net assets £m	Reported profit before tax £m	Underlying profit before tax £m	Net assets £m
Adopted policy	67	1,617	6,387	1,700	1,759	6,303
Difference	(30) <sup>1</sup>	(30)	(402)	(37)	(37)	(383) <sup>2</sup>
Alternative policy	37	1,587	5,985	1,663	1,722	5,920

<sup>1</sup> If the alternative policy were adopted, the difference would be included in profit before financing, which would change from £1,398m as reported to £1,368m.

<sup>2</sup> The 2013 adjustment includes a consequential adjustment to transactions with joint ventures, which was not reflected in the 2013 Annual Report.

### INTERNALLY GENERATED DEVELOPMENT COSTS

IAS 38 requires that internally generated development costs should only be recognised if strict criteria are met, in particular relating to technical feasibility and generation of future economic benefits. The directors consider that, due to the complex nature of new equipment programmes, these criteria are not met until relatively late in the programme – Civil aerospace programmes represent around half of development costs recognised; for these, the criteria are generally satisfied around the time of the initial engine certification.

### CUSTOMER FINANCING CONTINGENT LIABILITIES

The Group has contingent liabilities in respect of financing support provided to customers. In order to assess whether a provision should be recognised, judgement as to the likelihood of these crystallising is required. This judgement is based on an assessment on the knowledge of the customers' fleet plans, the underlying value of the security provided and, where appropriate, the customers' creditworthiness.

### KEY SOURCES OF ESTIMATION UNCERTAINTY

In applying the accounting policies, estimates are made in many areas; the actual outcome may differ from that calculated. The key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are set out below. The estimation of the relevant assets and liabilities involves the combination of a number of assumptions. Sensitivities are disclosed in the relevant notes where this is appropriate and practicable.

### FORECASTS AND DISCOUNT RATES

The carrying values of a number of items on the balance sheet are dependent on the estimates of future cash flows arising from the Group's operations, in particular:

- The assessment of whether the goodwill and other intangible assets (carrying value at 31 December 2014 **£1,658 million**, 31 December 2013 £1,864 million) arising on the consolidation of RRPS is impaired is dependent of the present value of the future cash flows expected to be generated by the business.
- The assessment as to whether there are any indications of impairment of development, participation, certification and contractual aftermarket rights recognised as intangible assets (carrying values at 31 December 2014 **£2,533 million**, 31 December 2013 £2,499 million) is dependent on estimates of cash flows generated by the relevant assets and the discount rate used to calculate a present value. These estimates include the performance of long-term contractual arrangements as described below, as well as estimates for future market share, pricing and unit cost for uncontracted business. The risk of impairment is generally higher for newer programmes and for customer specific intangible assets (CARs) for launch customers.

### ASSESSMENT OF LONG-TERM CONTRACTUAL ARRANGEMENTS

The Group has long-term contracts that fall into different accounting periods and which can extend over significant periods – the most significant of these are long-term service arrangements in the Civil aerospace business. The estimated revenues and costs are inherently imprecise and significant estimates are required to assess: engine flying hours, time on wing and other operating parameters; the pattern of future maintenance activity and the costs to be incurred; and life cycle cost improvements over the term of the contracts. The estimates take account of the inherent uncertainties and the risk of non-recovery of any resulting contract balances.

### POST-RETIREMENT BENEFITS

The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19. The accounting valuation, which is based on assumptions determined with independent actuarial advice, resulted in a net surplus of **£555 million** before deferred taxation being recognised on the balance sheet at 31 December 2014 (31 December 2013 net deficit £793 million). The size of the net surplus/deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 19.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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### 1 ACCOUNTING POLICIES CONTINUED

#### PROVISIONS

As described in the accounting policy on page 108, the Group measures provisions (carrying value at 31 December 2014 **£807 million**, 31 December 2013 **£733 million**) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates take account of information available and different possible outcomes.

#### TAXATION

The tax payable on profits is determined based on tax laws and regulations that apply in each of the numerous jurisdictions in which the Group operates. Where the precise impact of these laws and regulations is unclear then reasonable estimates may be used to determine the tax charge included in the financial statements.

#### SIGNIFICANT ACCOUNTING POLICIES

The Group's significant accounting policies are set out below. These accounting policies have been applied consistently to all periods presented in these consolidated financial statements and by all Group entities.

#### BASIS OF CONSOLIDATION

The Group consolidated financial statements include the financial statements of the Company and its subsidiary undertakings together with the Group's share of the results of joint arrangements and associates made up to 31 December. In line with common practice in Germany, a small number of immaterial subsidiaries of Rolls-Royce Power Systems are not consolidated and are carried at cost in other investments. If such subsidiaries become material, they are consolidated. The difference between the net assets recognised and the investment cost eliminated is recognised in other operating income.

A subsidiary is an entity controlled by the Company. Control exists when the Company has power over an entity, exposure to variable returns from its involvement with an entity and the ability to use its power over an entity so as to affect the Company's returns.

A joint arrangement is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. Joint arrangements may be either joint ventures or joint operations; all the Group's joint arrangements have been classified as joint ventures. An associate is an entity, being neither a subsidiary nor a joint arrangement, in which the Group holds a long-term interest and where the Group has a significant influence. The results of joint ventures and associates are accounted for using the equity method of accounting.

Any subsidiary undertakings, joint ventures or associates sold or acquired during the year are included up to, or from, the dates of change of control. Transactions with non-controlling interests are recorded directly in equity.

Where a put option over shares held by a non-controlling interest has been agreed, the Group recognises a liability for the estimated exercise value of that option. Movements in the estimated liability after initial recognition are recognised in the income statement.

All intra-group transactions, balances, income and expenses are eliminated on consolidation. Adjustments are made to eliminate the profit or loss arising on transactions with joint ventures and associates to the extent of the Group's interest in the entity.

#### REVENUE RECOGNITION

Revenues comprise sales to outside customers after discounts, excluding value added taxes.

**Sales of products** (both original equipment and spare parts) are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured – this is generally on delivery. On occasion, the Group may participate in the financing of OE, most commonly by the provision of guarantees as described in note 18. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing when the significant risks and rewards of ownership have been transferred to the customer. As described on page 101, a sale of OE at a contractual price below its cost of manufacture is considered to give rise to revenue to the extent that an intangible asset, (contractual aftermarket right), is recognised at the same time.

**Sales of services** are recognised by reference to the stage of completion based on services performed to date. As described on page 103, the assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on: flying hours or equivalent for long-term aftermarket arrangements where the service is provided on a continuous basis; costs incurred to the extent these relate to services performed up to the reporting date; or achievement of contractual milestones where relevant.

As described on page 102, **sales of products and services** are treated as though they are a single contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single transaction with an overall profit margin. The total revenue is allocated between the two components such that the total agreed discount to list prices is allocated to revenue for each of the two components pro rata, based on list prices. The revenue is then recognised for each component on this basis as the products are delivered and services provided, as described above. Where the contractual price of the OE component is below the revenue allocated from the combined arrangement, this will give rise to an asset included in 'amounts recoverable on contracts'. This asset reduces as services are provided, increases as costs are incurred, and reduces to zero by the end of the contract. Where the balance is a liability, it is recognised in 'accruals and deferred income'.

## 1 ACCOUNTING POLICIES CONTINUED

Provided that the outcome of construction contracts can be assessed with reasonable certainty, the revenues and costs on such contracts are recognised based on stage of completion and the overall contract profitability. Full provision is made for any estimated losses to completion of contracts, having regard to the overall substance of the arrangements.

Progress payments received, when greater than recorded revenue, are deducted from the value of work in progress except to the extent that payments on account exceed the value of work in progress on any contract where the excess is included in accruals and deferred income within trade and other payables. The amount by which recorded revenue of long-term contracts is in excess of payments on account is classified as amounts recoverable on contracts and is separately disclosed within trade and other receivables.

### TOTALCARE ARRANGEMENTS

As described above, these are accounted for on a stage of completion basis, with the stage of completion based on the proportion of flying hours completed compared to the total estimated under the contract. In making the assessment of future revenues, costs and the level of profit recognised the Group takes account of: (i) the forecast utilisation of the engines by the operator; (ii) the forecast costs to maintain the engines in accordance with the contractual requirements – the principal variables being the time between shop visits and the cost of each shop visit; and (iii) the recoverability of any contract asset arising. The Group benchmarks the forecast costs against previous programmes, recognising that the reliability of the forecasts will improve as operational experience of the engine increases. To the extent that actual costs differ from forecast costs or that forecast costs change, the cumulative impact is recognised in the period. An allowance is made against contract assets arising, based on both the customer's creditworthiness and an assessment of the importance of the particular engine fleet to the customer. Again, changes in this allowance are recognised in the period.

### RISK AND REVENUE SHARING ARRANGEMENTS (RRSAs)

As described on page 102, the Group enters into arrangements with certain workshare partners under which these suppliers: (i) contribute to the forecast costs of developing an engine by performing their own development work, providing development parts and paying a non-refundable cash entry fee; and (ii) supply components for the production phase for which they receive consideration, which is an agreed proportion of the total programme revenues. Both the suppliers' contributions to the forecast non-recurring development costs and their consideration are determined by reference to their proportionate forecast scopes of supply relative to that of the engine overall. Once the forecast costs and the scopes of supply have been agreed at the inception of the contract, each party is then accountable for its own incurred costs. No accounting entries are recorded when the suppliers undertake development work or when development components are supplied. Cash sums received are recognised in the income statement, as a reduction in research and development costs incurred, to match the expensing of the Group's related costs – where the cash sums are received in advance of the related costs being expensed or where the related costs are capitalised as intangible assets, the recognition of the cash received is deferred (in accruals and deferred income) to match the recognition of the related expense or the amortisation of the related intangible asset respectively. The payments to suppliers of their shares of the programme revenues for their production components are charged to cost of sales as programme revenues arise.

The Group has arrangements with partners who do not undertake development work or supply parts. Such arrangements are considered to be financial instruments as defined by IAS 32 *Financial Instruments: Presentation* and are accounted for using the amortised cost method.

### GOVERNMENT INVESTMENT

Where a government or similar body has previously invested in a development programme, the Group treats payments to that body as royalty payments, which are matched to related sales.

### GOVERNMENT GRANTS

Government grants are recognised in the income statement so as to match them with the related expenses that they are intended to compensate. Where grants are received in advance of the related expenses, they are included in the balance sheet as deferred income. Non-monetary grants are recognised at fair value.

### INTEREST

Interest receivable/payable is credited/charged to the income statement using the effective interest method. Where borrowing costs are attributable to the acquisition, construction or production of a qualifying asset, such costs are capitalised as part of the specific asset.

### TAXATION

The tax charge/credit on the profit or loss for the year comprises current and deferred tax:

- Current tax is the expected tax payable for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.
- Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and the amounts used for taxation purposes and is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled.

Tax is charged or credited in the income statement or other comprehensive income (OCI) as appropriate, except when it relates to items credited or charged directly to equity in which case the tax is also dealt with in equity.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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### 1 ACCOUNTING POLICIES CONTINUED

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax is not recognised on taxable temporary differences arising on the initial recognition of goodwill or for temporary differences arising from the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit.

Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be utilised.

Accruals for tax contingencies require management to make judgements and estimates of exposures in relation to tax audit issues. Tax benefits are not recognised unless the tax positions will probably be sustained. Once considered to be probable, management reviews each material tax benefit to assess whether a provision should be taken against full recognition of that benefit on the basis of potential settlement through negotiation and/or litigation. All provisions are included in current liabilities. Any liability relating to interest on tax liabilities is provided for in the tax charge.

#### FOREIGN CURRENCY TRANSLATION

Transactions denominated in currencies other than the functional currency of the transacting Group undertaking are translated into the functional currency at the exchange rates ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the rate ruling at the year end. Exchange differences arising on foreign exchange transactions and the retranslation of assets and liabilities into functional currencies at the rate ruling at the year end are taken into account in determining profit before taxation.

The trading results of Group undertakings are translated into sterling at the average exchange rates for the year. The assets and liabilities of overseas undertakings, including goodwill and fair value adjustments arising on acquisition, are translated at the exchange rates ruling at the year end. Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are recognised in OCI. The cumulative amount of exchange adjustments was, on transition to IFRS in 2004, deemed to nil.

#### FINANCIAL INSTRUMENTS

IAS 39 *Financial Instruments: Recognition and Measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different. The Group has classified its financial instruments as follows:

- short-term investments are generally classified as **available for sale**;
- short-term deposits (principally comprising funds held with banks and other financial institutions), trade receivables and short-term investments not designated as available for sale are classified as **loans and receivables**;
- borrowings, trade payables, financial RRSAs, put options on NCI, and C Shares are classified as **other liabilities**; and
- derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as **fair value through profit or loss**.

Financial instruments are recognised at the contract date and initially measured at fair value. Their subsequent measurement depends on their classification:

- **Available for sale assets** are held at fair value. Changes in fair value arising from changes in exchange rates are included in the income statement. All other changes in fair value are taken to equity. On disposal, the accumulated changes in value recorded in equity are included in the gain or loss recorded in the income statement.
- **Loans and receivables** and **other liabilities** are held at amortised cost and not revalued (except for changes in exchange rates and forecast contractual cash flows, which are included in the income statement) unless they are included in a fair value hedge accounting relationship. Where such a hedging relationship exists, the instruments are revalued in respect of the risk being hedged, with the change in value included in the income statement.
- **Fair value through profit or loss** items are held at fair value. Changes in fair value are included in the income statement unless the instrument is included in a cash flow hedge. If the instruments are included in an effective cash flow hedging relationship, changes in value are taken to equity. When the hedged forecast transaction occurs, amounts previously recorded in equity are recognised in the income statement.

Financial instruments are derecognised on expiry or when all contractual rights and obligations are transferred.

#### HEDGE ACCOUNTING

The Group does not generally apply hedge accounting in respect of forward foreign exchange contracts or commodity swaps held to manage the cash flow exposures of forecast transactions denominated in foreign currencies or in commodities respectively.

The Group applies hedge accounting in respect of transactions entered into to manage the fair value and cash flow exposures of its borrowings. Forward foreign exchange contracts are held to manage the fair value exposures of borrowings denominated in foreign currencies and are designated as fair value hedges. Interest rate swaps are held to manage the interest rate exposures and are designated as fair value or cash flow hedges of fixed and floating rate borrowings respectively.

## 1 ACCOUNTING POLICIES CONTINUED

Changes in the fair values of derivatives designated as fair value hedges and changes in fair value of the related hedged item are recognised directly in the income statement.

Changes in the fair values of derivatives that are designated as cash flow hedges and are effective are recognised directly in equity. Any ineffectiveness in the hedging relationships is included in the income statement. The amounts deferred in equity are recognised in the income statement to match the recognition of the hedged item.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, exercised, or no longer qualifies for hedge accounting. At that time, for cash flow hedges and if the forecast transaction remains probable, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss previously recognised in equity is transferred to the income statement.

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in equity. The ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in the translation reserve will be recycled to profit when the foreign operation is sold.

### BUSINESS COMBINATIONS AND GOODWILL

On the acquisition of a business, fair values are attributed to the identifiable assets and liabilities and contingent liabilities unless the fair value cannot be measured reliably, in which case the value is subsumed into goodwill. Where fair values of acquired contingent liabilities cannot be measured reliably, the assumed contingent liability is not recognised but is disclosed in the same manner as other contingent liabilities.

Goodwill recognised represents the excess of the fair value of the purchase consideration over the fair value to the Group of the net of the identifiable assets acquired and the liabilities assumed. On transition to IFRS on 1 January 2004, business combinations were not retrospectively adjusted to comply with Adopted IFRS and goodwill was recognised based on the carrying value under the previous accounting policies. Goodwill in respect of the acquisition of a subsidiary is recognised as an intangible asset. Goodwill arising on the acquisition of joint ventures and associates is included in the carrying value of the investment.

### CERTIFICATION COSTS AND PARTICIPATION FEES

Costs incurred in respect of meeting regulatory certification requirements for new civil aero-engine/aircraft combinations including payments made to airframe manufacturers for this and participation fees are carried forward in intangible assets to the extent that they can be recovered out of future sales and are charged to the income statement over the programme life, up to a maximum of 15 years from the entry into service of the product.

### RESEARCH AND DEVELOPMENT

In accordance with IAS 38 *Intangible Assets*, expenditure incurred on research and development is distinguished as relating either to a research phase or to a development phase.

All research phase expenditure is charged to the income statement. Development expenditure is capitalised as an internally generated intangible asset only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits. As described on page 103, the Group considers that it is not possible to distinguish reliably between research and development activities until relatively late in the programme.

Expenditure capitalised is amortised over its useful economic life, up to a maximum of 15 years from the entry into service of the product.

### CONTRACTUAL AFTERMARKET RIGHTS

As described under key judgements on page 101, the Group may sell OE to customers at a price below its cost, on the basis that it also receives valuable aftermarket rights. Such a sale is considered to give rise to an intangible asset which is recognised, in accordance with IAS 38, at the same time as the revenue at an amount equal to the cash deficit and is amortised on a straight-line basis over the period that highly probable aftermarket sales are expected to be earned.

### CUSTOMER RELATIONSHIPS

The fair value of customer relationships recognised as a result of a business combination relate to the acquired company's established relationships with its existing customers that result in repeat purchases and customer loyalty. Amortisation occurs on a straight-line basis over its useful economic life, up to a maximum of 15 years.

### SOFTWARE

The cost of acquiring software that is not specific to an item of property, plant and equipment is classified as an intangible asset and amortised over its useful economic life, up to a maximum of five years.

### PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment assets are stated at cost less accumulated depreciation and any provision for impairment in value.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 1 ACCOUNTING POLICIES CONTINUED

Depreciation is provided on a straight-line basis to write off the cost, less the estimated residual value, of property, plant and equipment over their estimated useful lives. No depreciation is provided on assets in the course of construction. Estimated useful lives are as follows:

- i) land and buildings, as advised by the Group's professional advisers:
  - a) freehold buildings – five to 45 years (average 25 years);
  - b) leasehold buildings – lower of adviser's estimates or period of lease;
  - c) no depreciation is provided on freehold land;
- ii) plant and equipment – five to 25 years (average 13 years);
- iii) aircraft and engines – five to 20 years (average 14 years).

#### OPERATING LEASES

Payments made and rentals received under operating lease arrangements are charged/credited to the income statement on a straight-line basis.

#### IMPAIRMENT OF NON-CURRENT ASSETS

Impairment of non-current assets is considered in accordance with IAS 36 *Impairment of Assets*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the cash-generating unit to which the asset belongs. Goodwill and intangible assets not yet available for use are tested for impairment annually. Other intangible assets, property, plant and equipment and investments are assessed for any indications of impairment annually. If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense. The recoverable amount is the higher of value in use or fair value less costs to sell, if this is readily available. The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset.

#### INVENTORIES

Inventories and work in progress are valued at the lower of cost and net realisable value on a first-in, first-out basis. Cost comprises direct materials and, where applicable, direct labour costs and those overheads, including depreciation of property, plant and equipment, that have been incurred in bringing the inventories to their present location and condition. Net realisable value represents the estimated selling prices less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

#### CASH AND CASH EQUIVALENTS

Cash and cash equivalents includes cash at bank and in hand, investments in money-market funds and short-term deposits with a maturity of three months or less on inception. The Group considers overdrafts (repayable on demand) to be an integral part of its cash management activities and these are included in cash and cash equivalents for the purposes of the cash flow statement.

#### PROVISIONS

Provisions are recognised when the Group has a present obligation as a result of a past event, and it is probable that the Group will be required to settle that obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

#### POST-RETIREMENT BENEFITS

Pensions and similar benefits (principally healthcare) are accounted for under IAS 19 *Employee Benefits*.

For defined benefit plans, obligations are measured at discounted present value, using a discount rate derived from high-quality corporate bonds denominated in the currency of the plan, whilst plan assets are recorded at fair value. Surpluses in schemes are recognised as assets only if they represent economic benefits available to the Group in the future. A liability is recognised to the extent that the minimum funding requirements in respect of past service will give rise to an unrecognisable surplus.

The service and financing costs of such plans are recognised separately in the income statement:

- current service costs are spread systematically over the lives of employees;
- past-service costs are recognised immediately; and
- financing costs are recognised in the periods in which they arise.

Actuarial gains and losses and movements in unrecognised surpluses and minimum funding liabilities are recognised immediately in OCI.

Payments to defined contribution schemes are charged as an expense as they fall due.

## 1 ACCOUNTING POLICIES CONTINUED

### SHARE-BASED PAYMENTS

The Group provides share-based payment arrangements to certain employees. These are principally equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant. The fair value is expensed on a straight-line basis over the vesting period. The amount recognised as an expense is adjusted to reflect the actual number of shares or options that will vest, except where additional shares vest as a result of the total shareholder return (TSR) performance condition in the Performance Share Plan (PSP).

Cash-settled share options (grants in the International ShareSave plan) are measured at fair value at the balance sheet date. The Group recognises a liability at the balance sheet date based on these fair values, taking into account the estimated number of options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

The cost of shares of Rolls-Royce Holdings plc held by the Group for the purpose of fulfilling obligations in respect of employee share plans is deducted from equity in the consolidated balance sheet. See note 21 for a further description of the share-based payment plans.

### SALES FINANCING SUPPORT

In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers. These arrangements fall into two categories: credit-based guarantees and asset-value guarantees. In accordance with the requirements of IAS 39 and IFRS 4 *Insurance Contracts*, credit-based guarantees are treated as insurance contracts. The Group considers asset-value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts. As described on page 103, the directors consider the likelihood of crystallisation in assessing whether provision is required for any contingent liabilities.

The Group's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio, and are reported on a discounted basis.

### REVISIONS TO ADOPTED IFRS IN 2014

With effect from 1 January 2014, the Group has adopted IFRS 10 *Consolidated Financial statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*. The principal potential effect was that certain entities previously classified as joint ventures might be classified as joint operations, requiring the Group's share of the individual assets and liabilities of these entities to be included in the financial statements rather than the equity accounting method previously applied. The Group has reviewed its material joint ventures and has concluded that none are to be classified as joint operations under the requirements of IFRS 11. Disclosures required by IFRS 12 are included in note 11.

### REVISIONS TO IFRS NOT APPLICABLE IN 2014

Standards and interpretations issued by the IASB are only applicable if endorsed by the EU.

Once endorsed, IFRS 9 *Financial Instruments* will simplify the classification of financial assets for measurement purposes, but is not anticipated to have a significant impact on the financial statements.

IFRS 15 *Revenue from Contracts with Customers* (effective for the year ending 31 December 2017, not yet endorsed by the EU) provides a single, principles-based five-step model to be applied to all sales contracts, based on the transfer of control of goods and services to customers. It replaces the separate models for goods, services and construction contracts currently included in IAS 11 *Construction Contracts* and IAS 18 *Revenue*. Given the nature of the Group's long-term contracts, it is likely that the adoption of IFRS 15 will require significant judgement.

Based on an initial assessment, IFRS 15 may have a significant impact on the timing of recognition of revenue on individual long-term contracts, although this impact is likely to be significantly reduced at a Group level when all long-term contracts (with different start and end dates) are combined. The Group will continue to assess the impact during 2015.

The Group does not consider that any other standards, amendments or interpretations issued by the IASB, but not yet applicable, will have a significant impact on the financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 2 SEGMENTAL ANALYSIS

The analysis by Division (business segment) is presented in accordance with IFRS 8 *Operating Segments*, on the basis of those segments whose operating results are regularly reviewed by the Board (the Chief Operating Decision Maker as defined by IFRS 8), as follows:

#### AEROSPACE DIVISION:

Civil – development, manufacture, marketing and sales of commercial aero engines and aftermarket services.  
 Defence – development, manufacture, marketing and sales of military aero engines and aftermarket services.

#### LAND & SEA DIVISION:

Power Systems – development, manufacture, marketing and sales of diesel engines and power systems.  
 Marine – development, manufacture, marketing and sales of marine-power propulsion systems and aftermarket services.  
 Nuclear & Energy – development, manufacture, marketing and sales of nuclear systems for civil power generation and naval propulsion systems (Nuclear) and power systems for the offshore oil & gas industry and electrical power generation (Energy) and aftermarket services. The Energy business was sold on 1 December 2014 – see note 25.

