



ANNUAL REPORT 2020

ROLLS-ROYCE HOLDINGS PLC





OUR PURPOSE

We pioneer the power that matters to connect, power and protect society.

OUR CHALLENGE

We will restore our financial performance, drive growth and position ourselves to benefit from new technologies, with a focus on sustainable power driven by our science-led innovation.

OUR COMMITMENT

Our technology will play a fundamental role in enabling the transition to a low carbon global economy. We have pledged to achieve net zero carbon in our operations by 2030 and we will play a crucial role in enabling the sectors in which we operate reach net zero carbon by 2050.

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WWW.ROLLS-ROYCE.COM

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Use of underlying performance measures in the Annual Report

All figures in the narrative of the Strategic Report are underlying unless otherwise stated. We believe this is the most appropriate basis to measure our in-year performance as underlying results reflect the substance of trading activity, including the impact of the Group's foreign exchange forward contracts, which lock in transactions at predetermined exchange rates. In addition, underlying results exclude the accounting impact of business acquisitions and disposals, impairment charges and exceptional items. A full definition of underlying and the reconciliation to the reported figures are in note 2 of the Consolidated Financial Statements on page 126. All references to organic change are at constant translational currency and exclude M&A.

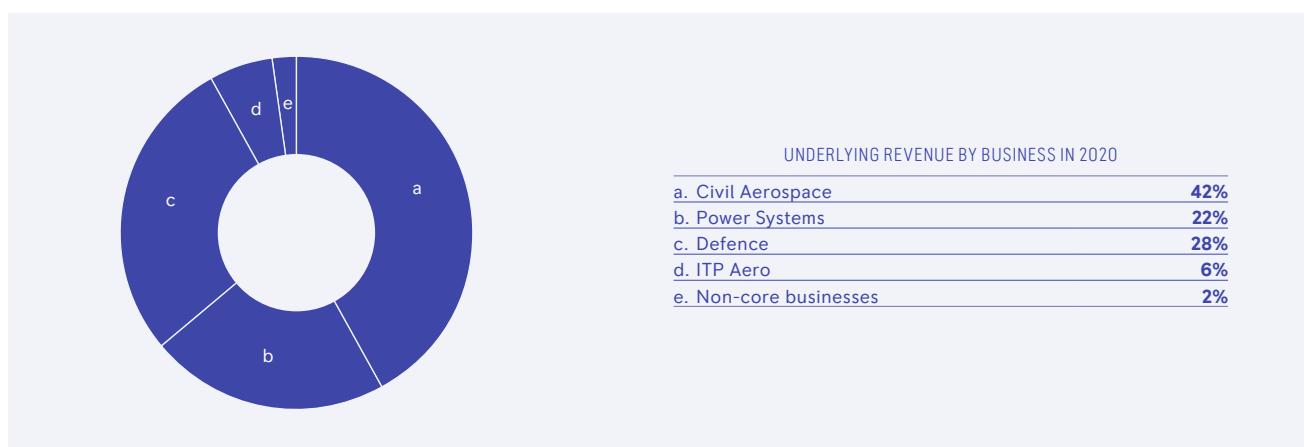
Forward-looking statements

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. This report is intended to provide information to shareholders, and 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. 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.

PIONEERS OF POWER

Rolls-Royce pioneers cutting-edge technologies that deliver clean, safe and competitive solutions to meet our planet's vital power needs. Our purpose is to pioneer the power that matters to connect, power and protect society.

FREE CASH FLOW ¹	REPORTED CASH FLOW ²	UNDERLYING REVENUE	REPORTED REVENUE
£(4,185)m 2019: £873m	£(995)m 2019: £(413)m	£11,763m 2019: £15,450m	£11,824m 2019: £16,587m
UNDERLYING OPERATING (LOSS)/PROFIT	REPORTED OPERATING (LOSS)	UNDERLYING (LOSS)/PROFIT BEFORE TAX	REPORTED (LOSS) BEFORE TAX
£(1,972)m 2019: £808m	£(2,081)m 2019: £(852)m	£(3,958)m 2019: £583m	£(2,910)m 2019: £(891)m
UNDERLYING EARNINGS PER SHARE ³	REPORTED EARNINGS PER SHARE ³	NET FUNDS ⁴	LIQUIDITY ⁵
(66.78)p 2019: 5.44p	(52.95)p 2019: (23.70)p	£(1,533)m 2019: £1,361m	£9.0bn 2019: £6.9bn



ORDER BACKLOG	GROSS R&D EXPENDITURE ⁶	COUNTRIES WITH ROLLS-ROYCE PRESENCE	EMPLOYEES (MONTHLY AVERAGE)
£53.7bn	£1.25bn	45	48,200

¹ Free cash flow is defined in note 29 on page 176.

² In 2020, reported cash flow includes £2bn cash from the rights issue in the year and £1.6bn from changes in borrowings and lease liabilities. A full reconciliation from free cash flow to reported cash flow is included on page 176.

³ 2019 EPS figures restated to reflect bonus element of rights issue, see note 6 on page 137.

⁴ Net funds (excluding lease liabilities) is defined on page 110.

⁵ Liquidity is defined as net funds plus any undrawn facilities, as listed on page 54.

⁶ See note 3 on page 132 for a reconciliation of gross R&D expenditure to total R&D expenditure.

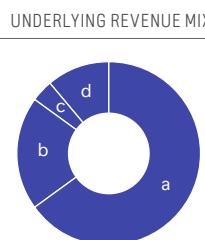
 See note 2 on page 126 for a reconciliation between underlying and reported results.

GROUP AT A GLANCE

CORE BUSINESSES IN 2020

CIVIL AEROSPACE

Civil Aerospace is a major manufacturer of aero engines for the large commercial aircraft, regional jet and business aviation markets. The business uses engineering expertise, in-depth knowledge and capabilities to provide through-life support solutions for its customers.



a. Large Engines	65%
b. Business Aviation	20%
c. Regional	4%
d. V2500	11%

UNDERLYING REVENUE

£5,089m

2019: £8,107m

UNDERLYING OPERATING (LOSS)/PROFIT

£(2,574)m

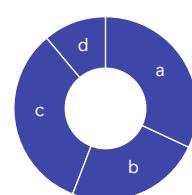
2019: £44m



See page 25

POWER SYSTEMS

Power Systems is a leading provider of high-speed reciprocating engines, and complete propulsion and power generation systems. It serves the marine, defence, power generation and industrial markets.



a. Marine	32%
b. Industrial	24%
c. Power Generation	33%
d. Defence	11%

UNDERLYING REVENUE

£2,745m

2019: £3,184m

UNDERLYING OPERATING PROFIT

£178m

2019: £367m

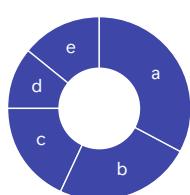


See page 28

2019 figures restated to exclude Civil Nuclear Instrumentation & Control and Bergen Engines

DEFENCE

Defence is a market leader in aero engines for military transport and patrol aircraft with strong positions in combat and helicopter applications. It has significant scale in naval and provides through-life support of the nuclear power plant for the Royal Navy's submarine fleet.



a. Transport	33%
b. Combat	24%
c. Submarines	18%
d. Naval	11%
e. Other	14%

UNDERLYING REVENUE

£3,366m

2019: £3,250m

UNDERLYING OPERATING PROFIT

£448m

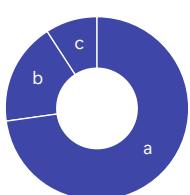
2019: £415m



See page 30

ITP AERO

ITP Aero is a global leader in aero-engine subsystem design. Alongside the development, manufacturing, assembly and testing of engine components, it provides MRO services for regional airlines, business aviation, industrial and defence applications.



a. Civil	73%
b. Defence	18%
c. In-Service Support	9%

UNDERLYING REVENUE

£705m

2019: £936m

UNDERLYING OPERATING PROFIT

£68m

2019: £111m



See page 32

A CHALLENGING YEAR

The impact of the COVID-19 pandemic on Rolls-Royce has been stark and driven decisive and transformative action. The steps we have taken in 2020 will provide the Group with improved financial resilience in order to weather macroeconomic risks before we return to strong cash generation.