The operating results reviewed by the Board are prepared on an underlying basis, which the Board consider reflects better the economic substance of the Group's trading during the year. Additional disclosure of the two segments is also provided. The principles adopted to determine underlying results are:

**Underlying revenues** – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these reflect the achieved exchange rates arising on settled derivative contracts.

**Underlying profit before financing** – Where transactions are denominated in a currency other than the functional currency of the Group undertaking, this reflects the transactions at the achieved exchange rates on settled derivative contracts. In addition, adjustments have been made to exclude one-off past-service credits on post-retirement schemes, exceptional restructuring costs and the effect of acquisition accounting.

**Underlying profit before taxation** – In addition to those adjustments in underlying profit before financing:

- includes amounts realised from settled derivative contracts and revaluation of relevant assets and liabilities to exchange rates forecast to be achieved from future settlement of derivative contracts; and
- excludes unrealised amounts arising from revaluations required by IAS 39 *Financial Instruments: Recognition and Measurement*, changes in value of financial RRSA contracts arising from changes in forecast payments, changes in the value of put options on NCI and the net impact of financing costs related to post-retirement scheme benefits.

**Taxation** – the tax effect of the adjustments above are excluded from the underlying tax charge. In addition, changes in the amount of recoverable advance corporation tax recognised that arise from the above adjustments are also excluded.

This analysis also includes a reconciliation of the underlying results to those reported in the consolidated income statement.



## 2 SEGMENTAL ANALYSIS CONTINUED

	Aerospace			Land & Sea				Inter-segment £m	Total reportable segments £m	
	Civil £m	Defence £m	Total £m	Power Systems £m	Marine £m	Nuclear & Energy £m	Intra- segment £m			Total £m
<b>Year ended 31 December 2014</b>										
Underlying revenue from sale of original equipment	3,265	816	4,081	1,893	1,070	556	(78)	3,441	–	7,522
Underlying revenue from aftermarket services	3,572	1,253	4,825	827	639	852	(77)	2,241	–	7,066
<b>Total underlying revenue</b>	<b>6,837</b>	<b>2,069</b>	<b>8,906</b>	<b>2,720</b>	<b>1,709</b>	<b>1,408</b>	<b>(155)</b>	<b>5,682</b>	<b>–</b>	<b>14,588</b>
Underlying operating profit excluding share of results of joint ventures and associates	849	350	1,199	256	138	42	(13)	423	–	1,622
Share of results of joint ventures and associates	93	16	109	(3)	–	3	–	–	–	109
<b>Underlying profit before financing and taxation</b>	<b>942</b>	<b>366</b>	<b>1,308</b>	<b>253</b>	<b>138</b>	<b>45</b>	<b>(13)</b>	<b>423</b>	<b>–</b>	<b>1,731</b>
Segment assets	10,268	1,460	11,728	3,581	1,636	954	(22)	6,149	(1,269)	16,608
Investments in joint ventures and associates	507	13	520	7	5	7	–	19	–	539
Segment liabilities	(7,418)	(1,743)	(9,161)	(1,100)	(1,075)	(880)	–	(3,055)	1,269	(10,947)
<b>Net assets/(liabilities)</b>	<b>3,357</b>	<b>(270)</b>	<b>3,087</b>	<b>2,488</b>	<b>566</b>	<b>81</b>	<b>(22)</b>	<b>3,113</b>	<b>–</b>	<b>6,200</b>
Investment in intangible assets, property, plant and equipment and joint ventures and associates	836	78	914	144	36	62	–	242	–	1,156
Depreciation, amortisation and impairment	381	49	430	221	38	53	–	312	–	742
<b>Year ended 31 December 2013<sup>1</sup></b>										
Underlying revenue from sale of original equipment	3,035	1,385	4,420	2,004	1,288	565	(72)	3,785	–	8,205
Underlying revenue from aftermarket services	3,620	1,206	4,826	827	749	973	(75)	2,474	–	7,300
<b>Total underlying revenue</b>	<b>6,655</b>	<b>2,591</b>	<b>9,246</b>	<b>2,831</b>	<b>2,037</b>	<b>1,538</b>	<b>(147)</b>	<b>6,259</b>	<b>–</b>	<b>15,505</b>
Underlying operating profit excluding share of results of joint ventures and associates	708	424	1,132	296	233	63	2	594	–	1,726
Share of results of joint ventures and associates	136	14	150	(2)	–	11	–	9	–	159
<b>Underlying profit before financing and taxation</b>	<b>844</b>	<b>438</b>	<b>1,282</b>	<b>294</b>	<b>233</b>	<b>74</b>	<b>2</b>	<b>603</b>	<b>–</b>	<b>1,885</b>
Segment assets	9,587	1,437	11,024	3,927	1,701	1,616	(10)	7,234	(734)	17,524
Investments in joint ventures and associates	495	17	512	29	5	55	–	89	–	601
Segment liabilities	(6,243)	(1,660)	(7,903)	(3,034)	(985)	(1,015)	–	(5,034)	733	(12,204)
<b>Net assets/(liabilities)</b>	<b>3,839</b>	<b>(206)</b>	<b>3,633</b>	<b>922</b>	<b>721</b>	<b>656</b>	<b>(10)</b>	<b>2,289</b>	<b>(1)</b>	<b>5,921</b>
Investment in intangible assets, property, plant and equipment and joint ventures and associates	891	103	994	142	23	80	–	245	–	1,239
Depreciation and amortisation and impairment	349	53	402	272	63	63	–	398	–	800

<sup>1</sup> The split between OE and aftermarket revenue for the year ended 31 December 2013 in Marine and Nuclear & Energy has been amended compared with that included on page 123 of the 2013 Annual Report.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

## 2 SEGMENTAL ANALYSIS CONTINUED

## RECONCILIATION TO REPORTED RESULTS

	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Discontinued business £m	Group £m
<b>Year ended 31 December 2014</b>						
Revenue from sale of original equipment	7,522	–	7,522	61	(283)	7,300
Revenue from aftermarket services	7,066	–	7,066	(200)	(430)	6,436
<b>Total revenue</b>	<b>14,588</b>	<b>–</b>	<b>14,588</b>	<b>(139)</b>	<b>(713)</b>	<b>13,736</b>
Operating profit excluding share of results of joint ventures and associates	1,622	(53) <sup>1</sup>	1,569	(274)	1	1,296
Share of results of joint ventures and associates	109	–	109	(13)	(2)	94
Profit on transfer of joint ventures to subsidiaries	–	–	–	2	–	2
Profit on disposal of businesses	–	–	–	6	–	6
<b>Profit before financing and taxation</b>	<b>1,731</b>	<b>(53)</b>	<b>1,678</b>	<b>(279)</b>	<b>(1)</b>	<b>1,398</b>
Net financing		(61)	(61)	(1,270)	–	(1,331)
<b>Profit before taxation</b>		<b>(114)</b>	<b>1,617</b>	<b>(1,549)</b>	<b>(1)</b>	<b>67</b>
Taxation		(387)	(387)	239	(3)	(151)
Profit for the year from continuing operations			1,226	(1,310)	–	(84)
Profit for the year from discontinued operations			4	–	138	142
<b>Profit for the year</b>			<b>1,230</b>	<b>(1,310)</b>	<b>138</b>	<b>58</b>
Attributable to:						
Ordinary shareholders			1,224	(1,293)	138	69
Non-controlling interests			6	(17)	–	(11)

## Year ended 31 December 2013

Revenue from sale of original equipment	8,205	–	8,205	70	(328)	7,947
Revenue from aftermarket services	7,300	–	7,300	(62)	(543)	6,695
<b>Total revenue</b>	<b>15,505</b>	<b>–</b>	<b>15,505</b>	<b>8</b>	<b>(871)</b>	<b>14,642</b>
Operating profit excluding share of results of joint ventures and associates	1,726	(54) <sup>1</sup>	1,672	(297)	(45)	1,330
Share of results of joint ventures and associates	159	–	159	1	(11)	149
Profit on transfer of joint ventures to subsidiaries	–	–	–	119	–	119
Profit on disposal of businesses	–	–	–	216	–	216
<b>Profit before financing and taxation</b>	<b>1,885</b>	<b>(54)</b>	<b>1,831</b>	<b>39</b>	<b>(56)</b>	<b>1,814</b>
Net financing		(72)	(72)	(39)	(3)	(114)
<b>Profit before taxation</b>		<b>(126)</b>	<b>1,759</b>	<b>–</b>	<b>(59)</b>	<b>1,700</b>
Taxation		(434)	(434)	54	3	(377)
Profit for the year from continuing operations			1,269	54	–	1,323
Profit for the year from discontinued operations			56	–	–	56
<b>Profit for the year</b>			<b>1,325</b>	<b>54</b>	<b>–</b>	<b>1,379</b>
Attributable to:						
Ordinary shareholders			1,224	143	–	1,367
Non-controlling interests			101	(89)	–	12

<sup>1</sup> Central corporate costs

## DISCONTINUED OPERATIONS

	2014 £m	2013 £m
<b>Revenue</b>	<b>713</b>	<b>871</b>
<b>Profit before taxation</b>	<b>1</b>	<b>59</b>
Tax on ordinary activities	3	(3)
<b>Profit for the year from ordinary activities</b>	<b>4</b>	<b>56</b>
Profit on disposal	136	–
Tax on profit on disposal	2	–
<b>Profit for the year from discontinued operations</b>	<b>142</b>	<b>56</b>
Net cash (outflow)/inflow from operating activities	(127)	51
Net cash outflow from investing activities	(35)	(51)
Net cash flow from financing activities	–	–
<b>Net change in cash and cash equivalents</b>	<b>(162)</b>	<b>–</b>

## 2 SEGMENTAL ANALYSIS CONTINUED

## UNDERLYING ADJUSTMENTS

	2014				2013			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
<b>Underlying performance</b>	<b>14,588</b>	<b>1,678</b>	<b>(61)</b>	<b>(387)</b>	15,505	1,831	(72)	(434)
Revenue recognised at exchange rate on date of transaction	(139)	–	–	–	8	–	–	–
Realised gains on settled derivative contracts <sup>1</sup>	–	(87)	(5)	–	–	(10)	(5)	–
Net unrealised fair value changes to derivative contracts <sup>2</sup>	–	(15)	(1,141)	–	–	–	250	–
Effect of currency on contract accounting	–	13	–	–	–	(18)	–	–
Revaluation of trading assets and liabilities	–	(11)	(8)	–	–	–	–	–
Put option on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	–	–	(87)	–	–	–	(251)	–
Effect of acquisition accounting <sup>3</sup>	–	(142)	–	–	–	(265)	–	–
Pensions discretionary increase	–	–	–	–	–	(64)	–	–
Net post-retirement scheme financing	–	–	(29)	–	–	–	(26)	–
Profit on acquisition/reclassification of joint ventures	–	2	–	–	–	119	–	–
Profit on disposal of businesses	–	6	–	–	–	216	–	–
Exceptional restructuring <sup>4</sup>	–	(39)	–	–	–	–	–	–
Other <sup>5</sup>	–	(6)	–	–	–	61	(7)	–
Related tax effect	–	–	–	239	–	–	–	54
<b>Total underlying adjustments</b>	<b>(139)</b>	<b>(279)</b>	<b>(1,270)</b>	<b>239</b>	<b>8</b>	<b>39</b>	<b>(39)</b>	<b>54</b>
Discontinued operations	(713)	(1)	–	(3)	(871)	(56)	(3)	3
<b>Reported per consolidated income statement</b>	<b>13,736</b>	<b>1,398</b>	<b>(1,331)</b>	<b>(151)</b>	<b>14,642</b>	<b>1,814</b>	<b>(114)</b>	<b>(377)</b>

<sup>1</sup> Realised gains on settled derivative contracts include adjustments to reflect the gains in the same period as the related trading cash flows.

<sup>2</sup> Unrealised fair value changes to derivative contracts: (i) include those included in equity accounted joint ventures, which are included in profit before financing; and (ii) exclude those for which the related trading contracts have been cancelled when the fair value changes are recognised immediately in underlying profit.

<sup>3</sup> The adjustment eliminates charges recognised as a result of recognising assets in acquired businesses at fair value.

<sup>4</sup> Restructuring is excluded from the underlying performance when it relates to the closure of a significant business or a site.

<sup>5</sup> In 2013, other included the exclusion of other operating income £63m and the revaluation of preference shares in RRP AG, which were acquired.

The reconciliation of underlying earnings per ordinary share is shown in note 6.

## RECONCILIATION TO THE BALANCE SHEET

	2014 £m	2013 £m
Reportable segment assets	16,608	17,524
Investments in joint ventures and associates	539	601
Cash and cash equivalents and short-term investments	2,869	4,311
Fair value of swaps hedging fixed rate borrowings	80	47
Income tax assets	388	332
Post-retirement scheme surpluses	1,740	248
<b>Total assets</b>	<b>22,224</b>	<b>23,063</b>
Reportable segment liabilities	(10,947)	(12,204)
Borrowings	(2,261)	(2,371)
Fair value of swaps hedging fixed rate borrowings	(22)	(48)
Income tax liabilities	(1,422)	(1,096)
Post-retirement scheme deficits	(1,185)	(1,041)
<b>Total liabilities</b>	<b>(15,837)</b>	<b>(16,760)</b>
<b>Net assets</b>	<b>6,387</b>	<b>6,303</b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 2 SEGMENTAL ANALYSIS CONTINUED

#### GEOGRAPHICAL SEGMENTS

The Group's revenue by destination from continuing operations is shown below:

	2014 £m	2013 £m
United Kingdom	1,599	1,677
Norway	322	520
Germany	734	972
Switzerland	670	868
Spain	113	174
Italy	201	233
France	292	259
Russia	86	111
Rest of Europe	575	637
United States of America	3,751	3,910
Canada	472	474
South America	407	302
Saudi Arabia	327	544
Rest of Middle East	418	339
India	161	230
China	1,290	1,038
South Korea	485	452
Japan	272	235
Malaysia	280	235
Singapore	396	544
Rest of Asia	493	596
Africa	115	87
Australasia	207	143
Other	70	62
	<b>13,736</b>	<b>14,642</b>

No single customer represented 10% or more of the Group's revenue.

The carrying amounts of the Group's non-current assets, excluding financial instruments, deferred tax assets and post-retirement benefit surpluses, by the geographical area in which the assets are located, are as follows:

	£m	£m
United Kingdom	3,864	3,649
United States of America	827	872
Nordic countries	724	823
Germany	2,493	2,739
Other	912	924
	<b>8,820</b>	<b>9,007</b>

### 3 RESEARCH AND DEVELOPMENT AND OTHER INCOME

#### RESEARCH AND DEVELOPMENT

	2014 £m	2013 £m
Expenditure in the year	(818)	(725)
Capitalised as intangible assets	83	110
Amortisation of capitalised costs	(125)	(130)
<b>Net research and development cost</b>	<b>(860)</b>	<b>(745)</b>
Entry fees received	51	126
Entry fees deferred in respect of charges in future years	(38)	(50)
Recognition of previously deferred entry fees	54	11
<b>Net cost recognised in the income statement</b>	<b>(793)</b>	<b>(658)</b>
Underlying adjustments relating to effects of acquisition accounting and foreign exchange	63	59
Discontinued operations	(25)	(25)
<b>Net underlying cost recognised in the income statement</b>	<b>(755)</b>	<b>(624)</b>

#### OTHER INCOME

In October 2011, Rolls-Royce and United Technologies Corp. (UTC) announced their intention to form a new joint venture to develop an engine to power future mid-size aircraft (120-230 passenger aircraft). In September 2013, the parties agreed not to proceed with the partnership. Other operating income in 2013 includes £63 million as a result of this.

### 4 NET FINANCING

	Note	2014		2013	
		Per consolidated income statement £m	Underlying financing <sup>1</sup> £m	Per consolidated income statement £m	Underlying financing <sup>1</sup> £m
<b>Financing income</b>					
Interest receivable		17	17	15	15
Fair value gains on foreign currency contracts <sup>2</sup>	17	2	–	287	–
Put option on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	17	89	–	8	–
Finance income on post-retirement scheme surpluses	19	13	–	17	–
		<b>121</b>	<b>17</b>	<b>327</b>	<b>15</b>
<b>Financing costs</b>					
Interest payable		(63)	(63)	(58)	(58)
Fair value losses on foreign currency contracts <sup>2</sup>	17	(1,127)	–	(3)	–
Financial RRSAs – financing	17	(7)	(5)	(9)	(9)
Put option on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	17	(174)	–	(259)	–
Fair value losses on commodity derivatives <sup>2</sup>	17	(15)	–	(34)	–
Finance cost on post-retirement scheme deficits	19	(42)	–	(43)	–
Net foreign exchange losses		(13)	–	(5)	–
Other financing charges		(11)	(10)	(30)	(20)
		<b>(1,452)</b>	<b>(78)</b>	<b>(441)</b>	<b>(87)</b>
<b>Net financing</b>		<b>(1,331)</b>	<b>(61)</b>	<b>(114)</b>	<b>(72)</b>
<b>Analysed as:</b>					
Net interest payable		(46)	(46)	(43)	(43)
Net post-retirement scheme financing		(29)	–	(26)	–
Net other financing		(1,256)	(15)	(45)	(29)
<b>Net financing</b>		<b>(1,331)</b>	<b>(61)</b>	<b>(114)</b>	<b>(72)</b>
<sup>1</sup> See note 2					
<sup>2</sup> Net (loss)/gain on fair value items through profit or loss	17	(1,140)	–	250	–

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

## 5 TAXATION

	UK		Overseas		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
<b>Current tax</b>						
Current tax charge for the year	8	7	240	301	248	308
Less double tax relief	–	(1)	–	–	–	(1)
	8	6	240	301	248	307
Adjustments in respect of prior years	1	2	12	29	13	31
	9	8	252	330	261	338
<b>Deferred tax</b>						
Deferred tax (credit)/charge for the year	(72)	212	(77)	(68)	(149)	144
Adjustments in respect of prior years	(14)	(8)	(11)	(37)	(25)	(45)
Derecognition of advance corporation tax	64	–	–	–	64	–
Credit resulting from reduction in tax rates	–	(59)	–	(1)	–	(60)
	(22)	145	(88)	(106)	(110)	39
<b>Recognised in the income statement</b>	<b>(13)</b>	<b>153</b>	<b>164</b>	<b>224</b>	<b>151</b>	<b>377</b>

## OTHER TAX (CHARGES)/CREDITS

	OCI				Equity	
	Items that will not be reclassified		Items that may be reclassified		2014 £m	2013 £m
	2014 £m	2013 £m	2014 £m	2013 £m		
Current tax:						
Share-based payments – direct to equity					3	5
Deferred tax:						
Movement in post-retirement schemes	(431)	10				
Share-based payments – direct to equity					(7)	8
Net investment hedge			(2)	1		
	(431)	10	(2)	1	(4)	13

## TAX RECONCILIATION ON CONTINUING OPERATIONS

	2014 £m	2013 £m
Profit before taxation	67	1,700
Less share of results of joint ventures and associates (note 11)	(94)	(149)
(Loss)/profit before taxation excluding joint ventures and associates	(27)	1,551
Nominal tax (credit)/charge at UK corporation tax rate 21.5% (2013 23.25%)	(6)	361
UK R&D credit	(6)	(13)
Rate differences	71	59
Profit on reclassification of joint ventures to subsidiaries	–	(27)
Change in value of put option on NCI	17	60
Other permanent differences	22	12
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	(3)	(7)
Tax losses in year not recognised in deferred tax	4	6
Adjustments in respect of prior years	(12)	(14)
Derecognition of advance corporation tax	64	–
Reduction in closing deferred taxes resulting from decrease in tax rates	–	(60)
	151	377
Underlying items (note 2)	390	431
Non-underlying items	(239)	(54)
	151	377

## 5 TAXATION CONTINUED

## TAX ON DISCONTINUED OPERATIONS

	2014 £m	2013 £m
Tax (credit)/charge on profit/loss on ordinary activities	(3)	3
Tax credit on disposal of discontinued operations	(2)	–
	(5)	3

## DEFERRED TAXATION ASSETS AND LIABILITIES

	2014 £m	2013 £m
At 1 January	(566)	(242)
Amount credited/(charged) to income statement	120	(53)
Amount (charged)/credited to other comprehensive income	(433)	11
Amount (charged)/credited to equity	(7)	8
Acquisition of businesses	(3)	(282)
Exchange differences	30	(8)
At 31 December	(859)	(566)
Deferred tax assets	369	316
Deferred tax liabilities	(1,228)	(882)
	(859)	(566)

The analysis of the deferred tax position is as follows:

	At 1 January 2014 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Disposal of businesses £m	Exchange differences £m	At 31 December 2014 £m
Intangible assets	(511)	41	–	–	–	15	(455)
Property, plant and equipment	(210)	20	–	–	(6)	1	(195)
Other temporary differences	80	23	(2)	(10)	(1)	7	97
Amounts recoverable on contracts	(380)	(146)	–	–	–	–	(526)
Pensions and other post-retirement scheme benefits	153	(54)	(431)	–	–	8	(324)
Foreign exchange and commodity financial assets and liabilities	(92)	226	–	–	–	1	135
Losses	323	65	–	3	4	(2)	393
R&D expenditure credit	7	9	–	–	–	–	16
Advance corporation tax	64	(64)	–	–	–	–	–
	(566)	120	(433)	(7)	(3)	30	(859)
Included in: Taxation		110					
Discontinued operations		10					

	At 1 January 2013 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Exchange differences £m	At 31 December 2013 £m
Intangible assets	(232)	34	–	–	(311)	(2)	(511)
Property, plant and equipment	(158)	17	–	–	(70)	1	(210)
Other temporary differences	12	9	1	3	60	(5)	80
Amounts recoverable on contracts	(351)	(29)	–	–	–	–	(380)
Pensions and other post-retirement scheme benefits	110	–	10	–	36	(3)	153
Foreign exchange and commodity financial assets and liabilities	(56)	(36)	–	–	–	–	(92)
Losses	369	(55)	–	5	3	1	323
R&D expenditure credit	–	7	–	–	–	–	7
Advance corporation tax	64	–	–	–	–	–	64
	(242)	(53)	11	8	(282)	(8)	(566)
Included in: Taxation		(39)					
Discontinued operations		(14)					

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 5 TAXATION CONTINUED

#### UNRECOGNISED DEFERRED TAX ASSETS

	2014 £m	2013 £m
Advance corporation tax	182	118
Losses and other unrecognised deferred tax assets	35	39
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	217	157

#### DEFERRED TAXATION ASSETS AND LIABILITIES

The UK corporation tax rate reduced to 21% from 1 April 2014 and will reduce further to 20% from 1 April 2015. As the reduction was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been calculated at this rate.

The deferred tax asset recognised relating to advance corporation tax has reduced during the year due to a decrease in the net deferred tax liabilities against which the asset can be offset. The main reasons for this are the additional shadow advance corporation tax arising on the share buyback and the unrealised fair value change on derivative contracts.

The temporary differences associated with investments in subsidiaries, joint ventures and associates, for which a deferred tax liability has not been recognised, aggregate to **£512 million** (2013 £573 million). No deferred tax liability has been recognised on the potential withholding tax due on the remittance of undistributed profits as the Group is able to control the timing of such remittances and it is probable that consent will not be given in the foreseeable future.

### 6 EARNINGS PER ORDINARY SHARE

Basic earnings per ordinary share (EPS) are calculated by dividing the profit attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares held under trust, which have been treated as if they had been cancelled.

Diluted EPS are calculated by adjusting the weighted average number of ordinary shares in issue during the year for the bonus element of share options.

	2014			2013		
	Basic	Potentially dilutive share options	Diluted <sup>1</sup>	Basic	Potentially dilutive share options	Diluted
Profit attributable to ordinary shareholders (£m)						
Continuing operations	(73)		(73)	1,311		1,311
Discontinued operations	142		142	56		56
	69		69	1,367		1,367
Weighted average number of ordinary shares (millions)	1,874	18	1,892	1,866	21	1,887
EPS (pence)						
Continuing operations	(3.90)	–	(3.90)	70.26	(0.78)	69.48
Discontinued operations	7.58	–	7.58	3.00	(0.04)	2.96
	3.68	–	3.68	73.26	(0.82)	72.44

<sup>1</sup> As there is a loss on continuing operations, the effect of potential dilutive ordinary shares is anti-dilutive.