SIR IAN DAVIS, CHAIRMAN

The impact of the COVID-19 pandemic on Rolls-Royce has been stark and we have taken decisive and transformative action to restructure fundamentally our operations, materially reduce our cost base and improve our financial position. During the year, we have launched the largest restructuring in our recent history, secured further liquidity through a rights issue and by raising additional debt, and launched a significant disposal programme. We believe these steps will provide the Group with improved financial resilience, in order to weather the macroeconomic risks, before we return to strong cash generation; and assist us in creating a more appropriate balance sheet structure as we position the Group for the long term to benefit from new technologies focused on sustainable power.

The sudden and material effect of measures taken by governments worldwide to stem the outbreak of COVID-19 has had a significant impact on the commercial aviation industry, particularly the market for long-haul travel. This resulted in a sharp deterioration in the financial performance of our Civil Aerospace business – which makes the majority of its cash flow from payments based on the number of hours that our engines are powering our customers' aircraft – and, to a much lesser extent, our Power Systems business.

We came into the year in a stronger position than previously, with net funds of £1.4bn and confident of our ability to achieve our target of at least £1bn of free cash flow, following significant progress made over the previous two years. As a result of the impact of the pandemic, however, we exited the year with net debt of £1.5bn and a free cash outflow of £4.2bn.

Decisive actions in response to COVID-19

The pandemic has affected lives throughout the world and impacted everyone at Rolls-Royce. The Board has actively scrutinised the actions being taken to secure the safety and wellbeing of our people. Alongside measures introduced to ensure physical health in the workplace, we have paid particular attention to mental health support. This has been a time of understandable anxiety for many employees, with the impact of the pandemic compounded by our restructuring, the pressures of remote working and, for some of our people, a period of time on furlough or similar schemes. The mental wellbeing of our people has been a significant focus for the Board.

Ensuring safety is one of our key values at Rolls-Royce and in our initial response to the outbreak, we rapidly implemented a number of proactive safety measures, in line with local and national guidelines (see pages 6 and 40). Despite the obvious pressure the virus has created, we continued to reduce workplace incidents (see page 41) while avoiding any significant outbreaks of the virus at our sites. The cultural and behavioural progress that Rolls-Royce has made over the past several years, I believe, also benefitted the Group during these incredibly testing times. Our people around the world have embraced agility, acted boldly, worked more collaboratively and promoted simplicity in the actions they have taken to deal with the impact of the pandemic. We also supported local and national efforts to combat the impact of the pandemic (see page 43) including participating in the production of additional healthcare equipment.

We implemented a number of cost mitigation measures to conserve cash from March and took action to bolster our liquidity position, allowing us time to conduct a more detailed review of the Group's capital structure and funding options. We also made use of government schemes, such as furlough in the UK, and remain grateful for the support we have received. In May, we launched a fundamental restructuring programme that will resize the cost base and capital requirements of our Civil Aerospace business and increase cost efficiency. This vital 'self-help' is intended to adjust our business to the new level of anticipated demand from customers and deliver larger, permanent savings to replace and expand on the mitigating actions delivered by the Group in 2020.

During the year, the Board increased oversight and scrutiny, providing counsel and constructive challenge to the Executive Team as it dealt with the pandemic, through a high number of additional meetings and calls (see page 70). We conducted a detailed review of the Group's

CHAIRMAN'S STATEMENT

outlook, balance sheet, capital structure and funding options, considering a number of different scenarios and assessing their potential impact on the Group's financial position. This included consideration of a severe but plausible downside scenario (see page 53). There remains significant uncertainty about the precise pace of the recovery and the possibility of delays remains a risk and, as a Board, we considered it prudent to prioritise resilience and flexibility. Taking into account, in particular, our severe but plausible downside scenario, alongside continued global and macroeconomic uncertainty, we determined in October that it was in the best interests of shareholders to seek to raise additional capital of approximately £2bn through a rights issue, secure additional facilities to take our total debt raised in the year to £5.3bn, and deliver a number of potential disposals to raise gross proceeds of at least £2bn by early 2022.

We thank shareholders for the overwhelming support we received for the rights issue, which enabled us to improve our liquidity headroom while supporting disciplined execution and investment to ensure we maximise value from our existing capabilities. It will allow us to continue on our journey to securing a more appropriate balance sheet and deliver disposals in a manner that ensures value for our shareholders, as we position the Group for the long term to benefit from new technologies focused on sustainable power.

Due to the limited visibility of the duration and impact of the pandemic, we withdrew our previous guidance for 2020 in April and subsequently made clear commitments to investors alongside our fund raising. It is vital that the interests of the Executive Team are aligned to our new reality, while our remuneration policy must avoid the potential for windfalls caused by a general market recovery following the pandemic. As a result, the Remuneration Committee has decided to replace our previous long-term incentive plan and introduce a new policy to be voted on at the 2021 AGM (see page 81).

As the world emerges from the pandemic, we will benefit from our broad portfolio, with Defence expected to remain resilient and Power Systems benefitting from its shorter cycle industrial end market exposure. We believe we have a clear responsibility to all our stakeholders to return the Group to strength with a sustainable and right-sized cost base, aimed at ensuring the Group's future success and the Board intends to take all appropriate actions to secure this outcome.

Shareholder payments

Although we took swift action to conserve cash and bolster our liquidity, the Board decided in April that, in light of the uncertain macro outlook, they would not recommend a final shareholder payment for 2019. This was a difficult but prudent decision as the scale of the crisis became apparent. We also confirmed in August that no interim shareholder payment would be made in 2020. For the foreseeable future, under the terms of certain of our loan facilities we have in place, we are currently restricted from making payments to our shareholders until after 31 December 2022. Further information can be found in Shareholder Information on page 211.

Board developments

In August, Stephen Daintith informed the Board that he had decided to leave to take up another opportunity. Stephen has remained in his role to ensure the effective delivery of the cost mitigations targeted in 2020 and will leave on 19 March 2021. He has been a valued member of the Board and management team and has made a huge contribution to the Group. I would like to thank him for his hard work. His successor, Panos Kakoullis, will take up his role on 3 May 2021. During the year, we welcomed George Culmer and Dame Angela Strank to the Board as Non-Executive Directors in January and May respectively. We have also appointed Paul Adams who joins us in March 2021. Finally, on behalf of the Board, I would like to thank Lewis Booth, Sir Frank Chapman and Jasmin Stablin, all of whom will be stepping down at the 2021 AGM, for their tremendous support during their tenure (see page 61).

Looking forward

Our markets remain fundamentally attractive and the actions we have taken in 2020 should enable us to deliver on the clear commitments we have made to investors. We must complete the fundamental restructuring of our business in order to be able to benefit from the eventual recovery in commercial aviation from COVID-19. Although the pathway to strong free cash flow remains dependent on the exact timing and shape of that recovery, notably with regards to long-haul air travel, our intent is to return the Group to positive free cash flow during the second half of 2021, with positive annual free cash flow as early as 2022, excluding the cash impact from our disposal programme. Continuing news about vaccine programmes being developed and undertaken around the world should give all of us cause for optimism about the future.

As countries across the world emerge from the restrictions designed to combat the pandemic and seek to revive their economies, the desire for economic development to be more robustly coupled with a reduction in global carbon emissions will only grow stronger. This represents a challenge for Rolls-Royce (see page 48), but also a very significant business opportunity, which we are grasping firmly as a central part of our strategy (see page 10). We believe that over the longer term, the end markets in which we operate will see growing demand for cleaner and more sustainable power and we are already positioning ourselves to play a crucial role in the world's transition towards a net zero carbon economy. Alongside our own commitment to achieve net zero greenhouse gas emissions in our operations and facilities by 2030 (see page 36), our technology will play a fundamental role in enabling the sectors in which we operate achieve net zero carbon by 2050 (see page 34).