The reconciliation between underlying EPS and basic EPS is as follows:

	2014		2013	
	Pence	£m	Pence	£m
Underlying EPS/Underlying profit attributable to ordinary shareholders	65.31	1,224	65.59	1,224
Total underlying adjustments to profit before tax (note 2)	(82.65)	(1,549)	–	–
Related tax effects	12.75	239	2.89	54
Profit on disposal of discontinued operations	7.36	138	–	–
Related NCI effects	0.91	17	4.78	89
EPS/Profit attributable to ordinary shareholders	3.68	69	73.26	1,367
Diluted underlying EPS	64.69		64.86	



## 7 EMPLOYEE INFORMATION

	2014 Number	2013 Number
<b>Average number of employees<sup>1</sup></b>		
United Kingdom	24,500	24,800
United States of America	7,900	8,500
Canada	1,500	1,600
Germany	10,500	10,500
Nordic countries	4,000	4,100
Rest of world	5,700	5,700
<b>Group</b>	<b>54,100</b>	<b>55,200</b>
Civil	23,900	23,400
Defence	7,000	7,900
<b>Aerospace Division</b>	<b>30,900</b>	<b>31,300</b>
Power Systems	10,700	10,700
Marine	6,400	6,900
Nuclear & Energy <sup>2</sup>	6,100	6,300
<b>Land &amp; Sea Division</b>	<b>23,200</b>	<b>23,900</b>
<b>Group</b>	<b>54,100</b>	<b>55,200</b>
	<b>£m</b>	<b>£m</b>
<b>Group employment costs<sup>3</sup></b>		
Wages and salaries	2,646	2,843
Social security costs	362	374
Share-based payments (note 21)	21	79
Pensions and other post-retirement scheme benefits (note 19)	328	421
	<b>3,357</b>	<b>3,717</b>

<sup>1</sup> See page 44.

<sup>2</sup> The disposal of the Energy business on 1 December 2014 reduced employees by 2,000, (average 2,200).

<sup>3</sup> Remuneration of key management personnel is shown in note 24.

## 8 AUDITORS' REMUNERATION

Fees payable to the Company's auditors and its associates were as follows:

	2014 £m	2013 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements <sup>1</sup>	0.2	0.2
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	5.5	5.6
Total fees payable for audit services	5.7	5.8
Fees payable to the Company's auditors and its associates for other services <sup>2</sup> :		
Audit related assurance services <sup>3</sup>	1.1	0.8
Taxation compliance services	0.7	0.8
Taxation advisory services	–	0.1
Internal audit services	–	0.2
All other services	0.4	1.0
	<b>7.9</b>	<b>8.7</b>
Fees payable in respect of the Group's pension schemes:		
Audit	0.2	0.2
Taxation compliance services	–	0.1

<sup>1</sup> The level of fees payable to the Company's auditors for the audit of the Company's annual financial statements reflects the fact that limited incremental work is required in respect of the audit of these financial statements. Rolls-Royce plc, a subsidiary of the Company, is also required to prepare consolidated financial statements and the fees payable to the Company's auditors for the audit of those financial statements, including the audit of the sub-consolidation, is included in the audit of the Company's subsidiaries pursuant to legislation.

<sup>2</sup> As described on pages 72 and 73, in 2014, fees for other services to KPMG in respect of Rolls-Royce Power Systems (RRPS) were £0.9m (2013 £2.1m). Following the consolidation of RRPS on 1 January 2013, the Audit Committee approved the continuation of engagements already in progress at that date.

<sup>3</sup> This includes £0.3m (2013 £0.3m) for the review of the half-year report.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

## 9 INTANGIBLE ASSETS

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Contractual aftermarket rights <sup>1</sup> £m	Customer relationships £m	Software £m	Other £m	Total £m
<b>Cost:</b>								
At 1 January 2013	1,111	740	1,028	499	45	385	142	3,950
Exchange differences	(18)	3	5	–	(3)	(1)	17	3
Additions	–	185	110	52	–	69	87	503
Acquisitions of businesses	773	–	508	–	433	–	286	2,000
Disposals	(5)	–	(5)	–	–	–	–	(10)
<b>At 1 January 2014</b>	<b>1,861</b>	<b>928</b>	<b>1,646</b>	<b>551</b>	<b>475</b>	<b>453</b>	<b>532</b>	<b>6,446</b>
Reclassifications <sup>2</sup>	(8)	–	4	–	11	19	(28)	(2)
Exchange differences	(112)	(8)	(43)	–	(17)	(1)	(28)	(209)
Additions	–	159	100	93	–	83	42	477
Acquisitions of businesses	1	–	–	–	–	–	–	1
Disposal of business	(67)	–	–	(35)	–	(11)	–	(113)
<b>At 31 December 2014</b>	<b>1,675</b>	<b>1,079</b>	<b>1,707</b>	<b>609</b>	<b>469</b>	<b>543</b>	<b>518</b>	<b>6,600</b>
<b>Accumulated amortisation:</b>								
At 1 January 2013	9	225	323	295	12	144	41	1,049
Exchange differences	(1)	–	(7)	–	(8)	–	5	(11)
Charge for the year <sup>3</sup>	–	40	130	28	61	54	91	404
Impairment	17	–	3	–	4	–	–	24
Disposals	(2)	–	(5)	–	–	–	–	(7)
<b>At 1 January 2014</b>	<b>23</b>	<b>265</b>	<b>444</b>	<b>323</b>	<b>69</b>	<b>198</b>	<b>137</b>	<b>1,459</b>
Reclassifications <sup>2</sup>	(8)	–	4	–	(11)	5	6	(4)
Exchange differences	–	–	(9)	–	(4)	–	(6)	(19)
Charge for the year <sup>3</sup>	–	46	125	37	42	63	53	366
Impairment	1	–	–	–	–	–	–	1
Disposal of business	–	–	–	–	–	(7)	–	(7)
<b>At 31 December 2014</b>	<b>16</b>	<b>311</b>	<b>564</b>	<b>360</b>	<b>96</b>	<b>259</b>	<b>190</b>	<b>1,796</b>
<b>Net book value:</b>								
<b>At 31 December 2014</b>	<b>1,659</b>	<b>768</b>	<b>1,143</b>	<b>249</b>	<b>373</b>	<b>284</b>	<b>328</b>	<b>4,804</b>
At 31 December 2013	1,838	663	1,202	228	406	255	395	4,987
At 1 January 2013	1,102	515	705	204	33	241	101	2,901

<sup>1</sup> Previously referred to as 'recoverable engine costs'.

<sup>2</sup> In 2013, following the acquisition of RRRPS, the Group revised the classification of intangible assets. During 2014, a number of minor inconsistencies in these classifications have been identified and amended. The net movement of £2m relates to software previously included in property, plant and equipment.

<sup>3</sup> Charged to cost of sales except development costs, which are charged to research and development costs.

**GOODWILL**

In accordance with the requirements of IAS 36 *Impairment of Assets*, goodwill is allocated to the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the business combination that gave rise to the goodwill as follows:

**CASH-GENERATING UNIT (CGU) OR GROUP OF CGUs**

	Primary reporting segment	2014 £m	2013 £m
Rolls-Royce Deutschland Ltd & Co KG	Aerospace	215	230
Commercial marine – arising from the acquisitions of Vinters Limited and Scandinavian Electric Holdings AS	Land & Sea	552	620
Commercial marine – arising from the acquisition of ODIM ASA	Land & Sea	77	88
Rolls-Royce Power Systems AG	Land & Sea	760	785
Other	Various	55	115
		<b>1,659</b>	<b>1,838</b>

## 9 INTANGIBLE ASSETS CONTINUED

Goodwill has been tested for impairment during 2014 on the following basis:

- The carrying values of goodwill have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long-term and established nature of many of the Group's products (product lives are often measured in decades), these forecasts generally cover the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates (2.0 – 2.75%) that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate.
- The key assumptions for the impairment tests are the discount rate and, in the cash flow projections, the programme assumptions, the growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs. Impairment tests are performed using prevailing exchange rates.
- The pre-tax cash flow projections have been discounted at **13%** (2013 13%), based on the Group's weighted average cost of capital, adjusted for specific risk where appropriate. The rate used for Rolls-Royce Power Systems AG takes account of the discount rate used for the agreement of the put option exercise price.

The principal value in use assumptions for goodwill balances considered to be individually significant are:

- **Rolls-Royce Power Systems AG** – Volume of equipment deliveries, pricing achieved and cost escalation. These are based on current and known future programmes, estimates of capture of market share and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into euros. For the purposes of the impairment test only, cash flows from recent management forecasts for a five-year period have been included. Cash flows beyond five years are assumed to grow at **2%** (2013 management forecast for ten years; thereafter 2% growth). Following the recognition of RRPS at fair value on 1 January 2013, reasonably possible changes in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. Such changes include: a reduction in the level of cash generation of 14%; or an increase in the assumed discount rate of 4%.
- **Rolls-Royce Deutschland Ltd & Co KG** – Volume of engine deliveries, flying hours of installed fleet and cost escalation. These are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposure is on translating US dollar income into euros. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at **2.5%** (2013 2.5%). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 81% to cause an impairment of this balance.
- **Vinters Limited** – Volume of equipment deliveries, capture of aftermarket and cost escalation. These are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into Norwegian kroner. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at **2.5%** (2013 2.5%). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 75% to cause an impairment of this balance.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 9 INTANGIBLE ASSETS CONTINUED

#### OTHER INTANGIBLE ASSETS

Certification costs and participation fees, development costs and contractual aftermarket rights have been reviewed for impairment in accordance with the requirements of IAS 36 *Impairment of Assets*. Where an impairment test was considered necessary, it has been performed on the following basis:

- The carrying values have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions over the lives of the respective programmes.
- The key assumptions underlying cash flow projections are assumed market share, programme timings, unit cost assumptions, discount rates, and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at **11%** (2013 11%), based on the Group's weighted average cost of capital, reduced where relevant to take account of the lower risk associated with contracted aftermarket flows.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Group's control (discount rate, exchange rate and airframe delays), could result in impairment in future years.
- As described in the Strategic Report, the Group is currently engaged in a number of Trent 900 sales campaigns. The carrying value of intangible assets relating to the Trent 900 programme assumes that a proportion of these campaigns are successful. If no further orders are obtained, the carrying value of these intangible assets (£142 million) may be impaired.

### 10 PROPERTY, PLANT AND EQUIPMENT

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
<b>Cost:</b>					
At 1 January 2013	1,072	2,889	223	511	4,695
Exchange differences	(11)	(28)	(2)	(8)	(49)
Additions	17	150	83	437	687
Acquisitions of businesses	202	300	–	44	546
Disposals of businesses	–	(1)	–	–	(1)
Reclassifications	19	242	21	(282)	–
Disposals/write-offs	(2)	(62)	(1)	(2)	(67)
<b>At 1 January 2014</b>	<b>1,297</b>	<b>3,490</b>	<b>324</b>	<b>700</b>	<b>5,811</b>
Exchange differences	(23)	(42)	(1)	2	(64)
Additions	24	160	57	427	668
Acquisitions of businesses	–	–	38	–	38
Disposals of businesses	(88)	(94)	(77)	(28)	(287)
Reclassifications <sup>1</sup>	134	137	32	(305)	(2)
Disposals/write-offs	(10)	(51)	(52)	(1)	(114)
<b>At 31 December 2014</b>	<b>1,334</b>	<b>3,600</b>	<b>321</b>	<b>795</b>	<b>6,050</b>
<b>Accumulated depreciation:</b>					
At 1 January 2013	355	1,714	62	–	2,131
Exchange differences	(9)	(22)	(1)	–	(32)
Charge for the year <sup>2</sup>	48	301	23	–	372
Reclassifications	(8)	8	–	–	–
Disposals of businesses	–	(1)	–	–	(1)
Disposals/write-offs	–	(51)	–	–	(51)
<b>At 1 January 2014</b>	<b>386</b>	<b>1,949</b>	<b>84</b>	<b>–</b>	<b>2,419</b>
Exchange differences	(8)	(26)	–	–	(34)
Charge for the year <sup>2</sup>	49	294	31	–	374
Impairment	–	–	–	1	1
Disposals of businesses	(29)	(62)	(9)	–	(100)
Disposals/write-offs	(7)	(46)	(3)	–	(56)
<b>At 31 December 2014</b>	<b>391</b>	<b>2,109</b>	<b>103</b>	<b>1</b>	<b>2,604</b>
<b>Net book value:</b>					
<b>At 31 December 2014</b>	<b>943</b>	<b>1,491</b>	<b>218</b>	<b>794</b>	<b>3,446</b>
At 31 December 2013	911	1,541	240	700	3,392
At 1 January 2013	717	1,175	161	511	2,564

<sup>1</sup> The net reclassification of £2m relates to software now included in intangible assets.

<sup>2</sup> Depreciation charged during the year is presented in the income statement or included in the cost of inventory as appropriate.

## 10 PROPERTY, PLANT AND EQUIPMENT CONTINUED

Property, plant and equipment includes:

	2014 £m	2013 £m
Net book value of finance leased assets:		
Land and buildings	6	7
Plant and equipment	9	4
Aircraft and engines	43	–
Assets held for use in operating leases:		
Cost	267	320
Depreciation	(64)	(79)
Net book value	203	241
Capital expenditure commitments	194	317
Net book value of assets held as security for liabilities (excluding finance leased assets)	–	–
Cost of fully depreciated assets	792	899

The Group's share of equity accounted entities' capital commitments is **£82 million** (2013 £150 million).

## 11 INVESTMENTS

### COMPOSITION OF THE GROUP

The principal entities contributing to the Group's financial results are listed on pages 152 and 153. These comprise 54 wholly-owned subsidiaries and 33 joint ventures which are located in the following countries.

	At 31 December 2014		At 31 December 2013		
	Wholly-owned subsidiaries	Joint ventures	Wholly-owned subsidiaries	Non-wholly-owned subsidiaries	Joint ventures
United Kingdom	13	8	13	1	9
Australia	–	–	–	–	1
Brazil	1	–	1	–	–
Canada	1	–	1	–	–
China	2	2	1	1	2
Finland	1	–	1	–	–
France	2	–	2	–	–
Germany	6	4	1	4	5
Guernsey	1	–	1	–	–
Hong Kong	1	1	–	1	1
India	3	1	3	–	1
Israel	–	1	–	–	1
Italy	2	–	1	1	–
Malaysia	–	–	–	–	1
Netherlands	1	–	–	1	–
Norway	2	–	1	1	–
Singapore	2	2	1	1	2
South Africa	1	–	–	–	–
Spain	1	1	–	1	1
Sweden	1	–	1	–	–
Turkey	1	–	–	1	–
United States of America	12	13	11	1	13

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 11 INVESTMENTS CONTINUED

The non-wholly owned subsidiaries above comprise the Rolls-Royce Power Systems group. On 7 March 2014, Daimler AG announced its intention to exercise its put option on its 50% of Rolls-Royce Power Systems Holding GmbH (RRPSH). Formal notice of this intention was served on 24 March 2014. From this date, the Group has an effective economic interest in RRPSH of 100% and NCI of £584 million was transferred to retained earnings. The Group acquired the shares on 26 August 2014, giving it a 100% interest in RRPSH. Non-controlling interests are as follows:

	Proportion of ownership interests held by NCI		Comprehensive income allocated to NCI		Accumulated NCI	
	2014	2013	2014 £m	2013 £m	2014 £m	2013 £m
Rolls-Royce Power Systems GmbH	–	50%	(12)	11	–	694
Other subsidiaries with NCI			1	1	5	4
			(11)	12	5	698

Summarised financial information for RRPSH is as follows:

	At 24 March 2014 <sup>1</sup> £m	At 31 December 2013 £m
Current assets	1,529	1,776
Non-current assets	2,511	2,567
Current liabilities	(974)	(1,035)
Non-current liabilities	(1,118)	(1,134)
Equity attributable to Rolls-Royce shareholders	1,364	1,480
Non-controlling interests	584	694

<sup>1</sup> Immediately prior to the exercise of the put option.

	Period to 24 March 2014 £m	Year to 31 December 2013 £m
Revenue	551	2,834
(Loss)/profit for the period	(25)	21
Attributable to ordinary shareholders	(12)	10
Non-controlling interests	(12)	10
Total comprehensive income for the period	(69)	21
Attributable to ordinary shareholders	(35)	11
Non-controlling interests	(35)	11
Dividends paid to non-controlling interests	(76)	(60)
Cash flow from operating activities	33	220
Cash flow from investing activities	(17)	(167)
Cash flow from financing activities	(158)	(97)
Net cash outflow	(142)	(44)

## 11 INVESTMENTS CONTINUED

## EQUITY ACCOUNTED AND OTHER INVESTMENTS

	Equity accounted			Other
	Joint ventures £m	Associates £m	Total £m	Unlisted £m
At 1 January 2013	1,798	2	1,800	6
Exchange differences	(4)	–	(4)	1
Additions	43	–	43	1
Taxation paid by the Group	6	–	6	–
Transfer to subsidiary	(1,327)	–	(1,327)	–
Acquisition of business	30	–	30	20
Share of retained profit	61	–	61	–
Disposals	(2)	–	(2)	(1)
Share of OCI – may be reclassified to profit or loss	(6)	–	(6)	–
<b>At 1 January 2014</b>	<b>599</b>	<b>2</b>	<b>601</b>	<b>27</b>
Reclassification <sup>1</sup>	(25)	–	(25)	–
Exchange differences	7	–	7	(2)
Additions	15	2	17	11
Taxation paid by the Group	3	–	3	–
Transfer to subsidiary	(1)	–	(1)	–
Share of retained profit	23	–	23	–
Disposals	(70)	–	(70)	–
Consolidation of previously non-consolidated subsidiary	–	–	–	(5)
Return of capital	(3)	–	(3)	–
Share of OCI – may be reclassified to profit or loss	(13)	–	(13)	–
<b>At 31 December 2014</b>	<b>535</b>	<b>4</b>	<b>539</b>	<b>31</b>

<sup>1</sup> The reclassification relates to an adjustment in the prior year relating to transactions between the Group and a joint venture which was included in creditors. It has now been transferred to investments in joint ventures.

Reconciliation to the income statement and cash flow statement:

	Continuing operations		Discontinued operations		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Share of profit after tax	94	149	2	11	96	160
Dividends received	(71)	(94)	(2)	(5)	(73)	(99)
Share of retained profit	23	55	–	6	23	61

The following joint ventures are considered to be individually material to the Group:

	Principal location	Activity	Effective interest
Alpha Partners Leasing Limited (APL)	UK	Aero engine leasing	50.0%
Hong Kong Aero Engine Services Limited (HAESL)	Hong Kong	Aero engine repair and overhaul	45.0%
Singapore Aero Engine Services Pte Limited (SAESL)	Singapore	Aero engine repair and overhaul	39.0%
Industria de Turbo Propulsores SA (ITP)	Spain	Aero engine component manufacture and maintenance	46.9%

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 11 INVESTMENTS CONTINUED

Summarised financial information of the Group's individually material joint ventures is as follows:

	APL		HAESL		SAESL		ITP	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Revenue	105	89	652	898	815	1,150	529	528
Profit from continuing operations	39	45	34	67	60	88	24	57
Post-tax profit from discontinued operations	–	–	–	–	–	–	–	–
Profit for the year	39	45	34	67	60	88	24	57
Other comprehensive income	–	–	–	–	–	–	–	–
Total comprehensive income for the year	39	45	34	67	60	88	24	57
Dividends received during the year	(13)	(11)	(30)	(61)	(56)	(86)	(19)	(24)
Profit for the year included the following:								
Depreciation and amortisation	(47)	(40)	(8)	(8)	(5)	(6)	(37)	(37)
Interest income	–	–	–	–	–	–	19	12
Interest expense	(15)	(18)	(1)	(1)	(1)	(1)	(12)	(14)
Income tax expense	(11)	–	(7)	(13)	–	–	4	15
Current assets	72	85	159	222	207	217	603	672
Non-current assets	1,171	891	86	79	102	82	525	659
Current liabilities	(62)	(58)	(61)	(133)	(88)	(95)	(415)	(493)
Non-current liabilities	(959)	(757)	(37)	(34)	(106)	(99)	(418)	(461)
Net assets	222	161	147	134	115	105	295	377
Included in the above:								
Cash and cash equivalents	11	16	8	5	11	13	94	243
Current financial liabilities <sup>1</sup>	(13)	(8)	–	–	–	–	(10)	(3)
Non-current financial liabilities <sup>1</sup>	(815)	(633)	(29)	(27)	(106)	(99)	(282)	(353)

<sup>1</sup> Excluding trade and other payables

Reconciliation to the carrying amount recognised in the consolidated financial statements:

Effective interest	50.0%	50.0%	45.0%	45.0%	39.0%	39.0%	46.9%	46.9%
Group share of net assets above	111	81	66	60	45	41	138	177

At the option of the current owner, the Group has an agreement to purchase the shares in ITP that it does not own. If the option is exercised, the price payable would be fair value, determined on a basis agreed between the parties taking into account earnings multiples and discounted cash flows. As the exercise price would be at the fair value of the shares, the Group does not consider that this derivative has a significant fair value.

The summarised aggregated results of the Group's share of equity accounted investments is as follows:

	Joint ventures		Associates		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Profit from continuing operations	94	149	–	–	94	149
Profit from discontinued operations	2	11	–	–	2	11
Profit for the year	96	160	–	–	96	160
Other comprehensive income	(13)	(6)	–	–	(13)	(6)
<b>Total comprehensive income for the year</b>	<b>83</b>	<b>154</b>	<b>–</b>	<b>–</b>	<b>83</b>	<b>154</b>



## 12 INVENTORIES

	2014 £m	2013 £m
Raw materials	553	593
Work in progress	984	1,177
Long-term contracts work in progress	22	15
Finished goods	1,149	1,426
Payments on account	60	108
	<b>2,768</b>	<b>3,319</b>
Inventories stated at net realisable value	265	447
Amount of inventory write-down	62	89
Reversal of inventory write-down	1	5

## 13 TRADE AND OTHER RECEIVABLES

	2014 £m	2013 £m
Trade receivables	1,531	1,601
Amounts recoverable on contracts	2,684	2,239
Amounts owed by joint ventures and associates	309	380
Other receivables	785	637
Prepayments and accrued income	200	235
	<b>5,509</b>	<b>5,092</b>
Analysed as:		
Financial instruments (note 17):		
Trade receivables and similar items	1,981	2,118
Other non-derivative financial assets	671	527
Non-financial instruments	2,857	2,447
	<b>5,509</b>	<b>5,092</b>
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	40	51
Amounts recoverable on contracts	2,444	1,751
Other receivables	61	41
Prepayments and accrued income	55	84
	<b>2,601</b>	<b>1,927</b>

Amounts recoverable on contracts include **£2,492 million** (2013 £1,901 million) of TotalCare assets.

## 14 CASH AND CASH EQUIVALENTS

	2014 £m	2013 £m
Cash at bank and in hand	739	982
Money-market funds	692	1,157
Short-term deposits	1,431	1,851
	<b>2,862</b>	<b>3,990</b>
Overdrafts (note 15)	–	(3)
Cash and cash equivalents per cash flow statement (page 98)	<b>2,862</b>	<b>3,987</b>
Cash held as collateral against third party obligations (note 18)	42	50

Cash and cash equivalents at 31 December 2014 includes **£30 million** (2013 £286 million) that is not available for general use by the Group. This balance relates to cash held in the Group's captive insurance company and non-wholly owned subsidiaries. The principal reason for the significant decrease is that Power Systems is now a wholly owned subsidiary (2013 50% interest).

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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### 15 BORROWINGS

	Current		Non-current		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
<b>Unsecured</b>						
Overdrafts	–	3	–	–	–	3
Bank loans	12	204	392	412	404	616
7¾% Notes 2016 £200m	–	–	200	200	200	200
6.55% Notes 2015 US\$83m <sup>1</sup>	55	–	–	55	55	55
6.75% Notes 2019 £500m <sup>2</sup>	–	–	547	535	547	535
2.125% Notes 2021 €750m <sup>1</sup>	–	–	615	611	615	611
3.375% Notes 2026 £375m <sup>2</sup>	–	–	395	350	395	350
<b>Secured</b>						
Obligations under finance leases <sup>3</sup>	1	–	44	1	45	1
	<b>68</b>	<b>207</b>	<b>2,193</b>	<b>2,164</b>	<b>2,261</b>	<b>2,371</b>

<sup>1</sup> These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge.

<sup>2</sup> These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest which form a fair value hedge.

<sup>3</sup> Obligations under finance leases are secured by related leased assets.

### 16 TRADE AND OTHER PAYABLES

	Current		Non-current		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Payments received on account <sup>1</sup>	1,291	1,594	860	750	2,151	2,344
Trade payables	1,348	1,370	13	16	1,361	1,386
Amounts owed to joint ventures and associates	235	191	4	–	239	191
Other taxation and social security	109	101	1	–	110	101
Other payables	1,756	1,820	320	143	2,076	1,963
Accruals and deferred income	2,052	1,969	1,247	1,229	3,299	3,198
	<b>6,791</b>	<b>7,045</b>	<b>2,445</b>	<b>2,138</b>	<b>9,236</b>	<b>9,183</b>
<sup>1</sup> Includes payments received on account from joint ventures and associates	158	180	99	151	257	331

Included within trade and other payables are government grants of **£80 million** (2013 £100 million). During the year, **£24 million** (2013 £26 million) of government grants were released to the income statement.

Included in accruals and deferred income are deferred receipts from RRSA workshare partners of **£244 million** (2013 £260 million) and **£687 million** (2013 £559 million) of TotalCare liabilities.

Trade and other payables are analysed as follows:

	2014 £m	2013 £m
Financial instruments (note 17):		
Trade payables and similar items	3,049	2,989
Other non-derivative financial liabilities	831	806
Non-financial instruments	5,356	5,388
	<b>9,236</b>	<b>9,183</b>

## 17 FINANCIAL INSTRUMENTS

## CARRYING VALUES AND FAIR VALUES OF FINANCIAL INSTRUMENTS

	Notes	Basis for determining fair value	Assets			Liabilities			Total
			Fair value through profit or loss £m	Loans and receivables £m	Available for sale £m	Cash £m	Fair value through profit or loss £m	Other £m	£m
<b>At 31 December 2014</b>									
Unlisted non-current asset investments	11	A	–	31	–	–	–	–	31
Trade receivables and similar items	13	B	–	1,981	–	–	–	–	1,981
Other non-derivative financial assets	13	B	–	671	–	–	–	–	671
Derivative financial assets <sup>1</sup>		C	129	–	–	–	–	–	129
Short-term investments		B	–	7	–	–	–	–	7
Cash and cash equivalents	14	B	–	1,431	692	739	–	–	2,862
Borrowings	15	D	–	–	–	–	–	(2,261)	(2,261)
Derivative financial liabilities <sup>1</sup>		C	–	–	–	–	(759)	–	(759)
Financial RRSAs		E	–	–	–	–	–	(145)	(145)
C Shares		B	–	–	–	–	–	(22)	(22)
Trade payables and similar items	16	B	–	–	–	–	–	(3,049)	(3,049)
Other non-derivative financial liabilities	16	B	–	–	–	–	–	(831)	(831)
			129	4,121	692	739	(759)	(6,308)	(1,386)
<b>At 31 December 2013</b>									
Unlisted non-current asset investments	11	A	–	27	–	–	–	–	27
Trade receivables and similar items	13	B	–	2,118	–	–	–	–	2,118
Other non-derivative financial assets	13	B	–	527	–	–	–	–	527
Derivative financial assets		C	748	–	–	–	–	–	748
Short-term investments		B	–	321	–	–	–	–	321
Cash and cash equivalents	14	B	–	1,851	1,157	982	–	–	3,990
Borrowings	15	D	–	–	–	–	–	(2,371)	(2,371)
Derivative financial liabilities		C	–	–	–	–	(295)	–	(295)
Exercise price of put option on NCI		F	–	–	–	–	–	(1,858)	(1,858)
Financial RRSAs		E	–	–	–	–	–	(167)	(167)
C Shares		B	–	–	–	–	–	(16)	(16)
Trade payables and similar items	16	B	–	–	–	–	–	(2,989)	(2,989)
Other non-derivative financial liabilities	16	B	–	–	–	–	–	(806)	(806)
			748	4,844	1,157	982	(295)	(8,207)	(771)

<sup>1</sup> In the event of counterparty default relating to derivative financial assets and liabilities, off-setting would apply and financial assets and liabilities held with the same counterparty would net off. If this occurred with every counterparty, total financial assets would be £15m and liabilities £645m.

Fair values equate to book values for both 2014 and 2013, with the following exceptions:

	2014		2013	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	(2,261)	(2,362)	(2,371)	(2,495)
Financial RRSAs	(145)	(152)	(167)	(184)

The fair value of a financial instrument is the price at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms-length transaction. Fair values have been determined with reference to available market information at the balance sheet date, using the methodologies described below.

A These primarily comprise unconsolidated companies where fair value approximates to the book value.

B Fair values are assumed to approximate to cost either due to the short-term maturity of the instruments or because the interest rate of the investments is reset after periods not exceeding six months.

C Fair values of derivative financial assets and liabilities are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. These financial instruments are included on the balance sheet at fair value, derived from observable market prices (Level 2 as defined by IFRS 13 *Fair Value Measurement*).

D Borrowings are carried at amortised cost. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date.

E The fair value of RRSAs is estimated by discounting expected future cash flows. The contractual cash flows are based on future trading activity, which is estimated based on latest forecasts (Level 3 as defined by IFRS 13).

F The fair value of the put option on NCI is determined in accordance with the contractual terms, which requires averaging three valuations, covering forecasts of the business performance and external metrics of comparable business and transactions (Level 3 as defined by IFRS 13). IFRS 13 defines a three level valuation hierarchy:

Level 1 – quoted prices for similar instruments;

Level 2 – directly observable market inputs other than Level 1 inputs; and

Level 3 – inputs not based on observable market data.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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## 17 FINANCIAL INSTRUMENTS CONTINUED

## CARRYING VALUES OF OTHER FINANCIAL ASSETS AND LIABILITIES

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Exercise price of put option on NCI £m	Financial RRSAs £m	C Shares £m	Total £m
<b>At 31 December 2014</b>								
Non-current assets	28	–	79	107	–	–	–	107
Current assets	22	–	–	22	–	–	–	22
Assets	50	–	79	129	–	–	–	129
Current liabilities	(144)	(21)	–	(165)	–	(22)	(22)	(209)
Non-current liabilities	(545)	(22)	(27)	(594)	–	(123)	–	(717)
Liabilities	(689)	(43)	(27)	(759)	–	(145)	(22)	(926)
	(639)	(43)	52	(630)	–	(145)	(22)	(797)
<b>At 31 December 2013</b>								
Non-current assets	631	–	43	674	–	–	–	674
Current assets	72	2	–	74	–	–	–	74
Assets	703	2	43	748	–	–	–	748
Current liabilities	(63)	(16)	(1)	(80)	(1,858)	(22)	(16)	(1,976)
Non-current liabilities	(142)	(25)	(48)	(215)	–	(145)	–	(360)
Liabilities	(205)	(41)	(49)	(295)	(1,858)	(167)	(16)	(2,336)
	498	(39)	(6)	453	(1,858)	(167)	(16)	(1,588)

## DERIVATIVE FINANCIAL INSTRUMENTS

The Group uses various financial instruments to manage its exposure to movements in foreign exchange rates. Where the effectiveness of a hedging relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the cash flow hedge reserve and released to match actual payments on the hedged item. The Group uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals). To hedge the currency risk associated with a borrowing denominated in US dollars, the Group has currency derivatives designated as part of fair value hedges. The Group uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates.

Movements in the fair values of derivative financial assets and liabilities were as follows:

	Foreign exchange instruments		Commodity instruments		Interest rate instruments		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
<b>At 1 January</b>	498	272	(39)	(13)	(6)	88	453	347
Business acquisitions	–	4	–	(1)	–	–	–	3
Movements in fair value hedges <sup>1</sup>	3	3	–	–	58	(91)	61	(88)
Movements in other derivative contracts <sup>2</sup>	(1,125)	284	(15)	(34)	–	–	(1,140)	250
Contracts settled <sup>3</sup>	(15)	(65)	11	9	–	(3)	(4)	(59)
<b>At 31 December</b>	(639)	498	(43)	(39)	52	(6)	(630)	453

<sup>1</sup> Loss on related hedged items £61m (2013 £88m gain).

<sup>2</sup> Included in financing.

<sup>3</sup> 2013 included £17m contracts settled in fair value hedges. Contracts settled in 2014 include a loss of £76m in relation to contracts put in place to hedge the settlement of the put option on RRSAs.

## NON-DERIVATIVE OTHER FINANCIAL LIABILITIES

The Group had agreed a put option with Daimler AG, such that Daimler could sell its interest in Rolls-Royce Power Systems Holding GmbH to the Group. Daimler AG exercised this option on 24 March 2014 and the Group acquired Daimler's 50% share of RRPSH on 26 August 2014. Prior to this, the present value of the exercise value of this option was included as a financial liability.

The Group has financial liabilities arising from financial RRSAs. These financial liabilities are valued at each reporting date using the amortised cost method. This involves calculating the present value of the forecast cash flows of the arrangements using the internal rate of return at the inception of the arrangements as the discount rate.

## 17 FINANCIAL INSTRUMENTS CONTINUED

Movements in the carrying values were as follows:

	Put option on non-controlling interests		Financial RRSAs	
	2014 £m	2013 £m	2014 £m	2013 £m
<b>At 1 January</b>	<b>(1,858)</b>	<b>(167)</b>	<b>(167)</b>	<b>(193)</b>
Business acquisitions	–	(2)	–	–
Additions	–	(1,432)	–	–
Exchange adjustments included in OCI	–	–	3	(4)
Financing charge <sup>1</sup>	–	–	(5)	(9)
Excluded from underlying profit:				
Financing charge <sup>1</sup>	(2)	–	–	–
Changes in put option exercise price <sup>1</sup>	(166)	(212)	–	–
Changes in forecast payments <sup>1</sup>	–	–	–	2
Exchange adjustments <sup>1</sup>	89	(45)	(8)	4
Cash paid to partners	–	–	32	33
Settlement of put option	1,937	–	–	–
<b>At 31 December</b>	<b>–</b>	<b>(1,858)</b>	<b>(145)</b>	<b>(167)</b>

<sup>1</sup> Included in financing.

### RISK MANAGEMENT POLICIES AND HEDGING ACTIVITIES

The principal financial risks to which the Group is exposed are: foreign currency exchange rate risk; liquidity risk; credit risk; interest rate risk; and commodity price risk. The Board has approved policies for the management of these risks.

**Foreign currency exchange rate risk** – The Group has significant cash flows (most significantly US dollars, followed by the euro) denominated in currencies other than the functional currency of the relevant trading entity. To manage its exposures to changes in values of future foreign currency cash flows, so as to maintain relatively stable long-term foreign exchange rates on settled transactions, the Group enters into derivative forward foreign currency transactions. For accounting purposes, these derivative contracts are not designated as hedging instruments.

The Group also has exposures to the fair values of non-derivative financial instruments denominated in foreign currencies. To manage the risk of changes in these fair values, the Group enters into derivative forward foreign exchange contracts, which are designated as fair value hedges for accounting purposes.

The Group regards its interests in overseas subsidiary companies as long-term investments. The Group aims to match its translational exposures by matching the currencies of assets and liabilities. Where appropriate, foreign currency financial liabilities may be designated as hedges of the net investment.

**Liquidity risk** – The Group's policy is to hold financial investments and maintain undrawn committed facilities at a level sufficient to ensure that the Group has available funds to meet its medium-term capital and funding obligations and to meet any unforeseen obligations and opportunities. The Group holds cash and short-term investments, which together with the undrawn committed facilities, enable the Group to manage its liquidity risk.

**Credit risk** – The Group is exposed to credit risk to the extent of non-payment by either its customers or the counterparties of its financial instruments. The effective monitoring and controlling of credit risk is a key component of the Group's risk management activities. The Group has credit policies covering both trading and financial exposures. Credit risks arising from treasury activities are managed by a central treasury function in accordance with the Group credit policy. The objective of the policy is to diversify and minimise the Group's exposure to credit risk from its treasury activities by ensuring the Group transacts strictly with 'BBB+' or higher rated financial institutions based on pre-established limits per financial institution. At the balance sheet date, there were no significant concentrations of credit risk to individual customers or counterparties. The maximum exposure to credit risk at the balance sheet date is represented by the carrying value of each financial asset, including derivative financial instruments.

**Interest rate risk** – The Group's interest rate risk is primarily in relation to its fixed rate borrowings (fair value risk), floating rate borrowings and cash and cash equivalents (cash flow risk). Interest rate derivatives are used to manage the overall interest rate profile within the Group policy, which is to maintain a higher proportion of net debt at floating rates of interest as a natural hedge to the net cash position. These are designated as either fair value or cash flow hedges as appropriate.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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### 17 FINANCIAL INSTRUMENTS CONTINUED

**Commodity risk** – The Group has exposures to the price of jet fuel and base metals arising from business operations. To minimise its cash flow exposures to changes in commodity prices, the Group enters into derivative commodity transactions. For accounting purposes, these derivative contracts are not designated as hedging instruments.

**Other price risk** – The Group's cash equivalent balances represent investments in money market instruments, with a term of up to three months. The Group does not consider that these are subject to significant price risk.

#### DERIVATIVE FINANCIAL INSTRUMENTS

The nominal amounts, analysed by year of expected maturity, and fair values of derivative financial instruments are as follows:

	Expected maturity					Fair value	
	Nominal amount £m	Within one year £m	Between one and five years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
<b>At 31 December 2014</b>							
Foreign exchange contracts:							
Fair value hedges	46	46	–	–	–	6	–
Non-hedge accounted	20,889	5,431	4,793	10,665	–	44	(689)
Interest rate contracts:							
Fair value hedges	1,512	53	–	500	959	74	(22)
Non-hedge accounted	2	2	–	–	–	5	(5)
Commodity contracts:							
Non-hedge accounted	240	79	62	71	28	–	(43)
	22,689	5,611	4,855	11,236	987	129	(759)
<b>At 31 December 2013</b>							
Foreign exchange contracts:							
Fair value hedges	46	–	46	–	–	3	–
Non-hedge accounted	19,654	4,759	4,530	9,493	872	700	(205)
Interest rate contracts:							
Fair value hedges	1,550	–	50	–	1,500	43	(48)
Non-hedge accounted	5	–	5	–	–	–	(1)
Commodity contracts:							
Non-hedge accounted	262	79	62	80	41	2	(41)
	21,517	4,838	4,693	9,573	2,413	748	(295)

As described above, all derivative financial instruments are entered into for risk management purposes, although these may not be designated into hedging relationships for accounting purposes.

#### CURRENCY ANALYSIS

Derivative financial instruments related to foreign exchange risks are denominated in the following currencies:

	Currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
<b>At 31 December 2014</b>					
Currencies sold forward:					
Sterling	–	429	–	199	628
US dollar	16,659	–	2,014	938	19,611
Euro	150	61	–	185	396
Other	167	9	114	10	300
<b>At 31 December 2013</b>					
Currencies sold forward:					
Sterling	–	429	–	10	439
US dollar	15,936	–	2,036	913	18,885
Euro	4	–	–	249	253
Other	22	23	75	3	123

## 17 FINANCIAL INSTRUMENTS CONTINUED

Other derivative financial instruments are denominated in the following currencies:

	2014 £m	2013 £m
Sterling	877	880
US dollar	292	300
Euro	584	637

Non-derivative financial instruments are denominated in the following currencies:

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
<b>At 31 December 2014</b>					
Unlisted non-current investments	–	–	30	1	31
Trade receivables and similar items	232	1,180	479	90	1,981
Other non-derivative financial assets	400	53	101	117	671
Short-term investments	–	–	–	7	7
Cash and cash equivalents	513	1,404	619	326	2,862
<b>Assets</b>	<b>1,145</b>	<b>2,637</b>	<b>1,229</b>	<b>541</b>	<b>5,552</b>
Borrowings	(1,341)	(101)	(819)	–	(2,261)
Financial RRSAs	–	(97)	(48)	–	(145)
C Shares	(22)	–	–	–	(22)
Trade payables and similar items	(1,489)	(887)	(545)	(128)	(3,049)
Other non-derivative financial liabilities	(248)	(333)	(161)	(89)	(831)
<b>Liabilities</b>	<b>(3,100)</b>	<b>(1,418)</b>	<b>(1,573)</b>	<b>(217)</b>	<b>(6,308)</b>
	<b>(1,955)</b>	<b>1,219</b>	<b>(344)</b>	<b>324</b>	<b>(756)</b>
<b>At 31 December 2013</b>					
Unlisted non-current investments	–	–	26	1	27
Trade receivables and similar items	199	995	829	95	2,118
Other non-derivative financial assets	289	48	89	101	527
Short-term investments	282	–	4	35	321
Cash and cash equivalents	1,619	1,080	980	311	3,990
<b>Assets</b>	<b>2,389</b>	<b>2,123</b>	<b>1,928</b>	<b>543</b>	<b>6,983</b>
Borrowings	(1,490)	(55)	(826)	–	(2,371)
Exercise price of put option on NCI	–	–	(1,858)	–	(1,858)
Financial RRSAs	–	(114)	(53)	–	(167)
C Shares	(16)	–	–	–	(16)
Trade payables and similar items	(1,501)	(641)	(653)	(194)	(2,989)
Other non-derivative financial liabilities	(208)	(328)	(158)	(112)	(806)
<b>Liabilities</b>	<b>(3,215)</b>	<b>(1,138)</b>	<b>(3,548)</b>	<b>(306)</b>	<b>(8,207)</b>
	<b>(826)</b>	<b>985</b>	<b>(1,620)</b>	<b>237</b>	<b>(1,224)</b>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**17 FINANCIAL INSTRUMENTS CONTINUED****CURRENCY EXPOSURES**

The Group's actual currency exposures after taking account of derivative foreign currency contracts, which are not designated as hedging instruments for accounting purposes, are as follows:

Functional currency of Group operations	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
<b>At 31 December 2014</b>					
Sterling	–	28	2	35	65
US dollar	(2)	–	(1)	8	5
Euro	2	5	–	11	18
Other	5	19	6	1	31
<b>At 31 December 2013</b>					
Sterling <sup>1</sup>	–	13	(1,855)	12	(1,830)
US dollar	8	–	–	7	15
Euro	(1)	(2)	–	–	(3)
Other	(5)	41	(11)	(4)	21

<sup>1</sup> Included in the 2013 £1,855m liability euro currency exposure was a liability of £1,858m relating to the put option on Daimler's interest in Rolls-Royce Power Systems Holding GmbH – see page 130.

**AGEING BEYOND CONTRACTUAL DUE DATE OF FINANCIAL ASSETS**

The ageing beyond contractual due date of the Group's financial assets is:

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
<b>At 31 December 2014</b>					
Unlisted non-current asset investments	31	–	–	–	31
Trade receivables and similar items	1,657	206	104	14	1,981
Other non-derivative financial assets	667	4	–	–	671
Derivative financial assets	129	–	–	–	129
Short-term investments	7	–	–	–	7
Cash and cash equivalents	2,862	–	–	–	2,862
	5,353	210	104	14	5,681
<b>At 31 December 2013</b>					
Unlisted non-current asset investments	27	–	–	–	27
Trade receivables and similar items	1,769	240	90	19	2,118
Other non-derivative financial assets	523	1	1	2	527
Derivative financial assets	748	–	–	–	748
Short-term investments	321	–	–	–	321
Cash and cash equivalents	3,990	–	–	–	3,990
	7,378	241	91	21	7,731



## 17 FINANCIAL INSTRUMENTS CONTINUED

## CONTRACTUAL MATURITY ANALYSIS OF FINANCIAL LIABILITIES

	Gross values				Discounting £m	Carrying Value £m
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m		
<b>At 31 December 2014</b>						
Borrowings	(148)	(385)	(214)	(1,880)	366	(2,261)
Derivative financial liabilities	(174)	(115)	(324)	(181)	35	(759)
Financial RRSAs	(17)	(19)	(72)	(52)	15	(145)
C Shares	(22)	–	–	–	–	(22)
Trade payables and similar items	(3,012)	(32)	(2)	(3)	–	(3,049)
Other non-derivative financial liabilities	(650)	(95)	(20)	(66)	–	(831)
	(4,023)	(646)	(632)	(2,182)	416	(7,067)
<b>At 31 December 2013</b>						
Borrowings	(290)	(140)	(609)	(1,894)	562	(2,371)
Derivative financial liabilities	(87)	(76)	(146)	(90)	104	(295)
Exercise price of put option on NCI	(1,858)	–	–	–	–	(1,858)
Financial RRSAs	(33)	(34)	(65)	(75)	40	(167)
C Shares	(16)	–	–	–	–	(16)
Trade payables and similar items	(2,972)	(17)	–	–	–	(2,989)
Other non-derivative financial liabilities	(751)	(28)	(16)	(11)	–	(806)
	(6,007)	(295)	(836)	(2,070)	706	(8,502)

## INTEREST RATE RISK

In respect of income earning financial assets and interest bearing financial liabilities, the following table indicates their effective interest rates and the periods in which they reprice. The value shown is the carrying amount.

	Effective interest rate	Total £m	Period in which interest rate reprices	
			6 months or less £m	6-12 months £m
<b>At 31 December 2014</b>				
Short-term investments <sup>1</sup>		7	5	2
Cash and cash equivalents <sup>2</sup>		2,862	2,862	–
<b>Unsecured bank loans</b>				
Other borrowings		(12)	(1)	–
Interest rate swaps	5.8156%	–	2	(2)
£200m floating rate loan	GBP LIBOR + 0.267	–	–	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–
€125m fixed rate loan	2.6000%	(97)	–	–
€75m fixed rate loan	2.0600%	(59)	–	–
€50m fixed rate loan	2.3500%	(36)	–	–
<b>Unsecured bond issues</b>				
7 <sup>3</sup> / <sub>8</sub> % Notes 2016 £200m	7.3750%	(200)	–	–
6.55% Notes 2015 US\$83m	6.5500%	(55)	–	(55)
Effect of interest rate swaps	USD LIBOR + 1.24	–	(55)	55
6.75% Notes 2019 £500m	6.7500%	(547)	–	–
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(547)	–
2.125% Notes 2021 €750m	2.1250%	(615)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.7005	–	(615)	–
3.375% Notes 2026 £375m	3.3750%	(395)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.8930	–	(395)	–
<b>Other secured</b>				
Obligations under finance leases	4.1089%	(45)	(1)	(1)
		608		

<sup>1</sup> Interest on the short-term investments are at fixed rates.

<sup>2</sup> Cash and cash equivalents comprises bank balances and demand deposits and earns interest at rates based on daily deposit rates.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 17 FINANCIAL INSTRUMENTS CONTINUED

At 31 December 2013	Effective interest rate	Total £m	Period in which interest rate reprices	
			6 months or less £m	6-12 months £m
Short-term investments <sup>1</sup>		321	318	3
Cash and cash equivalents <sup>2</sup>		3,990	3,990	–
<b>Unsecured bank loans</b>				
Other borrowings		(10)	(5)	–
Interest rate swaps	5.3225%	–	5	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–
€125m fixed rate loan	2.6000%	(104)	–	–
€75m fixed rate loan	2.0600%	(63)	–	–
€50m fixed rate loan	2.3500%	(42)	–	–
<b>Unsecured bond issues</b>				
7¾% Notes 2016 £200m	7.3750%	(200)	–	–
6.55% Notes 2015 US\$83m	6.5500%	(55)	–	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(55)	–
6.75% Notes 2019 £500m	6.7500%	(535)	–	–
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(535)	–
2.125% Notes 2021 €750m	2.1250%	(611)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.7005	–	(611)	–
3.375% Notes 2026 £375m	3.3750%	(350)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.8930	–	(350)	–
<b>Other secured</b>				
Obligations under finance leases	5.0000%	(1)	(1)	–
		1,940		

<sup>1</sup> Interest on the short-term investments are at fixed rates.

<sup>2</sup> Cash and cash equivalents comprises bank balances and demand deposits and earns interest at rates based on daily deposit rates.