Finally, I and the Board would like to thank everyone in Rolls-Royce for their resilience, determination and extraordinary hard work in what have been exceptionally challenging circumstances.

Sir Ian Davis

Chairman

DECISIVE ACTION TO SECURE OUR FUTURE

Unprecedented times have called for unprecedented action and we have a responsibility to all our stakeholders, who have shown such faith in us during 2020, to secure a sustainable and prosperous future for Rolls-Royce.



WARREN EAST, CHIEF EXECUTIVE

Unprecedented is a word I have used many times during 2020 and for good reason. The impact of the COVID-19 pandemic during the year on the largest part of our business, Civil Aerospace, has been exactly that and unprecedented times have called for unprecedented action. We have launched the largest restructuring in our recent history, embarked upon the consolidation of our global manufacturing footprint, introduced stringent cost reduction measures and begun a disposals programme to raise at least £2bn by early 2022. The hard work, dedication and sacrifice of everyone at Rolls-Royce in securing our future in the face of the sudden and material effect of the pandemic on the commercial aviation industry, has been exceptional.

During the year, we have had to call upon investors for funds, securing £2bn in equity and £5.3bn of debt to increase our resilience, support our long-term strategy and assist us in our journey towards enhancing our liquidity and strengthening the balance sheet. Of the existing facilities available to the Group, £5.5bn remains undrawn at the year-end. All of us at Rolls-Royce are grateful for the support that investors have given us in providing sufficient liquidity to weather this crisis. We now have a heightened sense of responsibility to all our stakeholders, who have shown such faith in us during 2020, to secure a sustainable and prosperous future for Rolls-Royce. My sense of responsibility is particularly acute to those who are leaving the business in the restructuring, to those who remain with us and those who will come after us and pioneer the technologies required for decades to come. As we recover from the impact of the pandemic on our business, we must retain and indeed strengthen our focus on playing a crucial role in the transition to a net zero carbon economy by creating the sustainable power that our customers require.

Safeguarding our people and business

The fact that we were able to act swiftly and decisively in 2020 owes much to the work we undertook over the previous two years to create a tangible and sustainable cultural and performance shift within our business. We entered 2020 with real momentum. Following a period of rapid growth and new engine programme launches, R&D investment demands were falling in Civil Aerospace and returns improving as we began to benefit from our large, growing and relatively young installed base. The benefits from this have now been delayed, but these fundamentals remain in place and position us well for the eventual rebound.

As the pandemic hit, we implemented proactive measures, aligned with local and national guidelines, to help keep our people safe and minimise operational disruption. These included introducing remote working practices alongside workplace measures such as social distancing, enhanced hygiene procedures and modified shift systems in our manufacturing facilities. As a result, our facilities have remained operational throughout the pandemic with no significant outbreaks. Recognising that the impact of the pandemic extends well beyond the purely physical, we also increased our focus on employee mental health and wellbeing, with additional online tools and an expansion of our network of mental health champions. We also provided practical assistance to our communities where we could. In the UK, we worked with partners, suppliers and healthcare professionals to build a parallel supply chain for new ventilator assembly plants. We also created a fast-make intubation shield for use with ventilators and we allowed many of our own employees to use their own initiative to create vital PPE for local hospitals. Our R² Data Labs team, meanwhile, launched the Emergent Alliance, a global community with more than 140 members that is using data analytics to assist the global economic recovery. As schools closed worldwide, we also increased the range of STEM (science, technology, engineering and mathematics) materials that we have available for free online.

As governments around the world moved quickly to try and halt the spread of COVID-19, much of the global airline fleet was grounded from the end of the first quarter of the year. At their lowest point, in April, our large engine flying hours (EFH) were down 80% on the same period in 2019. In response to this sudden market deterioration, we executed short-term mitigations to reduce our cash expenditure including minimising discretionary spend and reducing salary costs. These swift actions saved us more than £1bn in 2020.

Although flying activity increased from the low point in April, for the year as a whole large engine flying hours were 43% of 2019 levels, with a consequent dramatic impact on our free cash flow. The drop in activity in Civil Aerospace and our decision to cease invoice factoring (see page 18), resulted in an overall free cash outflow of £4.2bn for the year as a whole.

Fundamental restructuring

The impact of COVID-19 on our Civil Aerospace business will not just be felt in 2020. The pandemic has created probably the most difficult period that global aviation has faced in peacetime. The medium-term market for our Civil Aerospace business will be significantly smaller than previously anticipated. As a result, in May we launched a major restructuring programme to resize the cost base and capital requirements of our Civil Aerospace business to adapt to this new reality and deliver run-rate savings of at least £1.3bn by the end of 2022. The successful completion of this programme, alongside an anticipated recovery in our end markets, is vital to restoring our financial performance.

In total, we expect the restructuring to lead to the reduction of at least 9,000 roles. By the end of the year, approximately 7,000 roles (see page 42) had been removed with a significant proportion achieved through voluntary severance. Telling anyone that there is no longer a job for them is a terrible prospect and it is especially hard when all of us take so much pride in working for Rolls-Royce. But we have had to make tough choices to see the Group through these unprecedented times. Throughout the pandemic, we have made use of the short-term support mechanisms created by governments including furlough in the UK and comparable schemes in other countries. We are grateful for this support, but no government scheme can replace sustainable customer demand that is not there over the medium-term and we have had to act. Our Civil Aerospace facilities have seen a medium-term reduction in demand and so we must resize our manufacturing footprint. During the year, we announced proposals including the consolidation of widebody engine assembly and test from three global sites to one in Derby, UK, and the transfer of our aero-engine parts facility and workforce in Hucknall, UK, into ITP Aero.

ITP Aero is one of a number of assets that we have identified for potential disposal to raise proceeds of at least £2bn by early 2022. Notwithstanding the outcome, ITP Aero is a key partner and we will retain a long-term relationship with the business across our Civil Aerospace and Defence programmes. In December 2020, we announced the sale of our Civil Nuclear Instrumentation & Control business and in early in 2021, we also announced the sale of our Bergen Engines medium-speed gas and diesel engines business.

Power Systems and Defence

The impact of the pandemic on Power Systems has been far less severe than on Civil Aerospace and driven primarily by lower levels of economic activity caused by the restrictions imposed globally in order to contain the outbreak (see page 28). Diversified end market exposure resulted in a relatively resilient performance. Lower economic activity and reduced utilisation of the installed base of engines due to the pandemic caused a substantial drop in commercial and industrial markets. However, governmental demand remained intact and we grew strongly in China, where economic conditions were better. Power Systems has been working actively to improve its manufacturing fixed cost base, optimising efficiency and balancing its global footprint. As economic activity resumes, we expect Power Systems to recover relatively quickly. Some end markets may actually experience structurally higher demand as a result of the pandemic, notably in mission-critical power generation. This is one of the areas where we expanded the capabilities of Power Systems during the pandemic through acquisition, buying Kinolt Group, to strengthen our position in back-up power generation. That followed the acquisition of a majority stake in Qinous at the start of the year, which enhanced our microgrid offering.

The impact of COVID-19 on Civil Aerospace will not just be felt in 2020. A successful completion of our fundamental restructuring is vital to restoring our financial performance.

Our Defence business had a strong year and did not experience any material operational or financial disruption from the pandemic (see page 30). Support for the defence industry from governments and other customers in our key markets was swift. Action from the UK Government, for instance, has enabled us to redeploy engineers from Civil Aerospace into Defence in order to retain key skills. We also continued with our work on the Tempest future combat programme in the UK and won business during the year, with our MT30 marine gas turbine selected for the Republic of Korea Navy's FFX Batch III frigate.

Driving growth and maximising value from our existing capabilities

While the pandemic has not altered our commitment to our long-term strategy, we are pursuing stronger medium-term growth opportunities and placing a greater relative focus on investment in Power Systems and Defence.