Some of the Group's borrowings are subject to the Group meeting certain obligations, including customary financial covenants. If the Group fails to meet its obligations these arrangements give rights to the lenders, upon agreement, to accelerate repayment of the facilities. There are no rating triggers contained in any of the Group's facilities that could require the Group to accelerate or repay any facility for a given movement in the Group's credit rating.

In addition, the Group has **£1,277 million** of undrawn committed borrowing facilities (2013 £1,250 million) expiring after two years.

#### SENSITIVITY ANALYSIS

Sensitivities at 31 December (all other variables held constant) – impact on profit after tax and equity	2014 £m	2013 £m
Sterling 10% weaker against the US dollar	(1,336)	(1,177)
Sterling 10% stronger against the US dollar	1,093	963
Euro 10% weaker against the US dollar	(147)	(128)
Euro 10% stronger against the US dollar	123	100
Sterling 10% weaker against the Euro	15	(95)
Sterling 10% stronger against the Euro	(12)	78
Commodity prices 10% lower	(15)	(16)
Commodity prices 10% higher	15	16

At 31 December 2014 the Group had no material sensitivity to changes in interest rates on that date. The main interest rate sensitivity for the Group arises as a result of the gross up of net cash and this is mitigated as described under the interest rate risk management policies on page 131.

## 17 FINANCIAL INSTRUMENTS CONTINUED

### C SHARES AND PAYMENTS TO SHAREHOLDERS

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. C Shares in respect of a year are issued in the following year. Shareholders are able to redeem any number of their C Shares for cash. Any C Shares retained attract a dividend of 75% of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. The Company has the option to compulsorily redeem the C Shares, at any time, if the aggregate number of C Shares in issue is less than 10% of the aggregate number of C Shares issued, or on the acquisition or capital restructuring of the Company.

Movements in the C Shares during the year were as follows:

	2014		2013	
	Millions	Nominal value £m	Millions	Nominal value £m
<b>Issued and fully paid</b>				
<b>At 1 January</b>	<b>16,286</b>	<b>16</b>	10,418	10
Issued	413,669	414	366,041	366
Redeemed	(407,950)	(408)	(360,173)	(360)
<b>At 31 December</b>	<b>22,005</b>	<b>22</b>	16,286	16

Payments to shareholders in respect of the year represent the value of C Shares to be issued in respect of the results for the year. Issues of C Shares were declared as follows:

	2014		2013	
	Pence per share	£m	Pence per share	£m
Interim	9.0	170	8.6	162
Final	14.1	265	13.4	252
	<b>23.1</b>	<b>435</b>	22.0	414

## 18 PROVISIONS FOR LIABILITIES AND CHARGES

	At 1 January 2014 £m	Exchange differences £m	Disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At 31 December 2014 £m
Warranty and guarantees	419	(18)	(14)	(27)	181	(115)	426
Contract loss	67	(1)	(11)	(9)	16	(21)	41
Restructuring	25	1	–	–	121	(25)	122
Customer financing	73	–	–	(34)	15	(7)	47
Insurance	62	–	–	(13)	35	(19)	65
Other	87	(3)	(9)	(13)	76	(32)	106
	<b>733</b>	<b>(21)</b>	<b>(34)</b>	<b>(96)</b>	<b>444</b>	<b>(219)</b>	<b>807</b>
Current liabilities	<b>348</b>						<b>433</b>
Non-current liabilities	<b>385</b>						<b>374</b>

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.

Provisions for contract loss and restructuring are generally expected to be utilised within two years.

In connection with the sale of its products the Group will, on some occasions, provide financing support for its customers – generally in respect of civil aircraft. The Group's commitments relating to these financing arrangements are spread over many years, relate to a number of customers and a broad product portfolio and are generally secured on the asset subject to the financing. These include commitments of US\$1.8 billion to provide borrowing facilities to enable customers to purchase aircraft (of which approximately US\$300 million could be called in 2015). These facilities may only be used if the customer is unable to obtain financing elsewhere and are priced at a premium to the market rate. Consequently the directors do not consider that there is a significant exposure arising from the provision of these facilities.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 18 PROVISIONS FOR LIABILITIES AND CHARGES CONTINUED

Customer financing provisions cover guarantees provided for asset value and/or financing. These guarantees, the risks arising and the process used to assess the extent of the risk are described under the heading 'Customer financing' in the Financial Review on page 31. It is estimated that the provision will be utilised as follows:

	2014 £m	2013 £m
Potential claims with specific claim dates:		
In one year or less	32	29
In more than one year but less than five years	11	38
In more than five years	4	5
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	–	1
	47	73

Commitments on delivered aircraft in excess of the amounts provided are shown in the table below. These are reported on a discounted basis at the Group's borrowing rate to reflect better the time span over which these exposures could arise. These amounts do not represent values that are expected to crystallise. The commitments are denominated in US dollars. As the Group does not generally adopt cash flow hedge accounting for future foreign exchange transactions, this amount is reported, together with the sterling equivalent at the reporting date spot rate. The values of aircraft providing security are based on advice from a specialist aircraft appraiser.

	2014		2013	
	£m	\$m	£m	\$m
Gross commitments	388	605	356	589
Value of security <sup>1</sup>	(245)	(382)	(217)	(360)
Indemnities	(84)	(132)	(80)	(132)
<b>Net commitments</b>	<b>59</b>	<b>91</b>	59	97
Net commitments with security reduced by 20% <sup>2</sup>	90	140	78	129
<sup>1</sup> Security includes unrestricted cash collateral of:	42	66	50	83

<sup>2</sup> Although sensitivity calculations are complex, the reduction of relevant security by 20% illustrates the sensitivity to changes in this assumption.

There are also commitments in respect of undelivered aircraft, but it is not considered practicable to estimate these, as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

The Group's captive insurance company retains a portion of the exposures it insures on behalf of the remainder of the Group. Significant delays occur in the notification and settlement of claims and judgement is involved in assessing outstanding liabilities, the ultimate cost and timing of which cannot be known with certainty at the balance sheet date. The insurance provisions are based on information currently available, however it is inherent in the nature of the business that ultimate liabilities may vary. Provisions for outstanding claims are established to cover the outstanding expected liability as well as claims incurred but not yet reported.

Other provisions comprise a number of liabilities with varying expected utilisation rates.

## 19 POST-RETIREMENT BENEFITS

The Group operates a number of defined benefit and defined contribution schemes.

UK defined benefit schemes are funded, with the assets held in separate trustee administered funds. Employees are entitled to retirement benefits based on either their final or career average salaries and length of service.

Overseas defined benefit schemes are a mixture of funded and unfunded plans and provide benefits in line with local practice. Additionally in the US, and to a lesser extent in some other countries, the Group's employment practices include the provision of healthcare and life insurance benefits for retired employees. These schemes are unfunded.

The valuations of the defined benefit schemes are based on the most recent funding valuations, where relevant, updated by the scheme actuaries to 31 December 2014.

The defined benefit schemes expose the Group to actuarial risks such as longevity, interest rate, inflation and investment risks. In the UK, and in the principal US pension schemes, the Group has adopted investment policies to mitigate some of these risks. This involves investing a significant proportion of the schemes' assets in liability driven investment (LDI) portfolios, which hold investments designed to offset interest rate and inflation rate risks. In addition, in the UK, the Rolls-Royce Pension Fund has invested in a longevity swap, which is designed to offset longevity risks in respect of existing pensioners.

### AMOUNTS RECOGNISED IN THE INCOME STATEMENT

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost and administrative expenses	156	45	201	153	55	208
Past-service (credit)/cost	(18)	(13)	(31)	66	5	71
	138	32	170	219	60	279
Defined contribution schemes <sup>1</sup>	32	97	129	30	86	116
<b>Operating cost</b>	<b>170</b>	<b>129</b>	<b>299</b>	<b>249</b>	<b>146</b>	<b>395</b>
Net financing (income)/charge in respect of defined benefit schemes	(11)	40	29	(12)	38	26
<b>Total income statement charge</b>	<b>159</b>	<b>169</b>	<b>328</b>	<b>237</b>	<b>184</b>	<b>421</b>

<sup>1</sup> The 2013 reported figures did not include defined contribution costs for Rolls-Royce Power Systems AG.

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Cost of sales – included in underlying profit	117	141	84	74	201	215
Commercial and administrative costs	21	104	23	23	44	127
Research and development	27	28	17	14	44	42
	165	273	124	111	289	384
Discontinued operations	5	6	5	5	10	11
	170	279	129	116	299	395

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 19 POST-RETIREMENT BENEFITS CONTINUED

The Group operates a PaySave scheme in the UK. This is a salary sacrifice scheme under which employees elect to stop making employee contributions and the Group makes additional contributions in return for a reduction in gross contractual pay. As a result, there is a decrease in wages and salaries and a corresponding increase in pension costs of **£35 million** (2013 £37 million) in the year.

Net financing comprises:

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Financing on scheme obligations	390	64	454	371	59	430
Financing on scheme assets	(427)	(24)	(451)	(431)	(21)	(452)
Financing on unrecognised surpluses and minimum funding liability	26	–	26	48	–	48
Net financing (income)/charge in respect of defined benefit schemes	(11)	40	29	(12)	38	26
Financing income on scheme surpluses	(13)	–	(13)	(16)	(1)	(17)
Financing costs on scheme deficits	2	40	42	4	39	43

### AMOUNTS RECOGNISED IN OCI IN RESPECT OF DEFINED BENEFIT SCHEMES

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Actuarial gains and losses arising from demographic assumptions	23	(17)	6	(87)	(12)	(99)
Actuarial gains and losses arising from financial assumptions	(1,099)	(228)	(1,327)	(200)	116	(84)
Actuarial gains and losses arising from experience adjustments	(343)	(17)	(360)	65	31	96
Return on scheme assets excluding financing income	2,258	55	2,313	(363)	(42)	(405)
Movement in unrecognised surplus and related finance cost	513	–	513	407	–	407
Movement in minimum funding liability and related finance cost	47	–	47	133	–	133
	1,399	(207)	1,192	(45)	93	48

### AMOUNTS RECOGNISED IN THE BALANCE SHEET IN RESPECT OF DEFINED BENEFIT SCHEMES

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(10,606)	(664)	(11,270)	(9,046)	(558)	(9,604)
Fair value of scheme assets	12,341	593	12,934	9,776	504	10,280
Net asset/(liability) on funded schemes	1,735	(71)	1,664	730	(54)	676
Present value of unfunded obligations	–	(1,109)	(1,109)	–	(935)	(935)
Unrecognised surplus <sup>1</sup>	–	–	–	(488)	–	(488)
Minimum funding liability <sup>2</sup>	–	–	–	(46)	–	(46)
<b>Net asset/(liability) recognised in the balance sheet</b>	<b>1,735</b>	<b>(1,180)</b>	<b>555</b>	<b>196</b>	<b>(989)</b>	<b>(793)</b>
Post-retirement scheme surpluses	1,735	5	1,740	242	6	248
Post-retirement scheme deficits	–	(1,185)	(1,185)	(46)	(995)	(1,041)

<sup>1</sup> Where a surplus has arisen on a scheme, in accordance with IAS 19 and IFRIC 14, the surplus is recognised as an asset only if it represents an unconditional economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet. During 2014, the rules of one scheme were amended, which removed the restriction on recognising the surplus.

<sup>2</sup> A minimum funding liability arises where the statutory funding requirements require future contributions in respect of past service that will result in a future unrecognisable surplus.

Overseas schemes are located in the following countries:

	2014			2013		
	Assets £m	Obligations £m	Net £m	Assets £m	Obligations £m	Net £m
Canada	160	(208)	(48)	135	(181)	(46)
Germany	–	(592)	(592)	–	(500)	(500)
US pension schemes	414	(508)	(94)	347	(420)	(73)
US healthcare schemes	–	(423)	(423)	–	(352)	(352)
Other	19	(42)	(23)	22	(40)	(18)
<b>Net asset/(liability) recognised in the balance sheet</b>	<b>593</b>	<b>(1,773)</b>	<b>(1,180)</b>	<b>504</b>	<b>(1,493)</b>	<b>(989)</b>

## 19 POST-RETIREMENT BENEFITS CONTINUED

### DEFINED BENEFIT SCHEMES

#### ASSUMPTIONS

Significant actuarial assumptions for UK schemes (weighted average by size of the obligation) used at the balance sheet date were as follows:

UK schemes	2014	2013
Discount rate	3.6%	4.4%
Inflation assumption (RPI) <sup>1</sup>	3.2%	3.5%
Rate of increase in salaries	4.2%	4.5%
Male life expectancy from age 65 – current pensioner	22.5 years	22.5 years
– future pensioner currently aged 45	24.1 years	24.2 years

<sup>1</sup> The Consumer Price Index is assumed to be 1.1% lower.

Discount rates are determined by reference to the market yields on AA rated corporate bonds. The rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. In prior years, only bonds with an average AA rating by the three main agencies were included. The population of such bonds has reduced and limited the reliability of the derived yield curve, consequently this has been changed so that bonds rated AA by at least one agency are included. The impact of this change is to increase the discount rate at 31 December 2014 by approximately 0.3%.

The inflation assumption is determined by the market implied assumption based on the yields on long-term indexed linked government securities and increases in salaries are based on actual experience, allowing for promotion, of the real increase above inflation.

The mortality assumptions adopted for the UK pension schemes are derived from the SAP actuarial tables, with future improvements in line with the CMI 2014 core projections and long-term improvements of 1.25%. Where appropriate, these are adjusted to take account of the relevant scheme's actual experience.

Other assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and the assumptions used in the most recent funding valuation. The rate of increase of pensions in payment is based on the rules of the relevant scheme, combined with the inflation assumption where the increase is capped.

Assumptions for overseas schemes are less significant and are based on advice from local actuaries. The principal assumptions are:

Overseas schemes	2014	2013
Discount rate	3.3%	4.5%
Inflation assumption	2.2%	2.3%
Long-term healthcare cost trend rate	5.0%	3.7%
Male life expectancy from age 65 – current pensioner	21.1 years	19.6 years
– future pensioner currently aged 45	23.3 years	20.7 years

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 19 POST-RETIREMENT BENEFITS CONTINUED

#### CHANGES IN PRESENT VALUE OF DEFINED BENEFIT OBLIGATIONS

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
<b>At 1 January</b>	<b>(9,046)</b>	<b>(1,493)</b>	<b>(10,539)</b>	<b>(8,569)</b>	<b>(1,178)</b>	<b>(9,747)</b>
Exchange differences	–	(7)	(7)	–	16	16
Current service cost	(151)	(44)	(195)	(147)	(53)	(200)
Past-service cost	18	16	34	(66)	(4)	(70)
Finance cost	(390)	(63)	(453)	(371)	(59)	(430)
Contributions by employees	(4)	(5)	(9)	(4)	(4)	(8)
Benefits paid out	376	71	447	334	63	397
Acquisition of businesses	–	–	–	(1)	(402)	(403)
Disposal of businesses	10	16	26	–	–	–
Actuarial (losses)/gains	(1,419)	(266)	(1,685)	(222)	134	(88)
Settlement curtailment	–	6	6	–	–	–
Other movements	–	(4)	(4)	–	(6)	(6)
<b>At 31 December</b>	<b>(10,606)</b>	<b>(1,773)</b>	<b>(12,379)</b>	<b>(9,046)</b>	<b>(1,493)</b>	<b>(10,539)</b>
Funded schemes	(10,606)	(664)	(11,270)	(9,046)	(558)	(9,604)
Unfunded schemes	–	(1,109)	(1,109)	–	(935)	(935)
The defined benefit obligations are in respect of:						
Active plan participants	(4,170)	(974)	(5,144)	(3,492)	(849)	(4,341)
Deferred plan participants	(2,009)	(97)	(2,106)	(1,647)	(74)	(1,721)
Pensioners	(4,427)	(702)	(5,129)	(3,907)	(570)	(4,477)
Weighted average duration of obligations (years)	17	16	17	16	13	16

#### CHANGES IN FAIR VALUE OF SCHEME ASSETS

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
<b>At 1 January</b>	<b>9,776</b>	<b>504</b>	<b>10,280</b>	<b>9,794</b>	<b>534</b>	<b>10,328</b>
Exchange differences	–	18	18	–	(19)	(19)
Administrative expenses	(5)	(1)	(6)	(6)	(2)	(8)
Financing	427	24	451	431	21	452
Return on plan assets excluding financing	2,258	55	2,313	(363)	(42)	(405)
Contributions by employer	257	65	322	249	66	315
Contributions by employees	4	5	9	4	4	8
Benefits paid out	(376)	(71)	(447)	(334)	(63)	(397)
Acquisition of businesses	–	–	–	1	5	6
Settlements/curtailment	–	(6)	(6)	–	–	–
<b>At 31 December</b>	<b>12,341</b>	<b>593</b>	<b>12,934</b>	<b>9,776</b>	<b>504</b>	<b>10,280</b>
Total return on scheme assets	2,685	79	2,764	68	(21)	47



## 19 POST-RETIREMENT BENEFITS CONTINUED

## FAIR VALUE OF SCHEME ASSETS AT 31 DECEMBER

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Sovereign debt	7,282	167	7,449	5,929	231	6,160
Derivatives on sovereign debt	(2,622)	2	(2,620)	(987)	2	(985)
Corporate debt instruments	2,053	237	2,290	1,045	190	1,235
Interest rate swaps	4,218	–	4,218	1,361	–	1,361
Inflation swaps	(360)	–	(360)	(13)	–	(13)
Cash and similar instruments	193	127	320	257	44	301
<b>Liability driven investment (LDI) portfolios<sup>1</sup></b>	<b>10,764</b>	<b>533</b>	<b>11,297</b>	<b>7,592</b>	<b>467</b>	<b>8,059</b>
Longevity swap <sup>2</sup>	10	–	10	3	–	3
Listed equities	787	3	790	994	3	997
Unlisted equities	216	–	216	172	–	172
Sovereign debt	105	4	109	215	4	219
Corporate debt instruments	15	–	15	540	4	544
Cash	166	32	198	253	4	257
Other	278	21	299	7	22	29
<b>At 31 December</b>	<b>12,341</b>	<b>593</b>	<b>12,934</b>	<b>9,776</b>	<b>504</b>	<b>10,280</b>

<sup>1</sup> A portfolio of gilt and swap contracts, backed by LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

<sup>2</sup> Under the longevity swap, the Rolls-Royce Pension Fund (RRPF) has agreed an average life expectancy of pensioners with a counterparty. If pensioners live longer than expected the counterparty will make payments to the RRPF to offset the additional cost of paying pensioners. If the reverse applies the cost of paying pensioners will be reduced but the scheme will be required to make payments to the counterparty. The longevity swap is valued on an external fair market basis, rather than using the same assumptions as used for the valuation of the scheme's liabilities.

The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group. The longevity swap is valued by the scheme actuaries based on the difference between the agreed longevity assumptions at inception and actual longevity experience. All other fair values are provided by the fund managers. Where available, the fair values are quoted prices (eg listed equity, sovereign debt and corporate bonds). Unlisted investments (private equity) are included at values provided by the fund manager in accordance with relevant guidance. Other significant assets are valued based on observable inputs such as yield curves.

## MOVEMENTS IN UNRECOGNISED SURPLUS AND MINIMUM FUNDING LIABILITY

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
<b>At 1 January</b>	<b>(534)</b>	<b>–</b>	<b>(534)</b>	<b>(1,026)</b>	<b>–</b>	<b>(1,026)</b>
Movements in unrecognised surplus through OCI	513	–	513	407	–	407
Movements in minimum funding liability through OCI	47	–	47	133	–	133
Related finance costs	(26)	–	(26)	(48)	–	(48)
<b>At 31 December</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>(534)</b>	<b>–</b>	<b>(534)</b>

## FUTURE CONTRIBUTIONS

The Group expects to contribute approximately £250 million to its defined benefit schemes in 2015.

In the UK, the funding is set on the basis of a triennial funding valuation by the actuaries for which the assumptions may differ from those above. In particular, the discount rate used to value the obligations takes account of the investment strategy, rather than being based on market yields of AA corporate bonds. As a result of these valuations, the Group and the scheme trustees agree a Schedule of Contributions (SoC), which sets out the required contributions from the employer and employees for current service. Where the scheme is in deficit, the SoC also includes required contributions from the employer to eliminate the deficit. The most recent agreed triennial valuations for the principal schemes are:

	Obligations at 31 December 2014 £m	Valuation date
Rolls-Royce Pension Fund	7,330	31 March 2012
Rolls-Royce Group Pension Scheme	1,779	5 April 2013
Vickers Group Pension Scheme	696	31 March 2013

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 19 POST-RETIREMENT BENEFITS CONTINUED

#### SENSITIVITIES

The calculations of the defined benefit obligations are sensitive to the assumptions set out above. The following table summarises how the estimated impact of a change in a significant assumption would affect the UK defined benefit obligation at 31 December 2014, while holding all other assumptions constant. This sensitivity analysis may not be representative of the actual change in the defined benefit obligation as it is unlikely that the change in assumptions would occur in isolation of one another as some of the assumptions may be correlated.

For the most significant funded schemes, the investment strategies are designed to hedge the risks from interest rates, inflation on an economic basis and in the Rolls-Royce Pension Fund in the UK, the longevity of pensioners. Where appropriate, the table also includes the corresponding movement in the value of the plan assets.

		£m
Reduction in the discount rate of 0.25% <sup>1</sup>	Obligation	(473)
	Plan assets (LDI portfolio)	591
Increase in inflation of 0.25%	Obligation	(241)
	Plan assets (LDI portfolio)	209
Increase in real increase in salaries of 0.25%	Obligations	(95)
One year increase in life expectancy	Obligations	(250)

<sup>1</sup> The difference between the sensitivities on obligations and plan assets arises largely due to differences in the methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is approximately 96%.

### 20 SHARE CAPITAL

	Non-equity		Equity	
	Special Share of £1	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
<b>Issued and fully paid</b>				
At 1 January 2013	1	–	1,872	374
Proceeds from shares issued for share option schemes	–	–	8	2
<b>At 31 December 2013</b>	<b>1</b>	<b>–</b>	<b>1,880</b>	<b>376</b>
Shares issued to share trust	–	–	10	2
Purchase and cancellation of ordinary shares	–	–	(8)	(2)
<b>At 31 December 2014</b>	<b>1</b>	<b>–</b>	<b>1,882</b>	<b>376</b>

The rights attaching to each class of share are set out on page 162.

In accordance with IAS 32 *Financial Instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 17.

## 21 SHARE-BASED PAYMENTS

### EFFECT OF SHARE-BASED PAYMENT TRANSACTIONS ON THE GROUP'S RESULTS AND FINANCIAL POSITION

	2014 £m	2013 £m
Total charge recognised for equity-settled share-based payments transactions	26	61
Total (credit)/charge recognised for cash-settled share-based payments transactions	(5)	18
Share-based payments recognised in the consolidated income statement	21	79
Liability for cash-settled share-based payment transactions	13	19

A description of the share-based payment plans is included in the Directors' Remuneration Report on pages 77 to 89.

### MOVEMENTS IN THE GROUP'S SHARE-BASED PAYMENT PLANS DURING THE YEAR

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2013	26.8	447	0.1	77	14.0	4.0
Granted	10.0	961	–	–	2.8	1.6
Additional entitlements arising from TSR performance	–	–	–	–	0.6	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(0.6)	483	–	–	(0.6)	(0.1)
Exercised	(10.2)	404	(0.1)	77	(4.8)	(2.5)
<b>Outstanding at 1 January 2014</b>	<b>26.0</b>	<b>660</b>	<b>–</b>	<b>–</b>	<b>12.0</b>	<b>3.1</b>
Granted	–	–	–	–	2.9	1.1
Additional entitlements arising from TSR performance	–	–	–	–	0.5	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(1.0)	775	–	–	(1.2)	(0.2)
Exercised	(0.5)	487	–	–	(4.4)	(1.7)
<b>Outstanding at 31 December 2014</b>	<b>24.5</b>	<b>660</b>	<b>–</b>	<b>–</b>	<b>9.8</b>	<b>2.4</b>
<b>Exercisable at 31 December 2014</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>
Exercisable at 31 December 2013	–	–	–	–	–	–

As share options are exercised throughout the year, the weighted average share price during the year of **1013p** (2013 1123p) is representative of the weighted average share price at the date of exercise. The closing price at 31 December 2014 was **870p** (2013 1275p).

### FAIR VALUES OF SHARE-BASED PAYMENT PLANS

The weighted average fair value per share of equity-settled share-based payment plans granted during the year, estimated at the date of grant, are as follows:

	2014	2013
PSP – 25% TSR uplift	1105p	1128p
PSP – 50% TSR uplift	1227p	1254p
ShareSave – 3 year grant	n/a	287p
ShareSave – 5 year grant	n/a	349p
APRA	984p	1027p

#### PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value of the award relative to the share price at the date of grant.

#### SHARESAVE

The fair value of the options granted under the ShareSave plan is calculated using a binomial pricing model that assumes that participants will exercise their options at the beginning of the six-month window if the share price is greater than the exercise price. Otherwise it assumes that options are held until the expiration of their contractual term. This results in an expected life that falls somewhere between the start and end of the exercise window.

#### APRA

The fair value of shares awarded under APRA is calculated as the share price on the date of the award, excluding expected dividends (or equivalent).

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 22 LEASES

#### OPERATING LEASES

##### LEASES AS LESSEE

	2014 £m	2013 £m
Rentals paid – hire of plant and machinery	123	134
– hire of other assets	75	55
Non-cancellable operating lease rentals are payable as follows:		
Within one year	182	179
Between one and five years	542	545
After five years	438	507
	<b>1,162</b>	<b>1,231</b>

##### LEASES AS LESSOR

	2014 £m	2013 £m
Rentals received – credited within revenue from aftermarket services	15	56
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	16	19
Between one and five years	30	48
After five years	13	23
	<b>59</b>	<b>90</b>

The Group acts as lessee and lessor for both land and buildings and gas turbine engines, and acts as lessee for some plant and equipment.

- Sublease payments of **£1 million** (2013 £1 million) and sublease receipts of **£12 million** (2013 £27 million) were recognised in the income statement in the year.
- Purchase options exist on aero engines, land and buildings and plant and equipment with the period to the purchase option date varying between one to eight years.
- Renewal options exist on aero engines, land and buildings and plant and equipment with the period to the renewal option varying between one to 42 years at terms to be negotiated upon renewal.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total future minimum sublease payments expected to be made are **£6 million** (2013 £8 million) and sublease receipts expected to be received are **£31 million** (2013 £42 million).

#### FINANCE LEASES

##### LEASES AS LESSEE

Finance lease liabilities are payable as follows:

	2014			2013		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Within one year	3	2	1	–	–	–
Between one and five years	13	7	6	1	–	1
After five years	47	9	38	–	–	–
	<b>63</b>	<b>18</b>	<b>45</b>	<b>1</b>	<b>–</b>	<b>1</b>

## 23 CONTINGENT LIABILITIES

Contingent liabilities in respect of customer financing commitments are described in note 18.

On 6 December 2012, the Company announced that it had passed information to the Serious Fraud Office (SFO), following a request from the SFO for information about allegations of malpractice in overseas markets. On 23 December 2013, the Company announced that it had been informed by the SFO that it had commenced a formal investigation. Since the initial announcement, the Company has continued its investigations and is engaging with the SFO and other authorities in the UK, the USA and elsewhere in relation to the matters of concern.

The consequence of these disclosures will be decided by the regulatory authorities. It is too early to predict the outcomes, but these could include the prosecution of individuals and of the Group. Accordingly, the potential for fines, penalties or other consequences cannot currently be assessed. As the investigation is ongoing, it is not yet possible to identify the timescale in which these issues might be resolved.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Group has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Group is no longer fully insured against known and potential claims from employees who worked for certain of the Group's UK-based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group.

The Group's share of equity accounted entities' contingent liabilities is **£11 million** (2013 £13 million).

Following the sale of the Energy business to Siemens on 1 December 2014 and further to the announcement on 19 June 2014 of a £1 billion share buyback, on 10 December 2014, the Company put in place an initial £250 million programme for the purchase of its ordinary shares. The aim of the buyback is to reduce the share capital of the Company, helping enhance returns to shareholders. In the period to 31 December 2014, 8,215,000 shares were purchased at an average price of 840 pence, leaving a contracted commitment of £182 million.

## 24 RELATED PARTY TRANSACTIONS

	2014 £m	2013 £m
Sales of goods and services to joint ventures and associates	2,138	3,149
Purchases of goods and services from joint ventures and associates	(2,544)	(3,269)
Operating lease payments to joint ventures and associates	(81)	(69)
Guarantees of joint ventures' and associates' borrowings	9	7
Dividends received from joint ventures and associates	73	99
RRSA receipts from joint ventures and associates	2	4
Other income received from joint ventures and associates	2	1

The aggregated balances with joint ventures are shown in notes 13 and 16. Transactions with Group pension schemes are shown in note 19.

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.

Key management personnel are deemed to be the directors and the members of the ELT as set out on pages 54 to 57. Remuneration for key management personnel is shown below:

	2014 £m	2013 £m
Salaries and short-term benefits	9	11
Post-retirement schemes	1	1
Share-based payments	4	7
	14	19

More detailed information regarding the directors' remuneration, shareholdings, pension entitlements, share options and other long-term incentive plans is shown in the Directors' Remuneration Report on pages 76 to 85.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONTINUED

### 25 ACQUISITIONS AND DISPOSALS

#### ACQUISITIONS

On 5 March 2014, the Group acquired the 50% of Gate Leasing Limited that it did not already own for US\$5 million. The principal assets and liabilities acquired were aircraft engines (£37 million) and borrowings (£30 million).

#### DISPOSALS

On 1 December 2014, the Group sold its Energy business for £785 million which included a contribution to the costs of separating the Energy business from the Group's continuing activities, most significantly the creation of a stand-alone IT system. In addition, Rolls-Royce has received a further £200 million for a 25-year licensing agreement<sup>1</sup> granting Siemens access to relevant Rolls-Royce aero-derivative technology for use in the 4 to 85MW power output gas turbine range. The Energy business disposal gave rise to a cash inflow of £1,027 million. In accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*, the disposal of the Energy business has been accounted for as a discontinued operation.

In addition, on 1 October 2014 the Group sold its interest in MTU Australia Pty. Limited for £24 million. The principal activity of this company was to hold the Group's joint venture interest in MTU Detroit Diesel Australia Pty. Limited.

	Energy (discontinued operation) £m	MTU Australia £m
<b>PROCEEDS</b>		
Cash consideration	985	24
Adjustments and future obligations to the purchaser	(28)	–
<b>Total consideration before deferrals</b>	<b>957</b>	<b>24</b>
Receipt of licensing agreement proceeds deferred as at 1 December 2014 <sup>1</sup>	(58)	–
<b>Total consideration after deferrals</b>	<b>899</b>	<b>24</b>
<b>ASSETS AND LIABILITIES DISPOSED</b>		
Intangible assets	106	–
Property, plant and equipment	187	–
Investment in joint venture	56	14
Inventory	320	–
Deposits (payments received on account)	(11)	–
Trade and other receivables	337	–
Cash and cash equivalents	4	–
Trade and other payables	(253)	–
Provisions for liabilities and charges	(34)	–
<b>Net assets disposed</b>	<b>712</b>	<b>14</b>
<b>PROFIT ON DISPOSAL</b>		
<b>Profit on disposal before disposal costs and continuing obligations</b>	<b>187</b>	<b>10</b>
Cumulative currency translation gain/(loss)	32	(3)
Disposal costs and continuing obligations <sup>2</sup>	(98)	(1)
Post-retirement scheme net credit <sup>3</sup>	15	–
<b>Profit on disposal of business before tax</b>	<b>136</b>	<b>6</b>
Tax on disposal	2	–
<b>Profit on disposal of business after tax</b>	<b>138</b>	<b>6</b>
<b>RECONCILIATION TO CASH FLOW STATEMENT</b>		
<b>Total consideration after deferrals</b>	<b>899</b>	<b>24</b>
Adjustments, future obligations and receipt of licensing agreement proceeds deferred at 1 December 2014 <sup>4</sup>	158	–
Cash and cash equivalents disposed	(4)	–
Disposal costs paid in the year	(26)	–
<b>Cash inflow per cash flow statement</b>	<b>1,027</b>	<b>24</b>

<sup>1</sup> The £200m licensing agreement contained £142m to provide intellectual property which has been recognised in the period, whilst £58m relating to the provision of engineering services and supply of parts has been deferred over a period up to 25 years.

<sup>2</sup> Disposal costs £98m (incurred and accrued), includes costs to separate the Energy business including IT, legal and transactional fees.

<sup>3</sup> Profit on the sale of business includes pension and other post-retirement benefit plan curtailment gains of £26m (note 19) and an accrual to settle a pension deficit that is expected to transfer to Siemens during 2015.

<sup>4</sup> £58m of costs relating to future obligations to Siemens not yet incurred have been accrued and £58m relating to the licensing agreement have been deferred. In addition, the Energy disposal is subject to customary post-closing adjustments that are estimated to be £42m, which may include adjustments for working capital. Such adjustments may result in the final amounts received from the purchaser differing from the disposal proceeds above.

# COMPANY BALANCE SHEET

At 31 December 2014

	Notes	2014 £m	2013 £m
<b>Fixed assets</b>			
Investments – subsidiary undertakings	2	12,015	12,000
<b>Debtors – amounts falling due with one year</b>			
Amounts owed by subsidiary undertakings		57	–
<b>Creditors – amounts falling due within one year</b>			
Financial liabilities	3	(22)	(16)
Amounts owed to subsidiary undertakings		–	(995)
<b>Net current assets/(liabilities)</b>		35	(1,011)
<b>Total assets less current liabilities</b>		12,050	10,989
<b>Capital and reserves</b>			
Called-up share capital	4	376	376
Share premium account	5	179	80
Merger reserve	5	7,789	8,203
Capital redemption reserve	5	1,267	857
Other reserve	5	124	109
Profit and loss account	5	2,315	1,364
<b>Equity shareholders' funds</b>		12,050	10,989

The financial statements on pages 149 to 151 were approved by the Board on 12 February 2015 and signed on its behalf by:

JOHN RISHTON Chief Executive

DAVID SMITH Chief Financial Officer

Company's registered number: 7524813

## RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

For the year ended 31 December 2014

	£m
<b>At 1 January 2014</b>	10,989
Profit for the year	1,500
Arising on issue of ordinary shares	101
Purchase of ordinary shares	(69)
Issue of C Shares	(414)
Share-based payments – direct to equity	(57)
<b>At 31 December 2014</b>	12,050

# NOTES TO THE COMPANY FINANCIAL STATEMENTS

## 1 ACCOUNTING POLICIES

### BASIS OF ACCOUNTING

The financial statements have been prepared in accordance with applicable UK Accounting Standards on the historical cost basis.

As permitted by section 408 of the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements. As permitted by the audit fee disclosure regulations, disclosure of non-audit fees information is not included in respect of the Company. As permitted by FRS 1 *Cash flow statements*, no cash flow statement for the Company has been included. As permitted by FRS 8 *Related party disclosures*, no related party disclosures in respect of transactions between the Company and its wholly owned subsidiaries have been included.

### INVESTMENTS IN SUBSIDIARY UNDERTAKINGS

Investments in subsidiary undertakings are reported at cost less any amounts written off.

### SHARE-BASED PAYMENTS

As described in the remuneration report on pages 78 to 80, the Company grants awards of its own shares to employees of its subsidiary undertakings, (see note 21 of the consolidated financial statements). The costs of share-based payments in respect of these awards are accounted for, by the Company, as an additional investment in its subsidiary undertakings. The costs are determined in accordance with FRS 20 *Share-based payment*. Any payments made by the subsidiary undertakings in respect of these arrangements are treated as a return of this investment.

### FINANCIAL INSTRUMENTS

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's C Shares are classified as financial liabilities and held at amortised cost from the date of issue until redeemed.

## 2 INVESTMENTS – SUBSIDIARY UNDERTAKINGS

	£m
<b>Cost:</b>	
<b>At 1 January 2014</b>	<b>12,000</b>
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	15
<b>At 31 December 2014</b>	<b>12,015</b>

## 3 FINANCIAL LIABILITIES

### C SHARES

Movements in C Shares during the year were as follows:

	C Shares of 0.1p Millions	Nominal value £m
<b>Issued and fully paid</b>		
<b>At 1 January 2013</b>	<b>16,286</b>	<b>16</b>
Shares issued	413,669	414
Shares redeemed	(407,950)	(408)
<b>At 31 December 2014</b>	<b>22,005</b>	<b>22</b>

The rights attaching to C Shares are set out on page 162.



## 4 SHARE CAPITAL

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
<b>Issued and fully paid</b>					
<b>At 1 January 2014</b>	<b>1</b>	<b>–</b>	<b>–</b>	<b>1,880</b>	<b>376</b>
Cancellation of ordinary shares	–	–	–	(8)	(2)
Shares issued to share trust	–	–	–	10	2
<b>At 31 December 2014</b>	<b>1</b>	<b>–</b>	<b>–</b>	<b>1,882</b>	<b>376</b>

The rights attaching to each class of share are set out on page 162.

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 3.

## 5 MOVEMENTS IN CAPITAL AND RESERVES

	Non-distributable reserves					Profit and loss account £m	Total £m
	Share capital £m	Share premium £m	Merger reserve £m	Capital redemption reserve £m	Other reserve <sup>1</sup> £m		
<b>At 1 January 2014</b>	<b>376</b>	<b>80</b>	<b>8,203</b>	<b>857</b>	<b>109</b>	<b>1,364</b>	<b>10,989</b>
Profit for the year	–	–	–	–	–	1,500	1,500
Shares issued to share trust	2	99	–	–	–	–	101
Purchase of ordinary shares	–	–	–	–	–	(69)	(69)
Cancellation of ordinary shares	(2)	–	–	2	–	–	–
Issue of C Shares	–	–	(414)	–	–	–	(414)
Redemption of C Shares	–	–	–	408	–	(408)	–
Share-based payments – direct to equity	–	–	–	–	15	(72)	(57)
<b>At 31 December 2014</b>	<b>376</b>	<b>179</b>	<b>7,789</b>	<b>1,267</b>	<b>124</b>	<b>2,315</b>	<b>12,050</b>

<sup>1</sup> The 'Other reserve' represents the value of share-based payments in respect of employees of subsidiary undertakings for which payment has not been received.

## 6 CONTINGENT LIABILITIES

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee.

At 31 December 2014, these guarantees amounted to **£959 million** (2013 £1 billion).

Following the sale of the Energy business to Siemens on 1 December 2014 and further to the announcement on 19 June 2014 of a £1 billion share buyback, on 10 December 2014, the Company put in place an initial £250 million programme for the purchase of its ordinary shares. The aim of the buyback is to reduce the share capital of the Company, helping enhance returns to shareholders. In the period to 31 December 2014, 8,215,000 shares were purchased at an average price of 840 pence, leaving a contracted commitment of £182 million.

## 7 OTHER INFORMATION

### EMOLUMENTS OF DIRECTORS

The remuneration of the directors of the Company is shown in the Directors' Remuneration Report on pages 76 to 85.

### EMPLOYEES

The Company had no employees in 2014.

### SHARE-BASED PAYMENTS

Shares in the Company have been granted to employees of the Group as part of share-based payment plans, and are charged in the employing company.

## SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

The companies listed below are indirectly held by Rolls-Royce Holdings plc except Rolls-Royce Group plc which is directly held. Each company's principal place of business is its country of incorporation and the effective group interest is 100%.

In accordance with Section 410 of the Companies Act 2006, the subsidiaries, jointly controlled entities and associates are those where the results or financial position, in the opinion of the directors, principally affect the financial statements. A list of all related undertakings will be included in the Company's annual return to Companies House.

	Country of incorporation	Principal activity
Rolls-Royce Brasil Limitada	Brazil	Aero engine repair and overhaul and marine aftermarket support services
Rolls-Royce Canada Limited	Canada	Aero engine sales, service and overhaul
MTU Engineering (Suzhou) Company Limited	China	Service and spare parts centre
Rolls-Royce Marine Manufacturing (Shanghai) Limited	China	Manufacture and supply of marine equipment and marine aftermarket support services
Composite Technology and Applications Limited	England	Development of aero engine fan blades and fan cases
MTU UK Limited	England	Sale and services of off-highway diesel engines
Rolls-Royce Controls and Data Services Limited	England	Development and manufacture of aero engine controls and monitoring systems
Rolls-Royce Group plc	England	Holding company
Rolls-Royce International Limited	England	International support and commercial information services
Rolls-Royce Leasing Limited	England	Engine leasing
Rolls-Royce Marine Electrical Systems Limited	England	Marine electrical systems
Rolls-Royce Marine Power Operations Limited	England	Nuclear submarine propulsion systems
Rolls-Royce plc	England	Principal UK trading company
Rolls-Royce Power Development Limited	England	Generation of electricity from independent power projects
Rolls-Royce Power Engineering plc	England	Marine systems
Rolls-Royce Total Care Services Limited	England	Aero engine aftermarket support services
Vinters Engineering Limited	England	Production, repair and overhaul of power generation, transmission and conversion equipment for military and commercial activities
Rolls-Royce OY AB	Finland	Manufacture of marine winches and propeller systems
Rolls-Royce Civil Nuclear SAS	France	Instrumentation and control systems and life-cycle management for nuclear power plants
Rolls-Royce Technical Support SARL	France	Aero engine project support
L'Orange GmbH	Germany	Development and production of high-pressure injection systems for diesel engines
MTU Friedrichshafen GmbH	Germany	Development, production and distribution of gas turbines and engines
MTU Onsite Energy GmbH	Germany	Sales and service of gas engines
MTU Onsite Energy Systems GmbH	Germany	Manufacture and distributor of diesel-powered generating sets
Rolls-Royce Deutschland Ltd & Co KG	Germany	Aero engine design, development and manufacture
Rolls-Royce Power Systems AG	Germany	Supplier of engines and power trains for marine propulsion, distributed power generation and industrial off-highway sectors
Nightingale Insurance Limited	Guernsey	Insurance services
MTU Hong Kong Limited	Hong Kong	Distributor for off-highway products and after-sales service
Rolls-Royce India Private Limited	India	Diesel engine project management and customer support
Rolls-Royce Marine India Private Limited	India	Provision of marine support services
Rolls-Royce Operations (India) Private Limited	India	Engineering support services
Europea Microfusioni Aerospaziali S.p.A.	Italy	Manufacture of gas turbine engine castings
MTU Italia S.r.l.	Italy	Distributor for off-highway products and after-sales service
MTU Benelux B.V.	Netherlands	Sales and after-sales support for diesel engines
Bergen Engines AS	Norway	Design and manufacture of medium-speed diesel engines
Rolls-Royce Marine AS	Norway	Design and manufacture of ship equipment
MTU Asia Pte. Limited	Singapore	Distributor of diesel engines and spare parts
Rolls-Royce Singapore Pte. Limited	Singapore	Aero engine parts manufacturing and engine assembly and marine aftermarket support services
MTU South Africa (Pty.) Limited	South Africa	Distributor of off-highway products and after-sales service
MTU Ibérica Propulsión y Energía S.L.	Spain	Sales and service of transmission equipment with diesel and gas engines
Rolls-Royce AB	Sweden	Manufacture of marine propeller systems
MTU Motor Türbin Sanayi ve Tic. A.S.	Turkey	Production of diesel engines and manufacturer of control systems
Data Systems & Solutions LLC	US	Instrumentation and control systems and life-cycle management for nuclear power plants
MTU America Inc.	US	Sales and service of engines and systems
Optimized Systems and Solutions Inc.	US	Equipment health management and advanced data management services
PKMJ Technical Services Inc.	US	Civil nuclear engineering services and software solutions
R. Brooks Associates Inc.	US	Specialist civil nuclear reactor services
Rolls-Royce Corporation	US	Design, development and manufacture of gas turbine engines

	Country of incorporation	Principal activity
Rolls-Royce Crosspointe LLC	US	Manufacturing facility for aero engine parts
Rolls-Royce Defense Services Inc.	US	Aero engine repair and overhaul
Rolls-Royce Energy Systems Inc.	US	Energy turbine generator packages
Rolls-Royce Engine Services – Oakland Inc.	US	Aero engine repair and overhaul
Rolls-Royce High Temperature Composites Inc.	US	Production of state-of-the-art composite materials
Rolls-Royce Marine North America Inc.	US	Design and manufacture of marine equipment and aftermarket support services

The companies listed below are indirectly held by Rolls-Royce Holdings plc. Each company's principal place of business is its country of incorporation.

	Country of incorporation	Principal activity	Class of shares	% of class held	Group interest held %
Shanxi North MTU Diesel Co. Ltd	China	Manufacturer of aero engine parts	Ordinary	49	49
Xian XR Aero Components Co Limited	China	Manufacturer of aero engine parts	Ordinary	49	49
Airtanker Holdings Limited	England	Strategic tanker aircraft PFI project	Ordinary	20	20
Airtanker Services Limited	England	Provision of aftermarket services for strategic tanker aircraft	Ordinary	22	22
Alpha Partners Leasing Limited	England	Aero engine leasing	A ordinary	100	50
Genistics Holdings Limited	England	Trailer-mounted field mobile generator sets	A ordinary	100	50
Rolls-Royce Snecma Limited	England	Aero engine collaboration	B shares	100	50
TRT Limited	England	Aero engine turbine blade repair services	B ordinary	100	49.5
Turbine Surface Technologies Limited	England	Aero engine turbine surface coatings	B ordinary	100	50
Turbo-Union Limited	England	RB199 engine collaboration	Ordinary A shares	40 37.5	40
EPI Europrop International GmbH (effective group interest held 35.5%)	Germany	A400M engine collaboration	Ordinary	28	28
EUROJET Turbo GmbH (effective group interest held 39%)	Germany	EJ200 engine collaboration	Ordinary	33	33
MTU, Turbomeca, Rolls-Royce GmbH	Germany	MTR390 engine collaboration	Ordinary	33.3	33.3
N3 Engine Overhaul Services GmbH & Co KG	Germany	Aero engine repair and overhaul	Ordinary	50	50
Hong Kong Aero Engine Services Limited	Hong Kong	Aero engine repair and overhaul	Ordinary	45	45
International Aerospace Manufacturing Private Limited	India	Manufacturer of aero engine parts	Ordinary	50	50
Techjet Aerofoils Limited	Israel	Manufacturer of aero engine parts	A ordinary B ordinary	50 50	50
International Engine Component Overhaul Pte Limited	Singapore	Aero engine repair and overhaul	Ordinary	50	50
Singapore Aero Engine Services Private Limited (effective group interest 39%)	Singapore	Aero engine repair and overhaul	Ordinary	30	30
Industria de Turbo Propulsores SA	Spain	Aero engine component manufacture and maintenance	Ordinary	46.9	46.9
Alpha Leasing (US) LLC, Alpha Leasing (US) (No.2) LLC, Alpha Leasing (US) (No.4) LLC, Alpha Leasing (US) (No.5) LLC, Alpha Leasing (US) (No.6) LLC, Alpha Leasing (US) (No.7) LLC, Alpha Leasing (US) (No.8) LLC, Rolls-Royce & Partners Finance (US) LLC, Rolls-Royce & Partners Finance (US) (No.2) LLC	US	Aero engine leasing	Partnerships (no equity held)	–	50
Exostar LLC	US	Business to business internet exchange	Partnership (no equity held)	–	18.5
LG Fuel Cell Systems Inc.	US	Development of fuel cells	Common Stock	32	32
Texas Aero Engine Services, LLC	US	Aero engine repair and overhaul	Partnership (no equity held)	–	50

#### UNINCORPORATED

Light Helicopter Turbine Engine Company (LHTEC)	US	T800 engine development and market	Partnership (no equity held)	–	50
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# INDEPENDENT AUDITOR'S REPORT

to the members of Rolls-Royce Holdings plc only

## OPINIONS AND CONCLUSIONS ARISING FROM OUR AUDIT

### 1 OUR OPINION ON THE FINANCIAL STATEMENTS IS UNMODIFIED

We have audited the Financial Statements of Rolls-Royce Holdings plc for the year ended 31 December 2014 set out on pages 95 to 151. In our opinion:

- the Financial Statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2014 and of the Group's profit for the year then ended;
- the Group Financial Statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (Adopted IFRS);
- the parent company Financial Statements have been properly prepared in accordance with UK Accounting Standards; and
- the Financial Statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group Financial Statements, Article 4 of the IAS Regulation.