Increased investment in Power Systems will enable the continued development of new technologies such as hybrid-electric systems and assist us in exploiting the opportunities presented by fast growing markets and the move to more integrated power systems solutions. We have reorganised the internal structure of Power Systems to focus individually on stationary, mobile and sustainable power solutions with a fourth business unit concentrating solely on China.

In Defence, we have invested significantly in recent years in pursuing growth opportunities including two major opportunities in the US market: the re-engining of the iconic B-52 and the U.S. Army's Future Long-Range Assault Aircraft (FLRAA) programme (see page 31). These programmes have the potential for over 650 and 4,000 engines respectively, with a combined estimated lifetime value of roughly £7bn. In the latter competition, during the year, we signed an agreement with Bell Textron to provide the propulsion system for its offering, the V-280 Valor aircraft.

In Civil Aerospace, our priority is to drive higher cash returns from our existing installed base while seeking new approaches to reduce the investment requirements for the development of our next generation gas turbine technology. There is significant value embedded in our installed base of approximately 5,000 large and 9,000 small and business aviation engines and we have an important opportunity to realise that value through enhanced time-on-wing, further services offerings and improved engineering efficiency. My confidence in our ability to rise to this challenge was further bolstered in 2020 as we achieved zero aircraft on ground (AOG) for the Trent 1000 fleet half way through the year, assisted by the impact of the pandemic but beating our ambition of single digits.

Although we are exiting a period of very intense investment in new Civil Aerospace engine programmes – with seven new engines launched in the past decade – we are giving ourselves technological optionality for the future through our UltraFan programme (see page 10). During the year, we started a new phase of testing for its low emissions combustion system and put into production the first component sets required for a full engine demonstrator which will be fully assembled at the end of 2021. To deliver more compelling returns, we are actively exploring new forms of industrial partnership on the programme.

Focus on sustainable power

We have a target to achieve net zero greenhouse gas emissions in our operations and facilities by 2030, excluding product test emissions (see page 36). We believe, however, that the breadth of our engineering expertise and our established access to a range of end markets mean that we are also well positioned to play a crucial role in the world's transition to a net zero carbon economy. Once we achieve our aim of restoring financial returns and a more appropriate balance sheet, we intend to accelerate this aspect of our strategy to deliver substantial growth by 2025.

We are building on our existing capabilities within Power Systems where land and sea applications are already moving to more electric systems. We already have a proven microgrid product offering and are developing hybrid systems for applications including yachts. We

are also building the capability to produce world-class, modular and scalable electric power and propulsion systems for aviation. We have conducted successful ground tests of a hybrid M250 engine for the commuter and urban air mobility markets and have developed an all-electric aircraft, through the ACCEL programme, designed to break the world electric air speed record in 2021. It will provide us with invaluable insights into battery technology for these new disruptive markets. In addition, we are using our growing expertise to develop technologies for the electrification of larger regional aircraft. Electrification is also playing an increasing role in Defence projects.

The sheer scale of the challenge presented by the weight constraints of long-haul flight, means the gas turbine will remain the only viable propulsion option in widebody aircraft for multiple decades. As a result, we must make this technology compatible with a net zero

carbon future. We are working with governments and industrial partners to explore the development of sustainable aviation fuels (SAF) and already testing them within our existing Trent engines. As the cost of these new fuels is expected to be higher than existing kerosene-based fuel, an efficient gas turbine architecture, such as our next generation UltraFan, will be a vital component in achieving sustainable aviation. SAFs must be created in a way compatible with net zero carbon, which represents a real opportunity for our small modular reactor (SMR) concept to power their production.

We remain well positioned to play a crucial role in the world's transition to a net zero carbon economy.

2021 outlook and longer-term prospects

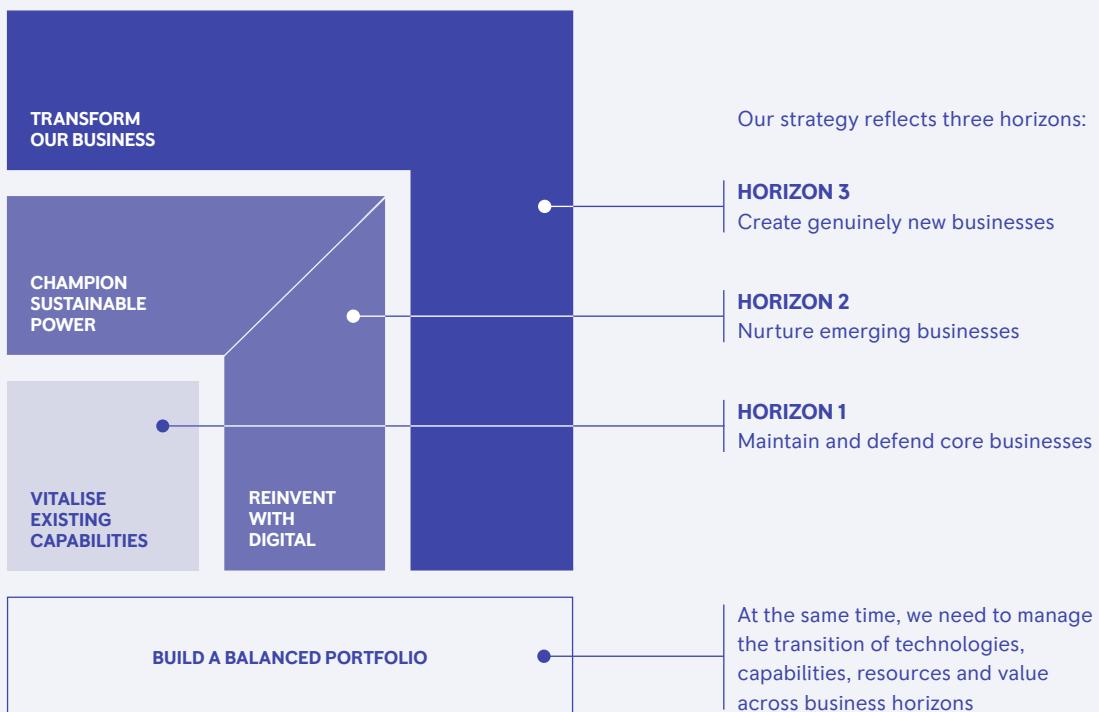
The decisive actions we have taken during 2020 leave us well placed as the recovery unfolds, but we must continue to drive our restructuring in order to realign our cost base. Based on our current view of the shape and timing of the recovery in air traffic, we expect a free cash outflow in the region of £2bn in 2021, weighted towards the first half before we turn free cash flow positive at some point during the second half. We are targeting a return to annual free cash flow of at least £750m (excluding disposals) as early as 2022.

Over the longer term, we believe that the key markets for all our businesses are fundamentally attractive and we remain committed to playing a key part in enabling the sectors in which we operate, some of which are among the hardest to abate, achieve net zero carbon by 2050. We clearly signalled our ambitions in this area during 2020 by joining the UN Race to Zero campaign (see page 36). I firmly believe the world needs the resourcefulness, ingenuity and determination of Rolls-Royce, not only to assist in the recovery of the global economy in the wake of the pandemic, but to provide solutions to the climate crisis. The way that we have tackled the challenge posed by COVID-19 during the year gives me increased confidence that we will repay the faith placed in us by all our stakeholders and achieve a sustainable and prosperous future.

PURPOSE, VISION AND STRATEGY

*We are one of the world's leading industrial technology companies.
We pioneer the power that matters to connect, power and protect society.*

OUR STRATEGY



STRATEGIC REFINEMENT IN 2020

Our key focus in the near-term in response to COVID-19 is to

Restore financial performance to improve returns and build a more resilient and appropriate balance sheet

Drive growth and maximise value from our existing capabilities

Position the Group to benefit from new technologies with a focus on sustainable power

Progress in 2020

We are a global power group with exposure to multiple markets and a central role to play in providing customers with vital power. Our vision is to pioneer the power that matters and our purpose is to use that power to connect, power and protect society. We believe that, despite the current impact of the pandemic, the key end markets for our businesses remain fundamentally attractive and as a result our overall strategic architecture remains largely unchanged. We have, however, refined our strategic pillar of 'champion electrification' to encompass a wider range of net zero carbon technologies under the banner 'champion sustainable power'. This is in recognition of the increasing importance of ensuring that economic recovery and growth is achieved in a manner compatible with combatting climate change. We are determined to play a crucial role in pioneering a resilient, inclusive, net zero carbon future (see page 36).

HORIZON 1

VITALISE EXISTING CAPABILITIES

Despite the obvious financial pressure caused by the pandemic, we have continued to invest in our existing thermomechanical products to ensure that they provide clean, safe and competitive solutions for our customers, while developing next generation technologies.

The gas turbine will continue to be the bedrock of long-haul aviation for many years and it is vital that we continue to increase its efficiency, not least to improve the economics of the transition to more sustainable fuels which are likely to be more expensive in the short-term than fossil fuels. During the year, we continued to develop the new technologies we will need to achieve this. We started a new phase of testing for our Advanced Low Emissions Combustion System (ALECSys) demonstrator, a key part of our UltraFan programme. Our work on UltraFan continued with parts for our first engine demonstrator going into production in 2020 including the power gearbox, fan blades and fan case. We ended the year training our team in Derby, UK, to build and assemble the engine and commissioning our new Testbed 80, which will be large enough to accommodate it. In business jets, we delivered the 8,000th engine from our site in Dahlewitz, Germany, and our BR725 engine achieved one million flying hours. Our latest business jet engine, the Pearl 700, successfully powered the new Gulfstream G700 for the first time.

In Power Systems, we launched a new MTU Series 500 engine for power generation, which will initially be offered for operation with natural gas but from the end of 2021 will also be available for power by biogas. The 500 series can also be converted to hydrogen operation. We also formed a 50:50 joint venture with Shanghai Cooltech Power, a leading Chinese manufacturer of power generation systems, to produce back-up generator sets powered by MTU engines.

In Defence, our MT30 marine gas turbine was selected for the Republic of Korea Navy's FFX Batch III frigate and we signed a collaborative agreement with the UK Ministry of Defence to strengthen ways of

working across key Royal Navy programmes and deliver ongoing support for MT30 and WR-21 engines. Work continued at pace on the Tempest future combat programme, with our engineers developing advanced combustion system technology and exploring composite materials and additive manufacturing to produce lightweight, more power-dense components capable of operating at higher temperatures. In North America, we completed the expansion of our Centre of Excellence for Naval Handling Equipment in Canada. Our Liberty-Works team completed rig testing on a new core design for a small engine, successfully executing a rapid prototyping plan from design to test in under a year; and delivered an upgraded thermal management and power system for directed energy applications.

HORIZON 2

CHAMPION SUSTAINABLE POWER

To meet the demands of a growing, more connected society, the power that matters must be sustainable, net zero carbon power. We have a key role to play in enabling the sectors in which we operate to achieve net zero carbon by 2050 and during the year we ratified this ambition by joining the UN Race to Zero campaign. This means pioneering new electric and hybrid-electric technologies, but also ensuring that our products can be utilised in a way that is compatible with net zero through the use of new innovative fuels. The journey to net zero will create significant business opportunities for Rolls-Royce from even more efficient gas turbines using sustainable aviation fuels (SAFs) and all-electric and hybrid-electric propulsion, to microgrids, battery containers and small modular reactors (SMRs).

Aviation has traditionally been seen as hard to decarbonise. We believe, however, that it can be compatible with a net zero future through relentless pursuit of airframe and engine efficiency improvements; improving the economics, and scaling up the production of SAFs; and the exploration of radically new methods of aviation propulsion and fuelling. The vast majority of CO₂ created from aviation is from flights beyond 1,500km, where we believe that radically new methods of propulsion are unlikely to play a significant part in decarbonisation prior to 2050. As a result, gas turbine efficiency improvements and the scale-up of SAFs will be vital. Following the development and entry into service of the world's most efficient large aero engine in service today, the Trent XWB, our UltraFan programme will offer a step-change in efficiency. We believe that the introduction, by regulators or governments, of mandated levels of SAF will bring about a cost burden for airlines and UltraFan will help mitigate rising fuel costs as well as reduce net emissions.

Towards the end of 2020, we conducted ground tests on a Trent 1000 using 100% SAF for the first time (see page 37). The scale-up of SAFs to meet global aviation demand is a major undertaking, with an estimated 500 million tonnes per year needed in order to fuel the global airline fleet that is expected to be flying in 2050. We are engaged with the world's leading energy companies to promote increased production. Our SMR concept also represents a potential low carbon

PURPOSE, VISION AND STRATEGY

power source for fully synthetic fuel production. Our Defence aviation customers are also becoming increasingly interested in SAF availability and engine compatibility for reasons of energy security and to assist in their own contribution to decarbonisation. The higher calorific value of SAFs, compared to fossil fuels, may also provide operating range benefits.

Electric and hybrid-electric technologies are set to power a new generation of fixed-wing and vertical take-off aircraft. During the year, we celebrated the first anniversary of the acquisition of eAircraft and we have sharpened our short-term focus to target the small propeller, commuter and urban air mobility (UAM) markets where we are developing complete propulsion systems.

In the small propeller category, our first prototype of an electric propulsion unit to serve aircraft with two to four seats, the RRP70, gained an agreed certification plan with EASA; and in the commuter market we announced plans to work with leading general aviation manufacturer, Tecnam, to jointly develop an all-electric 11-seater aircraft. In UAM, we provided the propulsion system for the CityAirbus demonstrator which successfully completed its flight test programme in 2020. During the year, we decided with our partner Airbus that we did not need to carry out a test flight programme for our E-Fan X technology demonstrator, having already learned valuable lessons. However, our technology in the megawatt space for regional sized jets continues to progress at pace with our 2.5MW generator now in ground testing with system integration tests planned for 2021.

During the year, our ACCEL all-electric aircraft programme completed ground testing of the technology that will power what we hope will be the world's fastest all-electric plane. The aircraft is a test environment for our pure electric flight pack and also intended to inspire the next generation of aerospace innovators. We are aiming to beat the current all-electric flight world speed record in 2021.

Land and sea power generation and propulsion also represent a significant proportion of global emissions and Power Systems is rapidly embracing the drive towards sustainable power. In 2020, we acquired a majority stake in electricity storage specialist Qinous which is now central to our microgrid solutions. We also increased our capacity for producing battery containers and formed a new 'Power Lab' to focus on innovative and net zero carbon drive and energy solutions.

REINVENT WITH DIGITAL

We are using digital technologies across our activities to generate new insights, new solutions and new opportunities. Our capabilities, expertise and connection with the wider data analysis and digital community were highlighted by two activities during the year: the Emergent Alliance and the Aletheia Framework. As the impact of the pandemic grew, we formed the Emergent Alliance of data analytics experts challenged with finding new, faster ways of supporting businesses and governments globally as they recover from its economic impact. At the end of the year, we released the Aletheia Framework,

a comprehensive ethical framework and trustworthiness process which we created to assure our own use of artificial intelligence in safety-critical processes. Both programmes were borne out of R² Data Labs which also launched Yocova, a collaboration platform for the aviation sector, in 2020. Across our business, we are making increasing use of digital skills and ensuring that our people can increase their capabilities through our Digital Academy. To help as many as possible during the pandemic, we made its content available online and more than 30,000 have already enrolled.

HORIZON 3

TRANSFORM OUR BUSINESS

We are advancing new opportunities that could capture substantial growth and value for the Group. During the year, the UK Government committed to £215m of grant funding for our consortium working on SMR power plants. This enables the consortium to begin securing additional private investment. The strength of the SMR concept was highlighted during the year as we announced a partnership with Exelon, one of America's largest operators of nuclear power stations, and signed a memorandum of understanding (MOU) with CEZ, the largest utility company in central and eastern Europe.