### 2 OUR ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT

We summarise below the risks of material misstatement that had the greatest effect on our audit, our key audit procedures to address those risks and our findings from those procedures in order that the Company's members as a body may better understand the process by which we arrived at our audit opinion. Our findings are the result of procedures undertaken in the context of and solely for the purpose of our statutory audit opinion on the Financial Statements as a whole and consequently are incidental to that opinion, and we do not express discrete opinions on separate elements of the Financial Statements.

Given the long-term nature of the Group's business, it is inevitable that the risks that had the greatest effect on our audit change little from year to year. Nevertheless, there have been a number of changes from 2013, the most significant being:

- for the 2014 audit, due to a number of revisions to the Group's published guidance on revenue and profit, we significantly increased our focus and work on the risk relating to *The pressure on and incentives for management to meet revised revenue and profit guidance*;
- the audit work in connection with the risk relating to *Accounting for risk and revenue sharing arrangements* was substantially less than that required in the 2013 audit as the Financial Reporting Council's enquiry was concluded during the 2013 audit, there have been no changes to relevant accounting standards and only a small number of new agreements have been entered into this year; and
- the risks relating to *Accounting for the consolidation of Rolls-Royce Power Systems Holding GmbH and the valuation of Daimler AG's put option* required substantially less audit effort than in earlier years when the transactions took place, in part due to the exercise of the put option by Daimler AG during 2014.

### The pressure on and incentives for management to meet revised revenue and profit guidance

Refer to pages 32 to 41 (*Business reviews*) and pages 69 to 71 (*Audit Committee report – Financial reporting*)

**The risk** – The Group published a number of revisions to its revenue and profit guidance during the year with a generally decreasing trend in profit and revenue and there have been significant associated decreases in the Group's share price. The Chief Executive clearly instructed the Executive Leadership Team and the senior finance executives on more than one occasion not to take any account of the pressure to meet forecasts in preparing the financial results and to be alert to how this might affect personnel across the wider Group. Nevertheless, the heightened pressure on and incentives for management to meet the latest guidance increased the inherent risk of manipulation of the Financial Statements. The financial results are sensitive to significant estimates and judgements, particularly in respect of revenues and costs associated with long-term contracts, and there is a broad range of acceptable outcomes of these that could lead to different profit and revenue reported in the Financial Statements. Relatively small changes in the basis of those judgements and estimates could result in the Group meeting, exceeding or falling short of guidance.

**Our response** – We have: (i) extended our enquiries designed to assess whether management had applied unconscious bias or had taken systematic actions to manipulate the reported results; (ii) compared the results to forecasts and challenged variances at a much more granular level than we would otherwise have done based on our understanding of factors affecting business performance with corroboration using external data where possible; (iii) applied an increased level of scepticism throughout the audit by increasing the involvement of the senior audit team personnel, with particular focus on audit procedures designed to assess whether revenues and costs have been recognised in the correct accounting period and whether central adjustments were appropriate; and (iv) challenged our entire audit approach based on an independent review by personnel with no other involvement in the audit.

In particular:

- when considering the risk relating to *The measurement of revenue and profit in the Civil aerospace business*, we challenged the basis for changes in the estimated revenues and costs in long-term contracts with a heightened awareness of the possibility of unconscious or systematic bias; and
- when considering the risk relating to *The presentation of underlying profit*, we sought to identify items that affected profit (and/or the trend in profit) unevenly in frequency or amount at a much lower level than we would otherwise have done and to assess the transparency of disclosure of these items.

**Our findings** – Aside from one transaction which had a very small impact on the Group's profit and which was subsequently corrected by management, our testing did not identify any indication of manipulation of results. We found the degree of caution/optimism adopted in estimates to be broadly consistent with that adopted in the previous year with no indication of conscious or unconscious bias.

### **The basis of accounting for revenue and profit in the Civil aerospace business**

*Refer to page 101 and 102 (Key areas of judgement – Introduction, Contractual aftermarket rights, Linkage of original and long-term aftermarket contracts), pages 104 and 105 (Significant accounting policies – Revenue recognition) and pages 69 to 71 (Audit Committee report – Financial reporting)*

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

**Our response** – We re-evaluated the appropriateness of the accounting bases the Group applies in the Civil aerospace business by reference to accounting standards, including examining correspondence and attending meetings between the Group and the Financial Reporting Council and re-examining historical long-term aftermarket contracts. We considered whether the enhanced disclosure included in the Financial Statements following this dialogue enables shareholders to understand how the accounting policies represent the commercial substance of the Group's contracts with its customers. We made our own independent assessment, with reference to the relevant accounting standards, of the accounting basis that should be applied to each long-term aftermarket contract entered into during the year and compared this to the accounting basis applied by the Group.

**Our findings** – We found that the Group has developed a framework for selecting the accounting bases which is consistent with a balanced interpretation of accounting standards (2013 audit finding: *balanced*) and has applied this consistently. We found that the enhanced disclosure was ample. For the agreements entered into during this year, it was clear which accounting basis should apply.

### **The measurement of revenue and profit in the Civil aerospace business**

*Refer to pages 101 and 102 (Key areas of judgement – Measurement of performance on long-term aftermarket contracts), pages 104 and 105 (Significant accounting policies – Revenue recognition and TotalCare arrangements) and pages 69 to 71 (Audit Committee report – Financial reporting)*

**The risk** – The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the assessment of the percentage of completion of long-term aftermarket contracts and the forecast cost profile of each arrangement. As long-term aftermarket contracts can extend over significant periods and the profitability of these arrangements typically assumes significant life-cycle cost improvement over the term of the contracts, the estimated outturn requires significant judgement to be applied in assessing engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred. The inherent nature of these estimates means that their continual refinement can have an impact on the profits of the Civil aerospace business that can be significant in an individual financial year. The assessment of the estimated outturn for each arrangement involves detailed calculations using large and complex databases with a significant level of manual intervention.

**Our response** – We tested the controls designed and applied by the Group to provide assurance that the estimates used in assessing revenue and cost profiles are appropriate and that the resulting estimated cumulative profit on such contracts is accurately reflected in the Financial Statements; these controls operated over both the inputs and the outputs of the calculations. We challenged the appropriateness of these estimates for each programme and assessed whether or not the estimates showed any evidence of conscious or unconscious management bias in the context of the heightened pressure on and incentives for management to meet the latest guidance discussed above. Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes, detailed assessments of the achievability of the Group's plans to reduce life-cycle costs and an analysis of the impact of these plans on forecast cost profiles taking account of contingencies and analysis of the impact of known technical issues on cost forecasts. Our analysis considered each significant airframe that is powered by the Group's engines and was based on our own experience supplemented by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuer was objective and suitably qualified. We also checked the mathematical accuracy of the revenue and profit for each arrangement and considered the implications of identified errors and changes in estimates.

**Our findings** – In 2013, our testing identified weaknesses in the design and operation of controls and we assessed the effectiveness of the Group's plans for addressing these weaknesses. In planning the 2014 audit, we anticipated that the control weaknesses identified in 2013 audit would be remediated. However, our testing identified continuing, albeit reduced, control weaknesses in some areas and so, as in 2013, we increased the scope and depth of our detailed testing and analysis from that originally planned. Overall, our assessment is that the assumptions and resulting estimates

# INDEPENDENT AUDITOR'S REPORT

CONTINUED

(including appropriate contingencies) resulted in mildly cautious (2013 audit finding: *mildly cautious*) profit recognition and we found no indication of conscious or unconscious bias.

## **Recoverability of intangible assets (certification costs and participation fees, development expenditure and contractual aftermarket rights) and amounts recoverable on contracts primarily in the Civil aerospace business**

Refer to page 103 (Key sources of estimation uncertainty – Forecasts and discount rates), pages 107 and 108 (Significant accounting policies – Certification costs and participation fees, Research and development, Contractual aftermarket rights and Impairment of non-current assets), page 122 (Note 9 to the Financial Statements – Intangible assets) and pages 69 to 71 (Audit Committee report – Financial reporting)

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

**Our response** – We tested the controls designed and applied by the Group to provide assurance that the assumptions used in preparing the impairment calculations are regularly updated, that changes are monitored, scrutinised and approved by appropriate personnel and that the final assumptions used in impairment testing have been appropriately approved. We challenged the appropriateness of the key assumptions in the impairment test (including market size, market share, pricing, engine and aftermarket unit costs, individual programme assumptions, price and cost escalation, discount rate and exchange rates) focusing particularly on those assets with a higher risk of impairment (those relating to the Trent 900 programme and launch customers on the Trent 900 and Trent 1000 programmes). Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, our understanding of the commercial prospects of key engine programmes, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes and customers and comparison of assumptions with publicly available data where this was available. We tested the mathematical accuracy of the impairment calculations. We considered whether the disclosures in note 9 to the Financial Statements describe the inherent degree of subjectivity in the estimates and the potential impact on future periods of revisions to these estimates.

**Our findings** – Our testing did not identify weaknesses in the design and operation of controls that would have required us to expand the nature or scope of our planned detailed test work. We found that the assumptions and resulting estimates were balanced (2013 audit finding: *balanced*) and that the disclosures were proportionate (2013 audit finding: *proportionate*). We found no errors in calculations (2013 audit finding: *none*).

## **Liabilities arising from sales financing arrangements**

Refer to page 103 (Key areas of judgement – Customer financing contingent liabilities), page 109 (Significant accounting policies – Sales financing support), pages 137 and 138 (Note 18 to the Financial Statements – Provisions for liabilities and charges) and pages 69 to 71 (Audit Committee report – Financial reporting)

**The risk** – The Group has contingent liabilities in respect of financing and asset value support provided to customers. This support typically takes the form of a guarantee with respect to the value of an aircraft at a future date, a commitment to buy used aircraft or a guarantee of a customer's future payments under an aircraft financing arrangement. Judgement is required to assess the likelihood of these liabilities crystallising, in order to assess whether a provision should be recognised and, if so, the amount of that provision. The total potential liability is significant and can be affected by the assessment of the residual value of the aircraft and the creditworthiness of the customers.

**Our response** – We analysed the terms of guarantees on aircraft delivered during the year in detail and obtained aircraft values from and held discussions with aircraft valuation specialists engaged by the Group. We assessed whether the valuer was objective and suitably qualified, had been appropriately instructed and had been provided with complete, accurate data on which to base its evaluation. For all contracts on delivered aircraft, we assessed the commercial factors relevant to the likelihood of the guarantees being called, including the credit ratings and recent financial performance of the relevant customers and their fleet plans, and critically assessed the Group's estimate of the required provisions for those liabilities. We considered movements in aircraft values and potential changes in the assessed probability of a liability crystallising since the previous year end and considered whether the evidence supported the Group's assessment as to whether or not a liability needs to be recognised and the amount of the liability recognised or contingent liability disclosed. We considered whether the related disclosure in note 18 to the Financial Statements appropriately explains the potential liability in excess of the amount provided for in the Financial Statements for delivered aircraft and highlights the significant but unquantifiable contingent liability in respect of aircraft which will be delivered in the future.

**Our findings** – We found that the assumptions and estimates were balanced (2013 audit finding: *balanced*) and that the disclosures were proportionate (2013 audit finding: *proportionate*).

### **Bribery and corruption**

Refer to page 147 (Note 23 to the Financial Statements – Contingent liabilities) and pages 69 to 71 (Audit Committee report – Financial reporting)

**The risk** – A large part of the Group's business is characterised by competition for individually significant contracts with customers, which are often directly or indirectly associated with governments, and the award of individually significant contracts to suppliers. The procurement processes associated with these activities are highly susceptible to the risk of corruption. In addition the Group operates in a number of territories where the use of commercial intermediaries is either required by the government or is normal practice. In December 2013, the Group announced that it had been informed by the Serious Fraud Office in the UK that it had commenced a formal investigation into bribery and corruption in overseas markets. The Group is cooperating with the Serious Fraud Office and other agencies, including the US Department of Justice. Breaches of laws and regulations in this area can lead to fines, penalties, criminal prosecution, commercial litigation and restrictions on future business.

**Our response** – We evaluated and tested the Group's policies, procedures and controls over the selection and renewal of intermediaries, contracting arrangements, ongoing management, payments and responses to suspected breaches of policy. We sought to identify and tested payments made to intermediaries during the year, made enquiries of appropriate personnel and evaluated the tone set by the Board and the Executive Leadership Team and the Group's approach to managing this risk. Having enquired of management, the Audit Committee and the Board as to whether the Group is in compliance with laws and regulations relating to bribery and corruption, we made written enquiries of the Group's legal advisers to corroborate the results of those enquiries and maintained a high level of vigilance to possible indications of significant non-compliance with laws and regulations relating to bribery and corruption whilst carrying out our other audit procedures. We discussed the areas of potential or suspected breaches of law, including the ongoing investigation, with the Audit Committee and the Board as well as the Group's legal advisers and assessed related documentation. We assessed whether the disclosure in note 23 to the Financial Statements of the Group's exposure to the financial effects of potential or suspected breaches of law or regulation complies with accounting standards and in particular whether it is the case that the investigation remains at too early a stage to assess the consequences (if any), including in particular the size of any possible fines.

**Our findings** – We found that disclosure to be proportionate (2013 audit finding: proportionate).

### **Presentation and explanation of results**

Refer to pages 32 to 41 (Business reviews), pages 28 to 31 (Financial Review), pages 112 and 113 (Note 2 to the Financial Statements – Segmental analysis) and pages 69 to 71 (Audit Committee report – Financial reporting)

#### ***The presentation of 'underlying profit'***

**The risk** – In addition to its Adopted IFRS Financial Statements, the Group presents an alternative income statement on an 'underlying' basis. The directors believe the 'underlying' income statement reflects better the Group's trading performance during the year. The basis of adjusting between the Adopted IFRS and 'underlying' income statements and a full reconciliation between them is set out in note 2 to the Financial Statements on pages 110 and 113. A significant recurring adjustment between the Adopted IFRS income statement and the 'underlying' income statement relates to the foreign exchange rates used to translate foreign currency transactions. The Group uses forward foreign exchange contracts to manage the cash flow exposures of forecast transactions denominated in foreign currencies but does not generally apply hedge accounting in its Adopted IFRS income statement. The 'underlying' income statement translates these amounts at the achieved foreign exchange rate on forward foreign exchange contracts settled in the period, retranslates assets and liabilities at exchange rates forecast to be achieved from future settlement of such contracts and excludes unrealised gains and losses on such contracts which are included in the Adopted IFRS income statement. The Group has discretion over which forward foreign exchange contracts are settled in each financial year, which could impact the achieved rate both for the period and in the future. In addition, adjustments are made to exclude one-off past-service costs on post-retirement schemes, restructuring activities that significantly change the shape of the Group's operations and the effect of acquisition accounting and a number of other items. Alternative performance measures can provide shareholders with appropriate additional information if properly used and presented. In such cases, measures such as these can assist shareholders in gaining a better understanding of a company's financial performance and strategy. However, when improperly used and presented, these kinds of measures might prevent the Annual Report being fair, balanced and understandable by hiding the real financial position and results or by making the profitability of the reporting entity seem more attractive.

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

# INDEPENDENT AUDITOR'S REPORT

CONTINUED

**Our findings** – We found no concerns regarding the basis of the ‘underlying’ financial information or its calculation and no indication of management bias in the settlement of forward foreign exchange contracts. We consider that there is proportionate disclosure of the nature and amounts of the adjustments to allow shareholders to understand the implications of the two bases on the financial measures being presented (*2013 audit finding: proportionate*). We found the overall presentation of the ‘underlying’ financial information to be balanced (*2013 audit finding: balanced*).

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

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

**Our response** – We sought to identify items that affect profit (and the trend in profit) which are uneven in frequency or amount at a much lower level than we would otherwise have done and to assess the transparency of disclosure of these items.

**Our findings** – We identified a number of significant items that had affected profit for the year or the prior year that required appropriate disclosure in the Annual Report to enable shareholders to assess the Group’s performance. We found that proportionate disclosure of these items had been provided in the Annual Report and Financial Statements taken as a whole.

In reaching our audit opinion on the Financial Statements we took into account the findings that we describe above and those for other, lower risk areas. Overall the findings from across the whole audit are that the Financial Statements have been prepared on the basis of appropriate accounting policies, use mildly cautious estimates, which are consistent when comparing this year to last, and provide proportionate disclosure. Having assessed these findings and evaluated uncorrected misstatements in the context of materiality and considered the qualitative aspects of the Financial Statements as a whole we have not modified our opinion on the Financial Statements.

**3 OUR APPLICATION OF MATERIALITY AND AN OVERVIEW OF THE SCOPE OF OUR AUDIT**

The materiality for the Group Financial Statements as a whole was set at £70 million (*2013: £86 million*), determined with reference to a benchmark of Group profit before taxation, normalised to exclude the volatility in reported profit due to gains and losses on revaluation of foreign currency and other derivative financial instruments which could otherwise result in an inappropriate materiality level being calculated. This materiality measure represents 4.6% of this benchmark and 34.3% of total reported profit before tax. We carry out full audit procedures to assess the accuracy of the gains and losses on these derivative financial instruments (which this year amounted to a £1.3 billion loss) as part of our audit of the Group’s treasury operations.

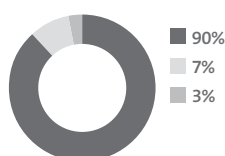
We report to the Audit Committee: (i) all material corrected identified misstatements; (ii) uncorrected identified misstatements exceeding £4 million for income statement items; and (iii) other identified misstatements that warranted reporting on qualitative grounds.

We subjected 33 of the Group’s reporting components to audits for group reporting purposes and 14 to specified risk-focused audit procedures. The latter were not individually financially significant enough to require an audit for group reporting purposes, but did present specific individual risks that needed to be addressed. This work also provided further audit coverage. The remaining reporting units were subject to analytical procedures by the Group audit team.

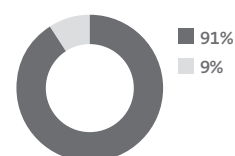
The Group operates shared service centres in Derby (UK) and Indianapolis (US), the outputs of which are included in the financial information of the reporting components they service and therefore they are not separate reporting components. Each of the service centres is subject to specified risk-focused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

**Summary audit scope**

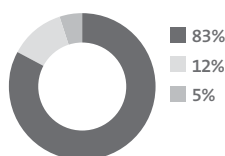
**REVENUE**



**UNDERLYING PROFIT BEFORE TAX**



**TOTAL ASSETS**



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

The Group audit team instructed component auditors, and the auditors of the shared service centres, as to the significant areas to be covered, including the relevant risks detailed above and the information to be reported back. The Group audit team approved the component materialities, which ranged from £0.3 million to £60 million, having regard to the mix of size and risk profile of the Group across the components. The work on 29 of the 47 components was performed by component auditors and the rest by the Group audit team. The Group audit team visited 25 component locations in the UK, the US, Germany and Norway, the purpose of which included an assessment of the audit risk and strategy. Telephone conference meetings were also held with these component auditors and with those of the higher risk components that were not physically visited. At these visits and meetings, the findings reported to the Group audit team were discussed in more detail, and any further work required by the Group audit team was then performed by the component auditor.



#### 4 OUR OPINION ON OTHER MATTERS PRESCRIBED BY THE COMPANIES ACT 2006 IS UNMODIFIED

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Strategic Report and Directors' Report for the financial year for which the Financial Statements are prepared is consistent with the Financial Statements.

#### 5 WE HAVE NOTHING TO REPORT IN RESPECT OF THE MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

Under ISA (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the Annual Report that contains a material inconsistency with either that knowledge or the Financial Statements, a material misstatement of fact, or that is otherwise misleading. In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the Annual Report and Financial Statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy; or
- the Audit Committee report does not appropriately address matters communicated by us to the Audit Committee.

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

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

Under the Listing Rules we are required to review:

- the directors' statement, set out on page 164, in relation to going concern; and
- the part of the corporate governance report on page 59 relating to the Company's compliance with the ten provisions of the UK Corporate Governance Code 2012 specified for our review.

We have nothing to report in respect of the above responsibilities.

#### Scope of report and responsibilities

As explained more fully in the directors' responsibilities statement set out on page 93, the directors are responsible for the preparation of the Financial Statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of Financial Statements is provided on the Financial Reporting Council's website at [www.frc.org.uk/auditscopeukprivate](http://www.frc.org.uk/auditscopeukprivate). This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at [www.kpmg.com/uk/auditscopeukco2014b](http://www.kpmg.com/uk/auditscopeukco2014b), which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

**JIMMY DABOO (SENIOR STATUTORY AUDITOR)**  
for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants  
15 Canada Square  
London E14 5GL  
12 February 2015

## ADDITIONAL FINANCIAL INFORMATION

### FOREIGN EXCHANGE

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

		2014	2013	Change
USD per GBP	Year end spot rate	1.56	1.65	-5%
	Average spot rate	1.65	1.56	+6%
EUR per GBP	Year end spot rate	1.28	1.20	+7%
	Average spot rate	1.24	1.18	+5%

### THE GROUP'S APPROACH TO MANAGING ITS TAX AFFAIRS

The Board is involved in setting the Group's tax policies which govern the way its tax affairs are managed. In summary, this means:

- i) the Group manages its tax costs through maximising the tax efficiency of business transactions. This includes taking advantage of available tax incentives and exemptions;
- ii) this must be done in a way which is aligned with the Group's commercial objectives and meets its legal obligations and ethical standards;
- iii) the Group also has regard for the intention of the legislation concerned rather than just the wording itself;
- iv) the Group is committed to building constructive working relationships with tax authorities based on a policy of full disclosure in order to remove uncertainty in its business transactions and to allow the authorities to review possible risks;
- v) where appropriate and possible, the Group enters into consultation with tax authorities to help shape proposed legislation and future tax policy; and
- vi) the Group seeks to price transactions between Group companies as if they were between unrelated parties, in compliance with the OECD Transfer Pricing Guidelines and the laws of the relevant jurisdictions.

### THE GROUP'S GLOBAL CORPORATE INCOME TAX CONTRIBUTION

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

In common with most multinational groups, the total of all profits in respect of which corporate tax is paid is not the same as the consolidated profit before tax reported on page 95. The main reasons for this are:

- i) the consolidated income statement is prepared under Adopted IFRS whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;

- ii) accounting rules require certain income and costs relating to our commercial activities to be eliminated from, or added to, the aggregate of all the profits of the Group companies when preparing the consolidated income statement ('consolidation adjustments'); and
- iii) specific tax rules including exemptions or incentives as determined by the tax laws in each country.

The Group's total corporation tax payments in 2014 were £276 million. The level of tax paid in each country is impacted by the above. In most cases, (i) and (ii) are only a matter of timing and therefore tax will be paid in an earlier or later year. As a result they only have a negligible impact on the Group's underlying tax rate which, excluding joint ventures, would be 25.5% (the underlying tax rate including joint ventures can be found on page 29). This is due to deferred tax accounting, details of which can be found in note 5 to the Financial Statements. The impact of (iii) will often be permanent depending on the relevant tax law.

### 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 require Board approval.

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

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

### FINANCIAL RISK MANAGEMENT

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

**CAPITAL STRUCTURE**

£ million	2014	2013
Total equity	6,387	6,303
Cash flow hedges	81	68
Group capital	6,468	6,371
Net funds	666	1,939

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 repaid a £200 million EIB loan.

At year end, the Group retained aggregate liquidity of £4.1 billion. This liquidity included net funds of £666 million and aggregate borrowing facilities of £3.5 billion, of which £1.3 billion remained undrawn.

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. The only facility to mature in 2015 is a US\$83 million note. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating.

The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This debt is further outlined in note 11.

**CREDIT RATING**

	Rating	Outlook	Grade
Moody's Investors Service	A3	Stable	Investment
Standard & Poor's	A	Stable	Investment

The Group subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings. At 31 December 2014, the Group maintained investment grade ratings from both agencies.

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

**ACCOUNTING**

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

With effect from 1 January 2014, the Group has adopted IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*. The impact of these and other changes to IFRS which have not been adopted in 2014 is included within the accounting policies in note 1.