During the year we also announced a collaboration with Boom Supersonic to explore a propulsion system for Overture, their flagship supersonic passenger aircraft; and signed an MOU with Virgin Galactic to collaborate in designing and developing engine propulsion technology for high-speed commercial aircraft.

BUILD A BALANCED PORTFOLIO

We actively manage our portfolio to focus on activities that are aligned with our strategy and business model. During the year, we announced plans to raise at least £2bn by early 2022 through disposals including ITP Aero. The business is a key partner and we plan to retain a long-term relationship with it across our Civil Aerospace and Defence programmes, but owning ITP Aero is not necessarily a strategic imperative and it may be able to unlock further investment and business opportunities under new ownership. During the year, we completed the sale of our Civil Nuclear North America Services business and announced the sale of our Civil Nuclear Instrumentation & Control business. In early 2021, we also announced the sale of our Bergen Engines medium-speed gas and diesel engines business. We made three acquisitions during 2020 to accelerate our strategy in Power Systems. We acquired a majority stake in electricity storage specialist Qinous, to enhance our microgrid offering. We completed the acquisition of Kinolt, a leader in dynamic uninterruptible power supply, to strengthen our market position in safety-critical applications. We also acquired Servowatch Systems, an international supplier of integrated marine automation solutions for navies, commercial vessels and large yachts, to expand our ship automation activities.

BUSINESS MODEL

OUR COMPETITIVE ADVANTAGE COMES FROM:

CUTTING-EDGE TECHNOLOGIES

We apply cutting-edge technologies to provide clean, safe and competitive solutions. Our technologies ensure that our customers have the vital power that meets their emerging needs in an increasingly sustainable manner.

SYSTEM SOLUTIONS

We integrate individual enabling technologies into complete systems and power solutions. This provides our customers with the ability to work with a single partner to provide their entire power needs for their chosen application.

SYSTEM LIFE

Our products have significant aftermarket and maintenance requirements during their operating lives, which typically run for decades. We provide complete through-life maintenance and support for our power.



PRINCIPAL RISKS

A Safety
B Business continuity
C Climate change
D Competitive environment

E Compliance
F Cyber threat
G Market shock
H Financial shock

I Political risk
J Restructuring
K Talent and capability



Principal Risks, page 46

BUSINESS MODEL

We believe we have a sustainable business model which will create value for all our stakeholders over the long term. See our Viability Statement on page 55 and Stakeholder Engagement on page 72.

1

Anticipate the needs of our customers

Our focus on building complete power solutions provides the basis for strong customer relationships as we act as a single, trusted power provider. Our aftermarket model of through-life support further deepens these relationships. We have built strong, direct customer relationships which have allowed us to continue winning business during a period of increased macroeconomic uncertainty associated with the pandemic.

2

Develop cutting-edge technologies

Our products incorporate significant intellectual property, capturing cutting-edge technologies that have been developed over decades. Commercial aero engines are extremely complex mechanical engineering products, requiring significant expertise in aerodynamic, thermodynamic and materials technologies. In our Defence business, we are one of only a handful of companies currently capable of designing, integrating and manufacturing complete military jet engines; with significant expertise in powerplants for nuclear-powered submarine applications. Our Power Systems business focuses on demanding, high-end applications for reciprocating engines, in areas such as mission-critical back-up power where start-up time and reliability are critical. We act as a global technology sponsor, drawing upon expertise inside and outside our organisation. In 2020, we continued to invest in R&D despite the pressures on our business caused by the pandemic, with £1.25bn in gross R&D expenditure, supported by governments around the world.

3

Design solutions

We harness the potential of digital technologies and design thinking to create solutions that generate the greatest value from our cutting-edge technologies. This activity is supported by our data innovation catalyst R² Data Labs. We produce digital twins in order to test our hypotheses and then validate our results through a rigorous physical testing regime. In our Civil Aerospace and Defence businesses, our capabilities cover end-to-end design, assembly and through-life support of complete gas turbine power solutions. Our Power Systems business is increasingly moving into the provision of complete power generation systems.

4

Develop world-class production capability

We generate value from our cutting-edge technologies and innovative solution designs through effective and efficient delivery of final products. We use our production expertise and network of Advanced Manufacturing Research Centres, alongside our supply chain partners, to harness new manufacturing techniques and technologies.

5

Grow installed original equipment base

Increasing our installed base of products generates both in-year growth and the potential for our business to capture long-term service revenue. In line with our strategic aim to vitalise existing capabilities, we continually look for ways to reduce the time and resource expended on producing existing products, and roll-back new technologies from new programmes into legacy products.

6

Capture through-life value of in-service products

We believe our substantial installed base provides a large, captive, visible, and long-term revenue and cash flow stream. The installed base within our Civil Aerospace business is relatively young, with approximately 9,000 small and business aviation engines in service with an average age of 19 years for small civil jets and 13 years for business jets, as well as approximately 5,000 large engines with an average age of less than nine years. Given an average expected engine life of approximately 40 years for a small or business aviation engine and approximately 25 years for a widebody engine, we expect significant aftermarket revenue and value from our installed base. Similarly, the installed base in our Defence business of approximately 16,000 defence engines is expected to continue to operate for many decades.

7

Generate stakeholder value

Our activities are global, complex and touch upon a wide variety of stakeholders. From investors, employees, customers, suppliers and partners, to communities, local and national authorities, regulatory bodies and armed forces, we aim to create trusted relationships. Over the longer term, the end-markets in which we operate will see growing demand for cleaner and more sustainable power. We will be well positioned to play a crucial role in the world's transition towards a net zero carbon economy and believe execution of our strategy will ultimately provide a strong platform to drive a significant improvement in free cash flow and deliver attractive shareholder returns.

BUSINESS ENVIRONMENT

GROUP TRENDS

COVID-19

In 2020, the Group's performance was significantly impacted by COVID-19. This was most strongly felt in our widebody business in Civil Aerospace, but also in business aviation and Power Systems. Conditions in Defence proved resilient despite the challenging global macroeconomic environment.

Market recovery

The Group expects its key markets to recover over time. Power Systems is expected to recover relatively quickly as economic conditions improve, while a more gradual improvement is expected in Civil Aerospace. Longer term, the outlook remains strong across the Group; global economic growth is expected to increase demand across Civil Aerospace, ITP Aero and Power Systems, while political tensions are expected to preserve the need for Defence products and services.

Our positioning

The Group expects to outperform many of its markets through this recovery period. In Civil Aerospace and ITP Aero, this is driven by our young installed base and strong product positions on new aircraft programmes. In Power Systems, this is due to growing market share in key markets and expanding our sales in low carbon products as our end markets transition to more sustainable power.

Low carbon power solutions

The Group sees common trends across all of its businesses towards electrification and lower carbon power solutions. This shift provides significant opportunities due to our strong technology positions in hybrid and electric power solutions in Power Systems and Civil Aerospace, as well as in small modular reactors and microgrid solutions.

CIVIL AEROSPACE

Market dynamics

- The civil aviation industry has been severely affected by the COVID-19 pandemic, with a particular impact on the widebody market.
- As a result, airlines have postponed investment in new aircraft, leading to a reduction in aircraft production from both Airbus and Boeing.
- Business aviation has also seen a reduction in activity as a result of the COVID-19 pandemic, however the impact was less severe than in the large commercial market.
- In the longer term, the business expects to return to growth, driven by the same market trends witnessed prior to COVID-19:
 - economic growth in both the developed and the developing world;
 - growth in business jet travel supported by further increases in the number of high-net-worth individuals; and
 - the need for newer, more efficient aircraft with reduced greenhouse gas emissions.

Opportunities

- The business has the potential for market share gains during COVID-19, as our relatively young installed base should be less impacted by retirements and recover more quickly than our competitors.
- The strong positions we hold on current in-production widebody aircraft should drive a return to growth in our installed base post-COVID-19.
- In business jets, we hold a strong position in the market by value. This market has been less impacted by COVID-19 and has good long-term fundamental drivers.
- We have the potential to disrupt new markets with sustainable power solutions in general aviation, commuter aircraft and urban air mobility.

Risk

- A slower than expected recovery of the civil aerospace market from the COVID-19 pandemic could significantly impact our financial performance.
- If our products do not achieve their required technical attributes, then our financial performance and reputation could be impacted.
- If a major product failure in service is experienced, then this could result in loss of life and significant financial and reputational damage.
- If there is disruption to the business' internal or external supply chain then our financial performance and reputation could be impacted.
- If there are significant changes to the regulatory environment for the airline industry, the business' market position could be impacted.

BUSINESS ENVIRONMENT

POWER SYSTEMS

Market dynamics

- Power Systems has a diverse end market exposure which has offered some protection against COVID-19.
- The most significant impact has been across industrial markets such as construction and agriculture, oil & gas and mining.
- In power generation, underlying demand for mission-critical back-up power remained strong, while in continuous power generation, the reduction in economic activity lowered demand.
- Marine has been more resilient with robust demand from governmental customers in the naval and coastguard markets, though there was an impact on our commercial vessel and yacht activities.
- Following the COVID-19 pandemic, many of the business' end markets are expected to recover quickly, with some even seeing accelerated growth opportunities.

Opportunities

- Power Systems has the potential to become a leader in low carbon power solutions. We have created a separate business unit to focus entirely on these opportunities.
- There is significant potential for market share growth in the Chinese market based on our strategy of using partnerships and localised manufacturing. We have created a separate business unit to focus entirely on these opportunities.
- There is significant growth potential in the mission-critical back-up power market. We have a strong product position in this area.
- Our gas product portfolio has been expanded in recent years, providing growth potential as a lower carbon alternative to diesels.
- Small modular reactors offer a significant opportunity in a new market, with the UK Government expressing support.

Risks

- If the recovery from COVID-19 takes longer than anticipated, then our financial performance could be materially impacted.
- If requirements on export licenses and/or local content increase, then this may affect our ability to export to certain markets.
- If the CO₂ price rises above our expectations and/or the demand for fossil-free power develops faster than anticipated, then this may affect demand for our products and/or affect margins.
- If new technologies or alternative propulsion concepts emerge, then this may lead to partial substitution or downsizing of diesel engines.

DEFENCE

Market dynamics

- Limited near-term impact from the COVID-19 pandemic, with customer demand remaining resilient and minimal operational disruption.
- We expect relatively stable conditions in key markets over the coming years, albeit with continued customer focus on cost reduction.
- In the US market, overall conditions are expected to be flat to slightly declining, while the UK market is expected to be relatively stable in the short term.
- Outside the critical US and UK markets, we expect continued strength in export markets partially driven by local geopolitical tensions.

Opportunities

- In the US, the business is well positioned for the B-52 re-engine competition for the US Air Force and the Future Vertical Long Range Assault Aircraft (FLRAA) competition for the US Army. The combined lifetime value of these programmes is expected to be approximately £7bn.
- In the UK, the Government has demonstrated its commitment to maintaining fighter capability through Project Tempest, with £2bn of initial MOD investment spending committed.
- The business is exploring more electric and hybrid-electric propulsion technologies as well as power generation and thermal management for the growing directed energy systems market.
- The business has various sales opportunities for existing products such as the MT30 naval gas turbine and the EJ200 Eurofighter Typhoon engine.

Risks

- If global defence spending experiences a significant downturn, then financial performance could be impacted.
- If a major product failure in service is experienced, then this may result in loss of life and significant financial and reputational damage.
- If we do not continue to invest in improving the portfolio performance and cost of Rolls-Royce products, then market share may be lost.
- If the business suffers a major disruption in its supply chain, then delivery schedules could be delayed, damaging financial performance and reputation.
- If electrification proceeds faster than expected, then the business may not be positioned to capitalise on this potential growth.
- If geopolitical issues impact government-to-government relations or export controls, then our routes to market may be impacted.

ITP AERO

Market dynamics

- A majority of the business' revenue relates to commercial aerospace markets, with the largest exposure being the Group's widebody engine programmes.
- As a result, the trends driving our Civil Aerospace business have a major impact on ITP Aero's widebody activities.
- A less significant impact is expected in ITP Aero's business aviation and narrowbody activities.
- In the defence market, COVID-19 has had a limited impact, with the reduction in sales in 2020 largely driven by phasing on key programmes.

Opportunities

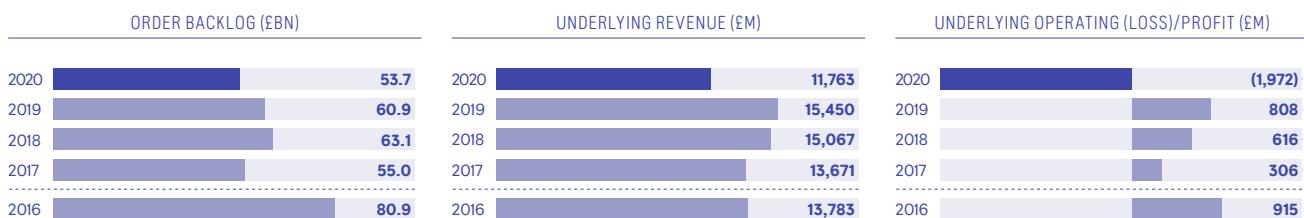
- Delivery volumes are expected to return to growth from 2021, driven by ITP Aero's position on narrowbody and business jet programmes.
- ITP Aero has won shares as a risk-and-revenue partner on relatively new programmes including the latest Rolls-Royce engines as well as the Pratt & Whitney PW1000G and PW800.
- ITP Aero will benefit from government defence budget growth, particularly in Spain. Mid-life enhancements of existing aircraft programmes and new European aircraft programmes also enable potential growth.

Risks

- If there is a worse-than-expected recovery following COVID-19, then ITP Aero's financial performance could be impacted.
- If ITP Aero's products do not achieve their required technical attributes, then our financial performance and reputation could be impacted.
- If a product failed in service, then this could result in loss of life and significant financial and reputational damage.
- If the business' internal or external supply chain is disrupted then ITP Aero's financial performance and reputation could be impacted.
- If customer programmes were to be delayed into service or production rates cut, then ITP Aero's financial performance could be impacted.

KEY PERFORMANCE INDICATORS

Financial performance indicators^{1,2}



How we define it

Total value of firm orders placed by customers for delivery of products and services. This KPI is the same as the statutory measure for order backlog. See note 2 on page 130 for more information.

Why it is important

Order backlog provides visibility of future business activity.

Link to remuneration

Customer orders drive future revenue growth which in turn, enables profit and cash flow growth. Profit and free cash flow performance are the key financial metrics in both the annual bonus plan and long-term incentive plan (LTIP).

How we define it

Revenue generated from operations at actual rates of foreign exchange including achieved hedge rates in the year. See note 2 on page 126 for a reconciliation to statutory reported revenue.

Why it is important

Underlying revenue provides a measure of business growth and activity.

Link to remuneration

Underlying revenue growth maximises the opportunity to improve profit and free cash flow performance in the year, both of which are key financial metrics in the annual bonus plan and LTIP.

How we define it

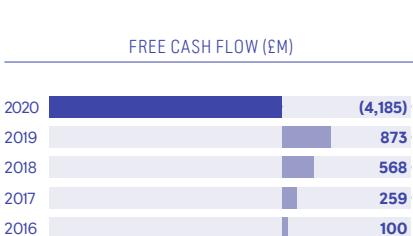
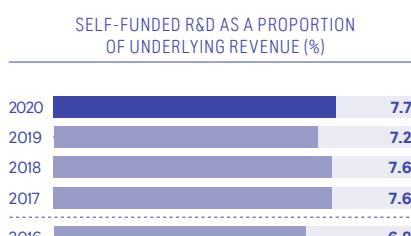
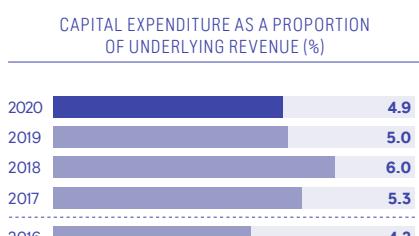
Profit generated from operations at actual rates of foreign exchange including achieved hedge rates in the year. It excludes exceptional and one-off items. See note 2 on page 126 for a reconciliation to statutory reported operating profit.