**SHARE PRICE**

During the year, the share price decreased by 32% from 1275 pence to 870 pence, compared to a 12% decrease in the FTSE aerospace and defence sector and 3% decrease in the FTSE 100. The Company's share price ranged from 1289 pence in January to 779.5 pence in October.

## OTHER STATUTORY INFORMATION

### SHARE CAPITAL

On 31 December 2014, 1,882,517,856 ordinary shares of 20 pence each, 22,005,007,762 C Shares of 0.1 pence each and one Special Share of £1 were in issue. The ordinary shares are listed on the London Stock Exchange.

### PAYMENT TO SHAREHOLDERS

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

Shareholders can choose to:

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

The CRIP is operated by Computershare Investor Services PLC (the Registrar). The Registrar will purchase ordinary shares in the market for shareholders electing to reinvest their C Share proceeds. Shareholders wishing to participate in the CRIP or redeem their C Shares must ensure that their instructions are lodged with the Registrar no later than 5.00pm on 1 June 2015. Redemption will take place on 3 July 2015.

At the AGM, the directors will recommend an issue of 141 C Shares with a total nominal value of 14.1 pence for each ordinary share. The C Shares will be issued on 1 July 2015 to shareholders on the register on 24 April 2015 and the final day of trading with entitlement to C Shares is 23 April 2015. Together with the interim issue on 2 January 2015 of 90 C Shares for each ordinary share with a total nominal value of 9.0 pence, this is the equivalent of a total annual payment to ordinary shareholders of 23.1 pence for each ordinary share.

Further information for shareholders is on page 166.

### SHARE CLASS RIGHTS

The full share class rights are set out in the Company's Articles of Association (Articles), which are available on the Group's website, and 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; to appoint one or more proxies or, if they are corporations, corporate representatives; and to 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 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, or on the acquisition or capital restructuring of the Company.

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

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

### SPECIAL SHARE

Certain rights attach to the special rights non-voting share (Special Share) issued to HM Government (Special Shareholder). Subject to the provisions of the Companies Act 2006, the Treasury Solicitor may redeem the Special Share at par at any time. The Special Share confers no rights to dividends but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

Certain Articles (in particular those relating to the foreign shareholding limit, disposals and the nationality of 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 United Kingdom 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 such holding. The Special Share may only be issued to, held by and transferred to the Special Shareholder or his successor or nominee.

### SHAREHOLDER AGREEMENTS AND CONSENT REQUIREMENTS

There are no known arrangements under which financial rights carried by any of the shares in the Company are held by a person other than the holder of the shares and no known agreements between the holders of shares with restrictions on the transfer of shares or exercise of voting rights. 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 business or the assets of the Group as a whole, without consent of the Special Shareholder.

## AUTHORITY TO ISSUE SHARES

At the AGM in 2014, authority was given to the directors to allot new ordinary shares up to a nominal value of £125,353,891 equivalent to one-third of the issued share capital of the Company.

In addition, a special resolution was passed to effect a disapplication of pre-emption rights for a maximum of 5% of the issued share capital of the Company. These authorities are valid until the AGM in 2015, and the directors propose to renew these authorities at that AGM. It is proposed to seek a further authority, at the AGM in 2015 to allot up to two thirds of the total issued share capital, but only in the case of a rights issue.

The Board believes that this additional authority will allow the Company to retain the maximum possible flexibility to respond to circumstances and opportunities as they arise; and to allot new C Shares up to a nominal value of £500 million as an alternative to a cash dividend. Such authority expires at the conclusion of the AGM in 2015. The directors propose to renew the authority to allot new C Shares at the AGM in 2015.

## AUTHORITY TO PURCHASE OWN SHARES

At the AGM in 2014, the Company was authorised by shareholders to purchase up to 188,030,836 of its own ordinary shares representing 10% of its issued ordinary share capital.

The Company announced on 19 June 2014 that, as there were no material acquisitions planned, and reflecting the strength of the balance sheet, the Company would return the proceeds of the sale of the Energy gas turbines and compressor business to shareholders by way of a £1 billion share buyback. The buyback commenced on 10 December 2014.

As at 31 December 2014, 8,215,000 ordinary shares of 20p each had been purchased at a total aggregate consideration of £68.96 million representing 0.44% of the called-up share capital. The purchased shares have been cancelled.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2015 or 18 months from 1 May 2014, whichever is the earlier. A resolution to renew it will be proposed at that meeting.

## VOTING RIGHTS

### DEADLINES FOR EXERCISING VOTING RIGHTS

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

### VOTING RIGHTS FOR EMPLOYEE SHARE PLAN SHARES

Shares are held in various employee benefit trusts for the purpose of satisfying awards made under the various employee share plans. For shares held in a nominee capacity or if plan/trust rules provide the participant with the right to vote in respect of specifically allocated shares, the trustee votes in line with the participants' instructions. For shares that are not held absolutely on behalf of

specific individuals, the general policy of the trustees, in accordance with investor protection guidelines, is to abstain from voting in respect of those shares.

## CHANGE OF CONTROL

### CONTRACTS AND JOINT VENTURE AGREEMENTS

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

### BORROWINGS AND OTHER FINANCIAL INSTRUMENTS

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At 31 December 2014 these facilities were less than 24% drawn (2013 35%).

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

### EMPLOYEE SHARE PLANS

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

- PSP – awards would vest pro rata to service in the performance period, subject to Remuneration Committee judgement of Group performance;
- APRA deferred shares – the shares would be released from trust immediately;
- ShareSave – options would become exercisable immediately. The new company might offer an equivalent option in exchange for cancellation of the existing option; and
- 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.

## MAJOR SHAREHOLDINGS

At 12 February 2015, the following companies had notified an interest in the issued ordinary share capital of the Company in accordance with the Financial Services Authority's Disclosure and Transparency Rules:

Company	Date notified	% of issued ordinary share capital
Invesco Limited	7 July 2014	4.99
Harbor International Fund	22 October 2014	4.02
The Capital Group Companies, Inc.	30 October 2014	4.99
Aberdeen Asset Managers Limited	7 November 2014	5.16

# OTHER STATUTORY INFORMATION

CONTINUED

## DIRECTORS

The names of the directors who held office during the year are set out on pages 54 and 55, with the exception of Iain Conn who retired on 1 May 2014, and Mark Morris who left the Company on 4 November 2014.

## DISCLOSURES IN THE STRATEGIC REPORT

The Board has taken advantage of Section 414C(11) of the Companies Act 2006 to include disclosures in the Strategic Report:

	page(s)
• disabled people and employee involvement	44
• the future development, performance and position of the Group	1 to 53
• the financial position of the Group	26 to 31
• R&D activities	20 and 21
• the principal risks and uncertainties	50 to 53

## GOING CONCERN

As described on page 161, the Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds and notes. At 31 December 2014, the Group had borrowing facilities of £3.5 billion and total liquidity of £4.1 billion, including: cash and cash equivalents of £2.9 billion and undrawn facilities of £1.3 billion. £67 million of the facilities mature in 2015.

The Group's forecasts and projections, taking into account reasonably possible changes in trading performance, show that the Group has sufficient financial resources. The directors have reasonable expectation that the Company and the Group are well placed to manage their business risks and to continue in operational existence for the foreseeable future, despite the current uncertain global economic outlook.

Accordingly, the directors continue to adopt the going concern basis (in accordance with the guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' issued by the FRC) in preparing the consolidated financial statements.

## POLITICAL DONATIONS

The Group's policy is not to make political donations and therefore did not donate any money to any political party during the year.

However, it is possible that certain activities undertaken by the Group may unintentionally fall within the broad scope of the provisions contained in the Companies Act 2006 (the Act). The resolution to be proposed at the AGM 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 (RRNAPAC) was US\$52,690 (2013: US\$69,430). 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 Company cannot affect how they are applied, although under US Law, the business expenses are paid by the Company. Such contributions do not require authorisation by shareholders under the Companies Act 2006 and therefore 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 2014 AGM.

## GREENHOUSE GAS EMISSIONS

Our greenhouse gas emissions reporting excludes data from our Power Systems business for 2013 and 2014, as detailed on page 46.

In 2014, our total greenhouse gas (GHG) emissions from our facilities, processes, and product test and development was 565 kilotonnes carbon dioxide equivalent (ktCO<sub>2</sub>e). This represents an increase of 2% compared with 554 ktCO<sub>2</sub>e in 2013 (see table below).

Total GHG emissions (ktCO <sub>2</sub> e)	2010	2011	2012	2013	2014*
Direct emissions – facilities, processes, product test and development (Scope 1)	221	218	219	241	231
Indirect emissions – facilities, processes, product test and development (Scope 2)	349	327	313	313	334
<b>Total for facilities, processes, product test and development</b>	<b>570</b>	<b>545</b>	<b>532</b>	<b>554</b>	<b>565</b>
Direct emissions – power generation to grid (Scope 1)				153	155
Indirect emissions – power generation to grid (Scope 2)				12	14
<b>Total for facilities, processes, product test and development, and power generation to grid</b>				<b>719</b>	<b>734</b>
<b>Normalised (by revenue) emissions ration for facilities, processes, product test and development (ktCO<sub>2</sub>e/£m)</b>	<b>0.058</b>	<b>0.056</b>	<b>0.049</b>	<b>0.048</b>	<b>0.047</b>

\* We engaged KPMG LLP to undertake a limited assurance engagement, reporting to Rolls-Royce Holdings plc, using the assurance standards ISAE 3000 and ISAE 3410 over the GHG and TRI data that have been highlighted in this report with  and as set out on page 46 and in the table above. Their full statement, as well as our methodology for reporting and the criteria used as set out in our Basis of Reporting document, is available on our website at [www.rolls-royce.com/sustainability](http://www.rolls-royce.com/sustainability). The level of assurance provided for a limited assurance engagement is substantially lower than a reasonable assurance agreement. In order to reach their opinion they performed a range of procedures over the GHG and TRI data including: evaluating the work performed and conclusions reached by the Rolls-Royce Internal Audit team; agreeing a selection of the data to the corresponding source documentation; and reviewing the data collation and validation processes at the head office level, including formulae used and manual calculations performed. A summary of the work they performed is included within their assurance opinion. Non-financial performance information, greenhouse gas quantification in particular, is subject to more inherent limitations than financial information. It is important to read the energy, GHG and TRI data in the context of the full limited assurance statement provided by KPMG LLP and the reporting criteria as set out in the Rolls-Royce Basis of Reporting document.

The figures in the table do not include emissions associated with our Power Systems business. We are in the process of integrating our Power Systems business into our HS&E management system. The figures presented have been adjusted to reflect the disposal of our Energy gas turbines and compressor business in December 2014.

Entities that were part of the Energy business that were not part of the disposal have been included.

Power generation relates to the operation of commercial gas-fired power stations and the figures have been adjusted to include emissions associated with Trigno Energy S.r.l.

We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) as of 31 December 2014 data gathered to fulfil our requirements under the Carbon Reduction Commitment (CRC) Energy Efficiency scheme, the UK Government's GHG reporting guidance and Department for Environment, Food & Rural Affairs' (Defra) emissions factors for company reporting for 2014 as the basis of our methodology.

Through our active participation in the International Aerospace Environment Group we have helped to introduce new guidance on greenhouse gas emissions reporting in June to enable consistent communications and reporting for aerospace industry companies. The Guidance is a voluntary consensus standard designed to supplement the World Resources Institute's (WRI) GHG Protocol. It earned the WRI 'Built on GHG Protocol' mark after public comment consultation.

#### **BRANCHES**

We are a global company and our activities and interests are operated through subsidiaries, branches of subsidiaries, joint ventures and associates which are subject to the laws and regulations of many different jurisdictions. Our principal subsidiaries and joint ventures are listed on page 152 and 153.

#### **POST BALANCE SHEET EVENTS**

There have been no events affecting the Group since 31 December 2014 which need to be reflected in the 2014 Financial Statements.

#### **FINANCIAL INSTRUMENTS**

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

#### **RELATED PARTY TRANSACTIONS**

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

#### **INFORMATION REQUIRED BY UK LISTING RULE 9.8.4**

There are no disclosures to be made under the above listing rule.

#### **MANAGEMENT REPORT**

The Strategic Report and the Directors' Report together are the management report for the purposes of the Disclosure and Transparency Rules 4.1.8R.

#### **DISCLOSURE OF INFORMATION TO AUDITORS**

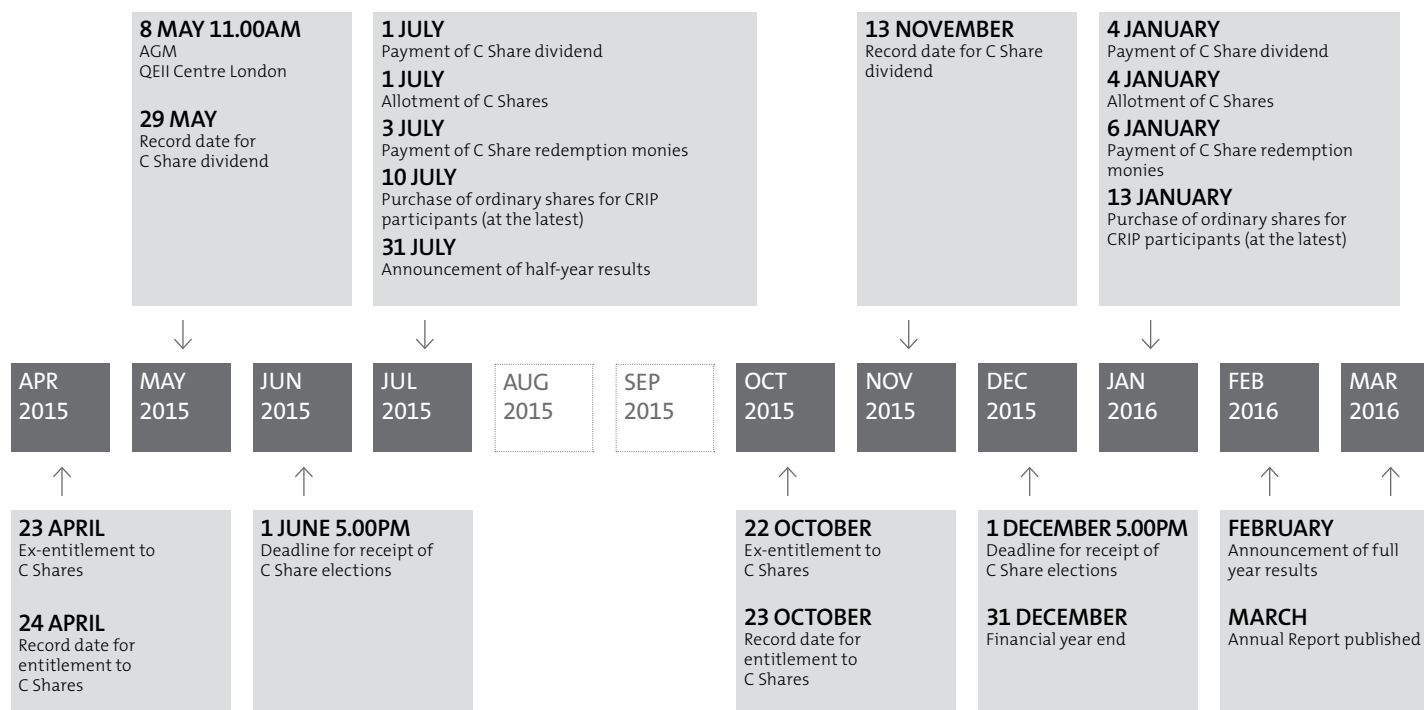
Each of the persons who is a director at the date of approval of this report confirms that:

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

This confirmation is given, and should be interpreted, in accordance with the provisions of Section 418 of the Companies Act 2006.

# SHAREHOLDER INFORMATION

## FINANCIAL CALENDAR 2015-2016



### 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), an 11-digit number that can be found on the right-hand side of your share certificate or in any other shareholder correspondence. It is very important that you keep your shareholding account details up to date by notifying the Registrar of any changes in your circumstances.

You can manage your shareholding at [www.investorcentre.co.uk](http://www.investorcentre.co.uk), speak to the Registrar on +44 (0)870 703 0162 (8.30am to 5.30pm Monday to Friday) or you can write to them at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8AE.

### PAYMENTS TO SHAREHOLDERS

The Company makes payments to shareholders by issuing redeemable C Shares of 0.1 pence each. You can still receive cash or additional ordinary shares from the Company 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 in the post and means that cleared payments will be credited to your bank account on the payment date.

### SHARE DEALING

The Registrar offers existing shareholders an internet dealing service at [www-uk.computershare.com/investor/sharedealing.asp](http://www-uk.computershare.com/investor/sharedealing.asp) and a telephone dealing service (+44 (0)870 703 0084). The service is available during market hours, 8.00am to 4.30pm, Monday to Friday excluding bank holidays. 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 plus £35. Please note that, in addition to dealing fees, stamp duty of 0.5% is payable on all purchases. Other share dealing facilities are available but you should always use a firm regulated by the Financial Conduct Authority (FCA). You can check the FCA register at [www.fca.org.uk/register](http://www.fca.org.uk/register).

### YOUR SHARE CERTIFICATE

If you sell or transfer your shares you must ensure 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 will be liable for any costs incurred by the broker. Share certificates previously issued by either Rolls-Royce Group plc or Rolls-Royce plc are invalid and should be destroyed. If you are unable to locate your share certificates please inform the Registrar immediately.

### AMERICAN DEPOSITARY RECEIPTS (ADR)

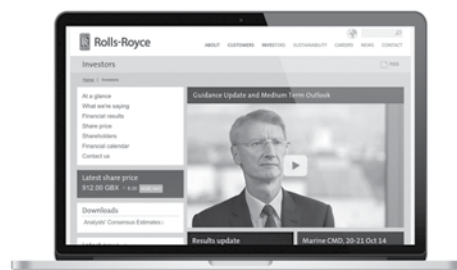
ADR holders should contact the depository, The Bank of New York Mellon by calling +1 888 269 2377 (toll free within the US) or emailing [shrrelations@cpushareownerservices.com](mailto:shrrelations@cpushareownerservices.com).



**WARNING TO SHAREHOLDERS – BOILER ROOM FRAUD**

We are aware that some shareholders might have received unsolicited phone calls or correspondence concerning investment matters. These are typically from overseas based 'brokers' who offer to sell them what often turn out to be worthless or high risk shares in US or UK investments. Such operations are known as 'boiler rooms' and these 'brokers' can be very persistent and extremely persuasive. You should always check that any firm calling you about investment opportunities is properly authorised by the FCA by checking their register at [www.fca.org.uk/register](http://www.fca.org.uk/register). If you need to contact the FCA urgently you should call their Consumer Helpline on 0800 111 6768 (overseas callers dial +44 20 7066 1000). If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme. You will find lots of useful advice and information about protecting yourself from investment scams on the FCA website [www.fca.org.uk/consumers](http://www.fca.org.uk/consumers).

Remember the golden rule – if it sounds too good to be true it probably is.



Available as a free download from the app store

**VISIT ROLLS-ROYCE ONLINE**

Visit [www.rolls-royce.com/investors](http://www.rolls-royce.com/investors) to find out more about the latest financial results, the share price, payments to shareholders, the financial calendar and shareholder services.

**KEEPING UP TO DATE**

You can sign up to receive the latest news to your phone or inbox. You can also download the Rolls-Royce Investor Relations app which provides the latest media and financial information.

**DIVIDENDS PAID ON C SHARES HELD**

C Share calculation period	C Share dividend rate (%)	Record date for C Share dividend	Payment date
1 July 2014 – 31 December 2014	0.263	14 November 2014	2 January 2015
1 January 2014 – 30 June 2014	0.233	2 June 2014	1 July 2014

**PREVIOUS C SHARE ISSUES**

Issue date	No. of C Shares issued per ordinary share	Record date for entitlement to C Shares	Latest date for receipt of Payment Instruction Forms by Registrar	Apportionment values		CGT apportionment		Date of redemption of C Shares	CRIP purchase date	CRIP purchase price (p)
				Price of ordinary shares on first day of trading (p)	Value of C Share issues per ordinary shares (p)	Ordinary shares (%)	C Shares (%)			
2 January 2015	90	24 October 2014	1 December 2014	864.250	9.0	98.97	1.03	6 January 2015	9 January 2015	863.372
2 July 2014	134	25 April 2014	2 June 2014	1066.685	13.4	98.76	1.24	3 July 2014	9 July 2014	1058.380

For earlier C Share issues, please refer to the Group's website.

**ANALYSIS OF ORDINARY SHAREHOLDERS AT 31 DECEMBER 2014**

Type of holder:	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	194,995	95.66	97,855,322	5.20
Institutional and other investors	8,857	4.34	1,784,695,534	94.80
<b>Total</b>	<b>203,852</b>	<b>100.00</b>	<b>1,882,517,856</b>	<b>100.00</b>
Size of holding:				
1 – 150	64,561	31.67	6,116,140	0.32
151 – 500	101,779	49.93	27,532,323	1.46
501 – 10,000	35,567	17.45	57,568,059	3.06
10,001 – 100,000	1,290	0.63	35,524,258	1.89
100,001 – 1,000,000	439	0.21	152,132,412	8.08
1,000,001 and over	216	0.11	1,603,644,664	85.19
<b>Total</b>	<b>203,852</b>	<b>100.00</b>	<b>1,882,517,856</b>	<b>100.00</b>

# GLOSSARY

<b>ABC</b>	anti-bribery and corruption	<b>IFRIC</b>	International Financial Reporting Interpretations Committee
<b>AGM</b>	Annual General Meeting	<b>IFRS</b>	International Financial Reporting Standards
<b>ANA</b>	All Nippon Airways	<b>KPIs</b>	key performance indicators
<b>APRA</b>	Annual Performance Related Award plan	<b>ktCO<sub>2</sub>e</b>	kilotonnes carbon dioxide equivalent
<b>Articles</b>	Articles of Association of Rolls-Royce Holdings plc	<b>LIBOR</b>	London Inter-Bank Offered Rate
<b>C Shares</b>	non-cumulative redeemable preference shares	<b>LTSA</b>	long-term service agreement
<b>C&amp;A</b>	commercial and administrative	<b>LNG</b>	liquefied natural gas
<b>CARs</b>	contractual aftermarket rights	<b>NCI</b>	non-controlling interest
<b>CEO</b>	chief executive officer	<b>NO<sub>x</sub></b>	nitrogen oxides
<b>CFO</b>	chief financial officer	<b>OCI</b>	other comprehensive income
<b>CGU</b>	cash-generating unit	<b>OE</b>	original equipment
<b>CO<sub>2</sub></b>	carbon dioxide	<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>Company</b>	Rolls-Royce Holdings plc	<b>PBT</b>	profit before tax
<b>CPS</b>	cash flow per share	<b>PSP</b>	Performance Share Plan
<b>CRIP</b>	C Share Reinvestment Plan	<b>R&amp;D</b>	research and development
<b>ELT</b>	Executive Leadership Team	<b>REACH</b>	Registration, Evaluation Authorisation and restriction of CHemicals
<b>EPS</b>	earnings per ordinary share	<b>Registrar</b>	Computershare Investor Services PLC
<b>EU</b>	European Union	<b>RRPS</b>	Rolls-Royce Power Systems AG
<b>EUR</b>	euro	<b>RRSAs</b>	risk and revenue sharing arrangements
<b>FRC</b>	Financial Reporting Council	<b>SFO</b>	Serious Fraud Office
<b>FX</b>	foreign exchange	<b>SIP</b>	Share Incentive Plan
<b>GBP</b>	Great British pound or pound sterling	<b>SO<sub>x</sub></b>	sulphur oxides
<b>GHG</b>	greenhouse gas	<b>STEM</b>	science, technology, engineering and mathematics
<b>Global Code</b>	Global Code of Conduct	<b>TCA</b>	TotalCare agreement
<b>Group</b>	Rolls-Royce Holdings plc and its subsidiaries	<b>TRI</b>	total reportable injuries
<b>HMRC</b>	HM Revenue & Customs	<b>TSR</b>	total shareholder return
<b>HS&amp;E</b>	health, safety and environment	<b>UAV</b>	unmanned aerial vehicle
<b>I&amp;C</b>	instrumentation and control	<b>USD/US\$</b>	United States dollar
<b>IAB</b>	International Advisory Board	<b>UTCs</b>	University Technology Centres
<b>IAS</b>	International Accounting Standards		



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