Why it is important

Underlying operating profit indicates how the effect of growing revenue and control of our costs delivers value for our shareholders.

Link to remuneration

Profit and EPS are key financial performance measures for our annual bonus plan and LTIP.



How we define it

Cash purchases of property, plant and equipment in the year relative to underlying revenue. There is no statutory equivalent to this KPI.

Why it is important

This measure demonstrates the balance between essential investments in infrastructure and delivering short-term shareholder returns.

Link to remuneration

Disciplined allocation of capital expenditure optimises in-year profit and cash flow performance without compromising longer-term growth. Metrics in our LTIP reward strong financial performance through EPS, CPS and TSR over the three-year life of the plan.

How we define it

In-year self-funded cash expenditure on R&D before any capitalisation or amortisation relative to underlying revenue. There is no statutory equivalent to this KPI.

Why it is important

This measure demonstrates the balance between long-term strategic investments and delivering short-term shareholder returns.

Link to remuneration

Disciplined control and allocation of R&D expenditure optimises in-year profit and cash flow performance without compromising long-term growth through innovation. There is a balance of metrics in our LTIP which reward strong financial performance through EPS, CPS and also relative returns to our shareholders through TSR over the three-year life of the plan.

How we define it

Free cash flow is the movement in net debt from cash flows excluding: transactions with ordinary shareholders; M&A activity; financial penalties paid; exceptional restructuring payments; and the capital element of lease payments. Cash flow is our statutory equivalent, see note 29 on page 176.

Why it is important

Free cash flow is the principal metric to measure the performance of our business and how effectively we are creating value for our shareholders. It enables the business to fund growth, reduce debt and make shareholder payments.

Link to remuneration

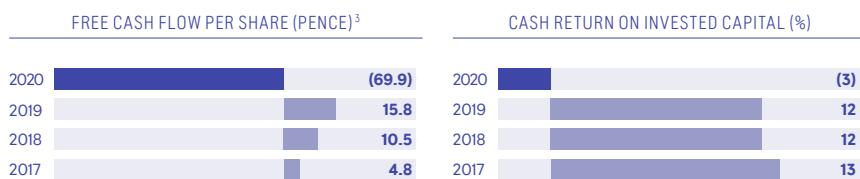
Free cash flow is our key financial metric in the annual bonus plan, accounting for 50% of the overall targets. CPS is a key driver for our LTIP.

¹ Following the adoption of IFRS 15 *Revenue from Contracts with Customers* in 2018, the 2017 figures were restated.

Dotted lines separate pre and post IFRS 15 figures on all affected KPIs.

² The adoption of IFRS 16 *Leases* in 2019 had no material impact on our financial KPIs, see page 206 for more information.

KEY PERFORMANCE INDICATORS

Financial performance indicators^{1,2}**How we define it**

Free cash flow in the year divided by the average number of shares in issue in the year. This measure was introduced in 2018. See page 176 for a reconciliation of underlying to reported cash flow.

Why it is important

Cash flow per share ensures alignment with shareholder interests and is a key measure of the economic performance of our business.

Link to remuneration

CPS is the largest driver of the LTIP at 60% of the total.

How we define it

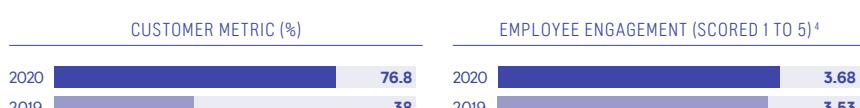
CROIC is calculated as free cash flow divided by invested capital in the year. See page 207 for a full definition of invested capital. This measure was introduced in 2018. See page 176 for a reconciliation of underlying to reported cash flow.

Why it is important

CROIC ensures we invest in programmes and projects which optimise returns for our shareholders with the correct balance between long-term and short-term value.

Link to remuneration

A key driver of CROIC is free cash flow, which is also an important financial performance measure for our annual bonus plan and LTIP.

Non-financial performance indicators**How we define it**

In 2019, we introduced a new balanced scorecard of metrics for each business. The scorecard includes on-time delivery, aircraft on ground and engine availability amongst other indicators. The aggregate outturn is used to determine the customer element of our bonus plan. See page 93 for more information.

Why it is important

Customer satisfaction demonstrates whether we are meeting our commitments to our customers across our businesses. This, in turn, drives our cash and profitability.

Link to remuneration

The customer metric accounts for 12.5% of the target bonus in our annual bonus plan.

How we define it

In 2019, we introduced a new survey, Gallup Q12. Responses are scored on a scale of one to five. The employee engagement score averages the responses to all 12 questions in the survey. See page 42 for more information.

Why it is important

Our people are crucial to delivering future business success. This is an objective way to assess how engaged our employees are with the business and its leaders.

Link to remuneration

Employee engagement performance against our target accounts for 12.5% of our annual bonus plan.

³ Figures for the comparative periods have been adjusted by a factor of 2.91 and restated to reflect the bonus element of the November 2020 rights issue.

⁴ External assurance over the employee engagement score is provided by Bureau Veritas. See page 204 for their assurance statement.

 See Other Financial Information on page 206 for additional commentary on our financial KPIs.

FINANCIAL REVIEW

We took significant and rapid actions to mitigate the financial impact of COVID-19, strengthening our liquidity and restructuring our cost base. These actions position us well to deliver improved financial returns in the future.



STEPHEN DAINTITH, CHIEF FINANCIAL OFFICER

2020 Overview

We entered 2020 with strong momentum having reported encouraging 2019 results. However, the sudden impact of COVID-19 during the first quarter resulted in an immediate and sharp deterioration of our financial performance and resulted in a re-evaluation of our expectations and targets. We responded quickly to this unprecedented crisis by undertaking a number of significant and rapid actions:

- Starting in March 2020, we took a number of proactive steps to conserve cash and delivered over £1bn of cash savings in the year. These savings were delivered through cutting non-critical capital expenditure, significantly reducing discretionary spend, reviewing and rephasing R&D and engineering spend together with role reductions and a temporary 10% salary reduction for our senior management. We prioritised strategic investment in critical programmes, with a focus on lower-carbon solutions and digitalisation.
- As part of this goal to reduce all unnecessary expenditure, we also took the decision to cease invoice factoring, a practice we have used in the past to align cash flows with the physical delivery of products to our customers. This had a one-time £1.bn negative impact on free cash flow in 2020, evident in our first half results.
- We took actions to substantially improve liquidity and protect our balance sheet. Despite the total free cash outflow of £4.2bn in 2020, our liquidity improved to £9.0bn at the end of the year. This reflected £5.3bn of new borrowing facilities and a £2.0bn rights issue. We were well supported by the UK Government through the CCFF loan scheme in April and by the guarantee from UK Export Finance for 80% of our new £2.0bn credit facility, which was syndicated in August.

There was strong appetite from investors for £2.0bn of new bonds in October and we arranged a new £1.0bn credit facility, both facilitated by the successful rights issue at the same time. We have made a good start on our disposal programme which aims to achieve at least £2.0bn of proceeds by early 2022. We have recently announced agreements to sell Civil Nuclear Instrumentation & Control and Bergen Engines, both expected to complete in 2021, and are progressing well with our plans for further disposals beyond these.

- We appreciate all the support that our stakeholders have given us in providing sufficient liquidity to weather the COVID-19 crisis. At the same time, we recognise the significant responsibility we have to secure a sustainable, profitable and cash generative future for Rolls-Royce. As a result, we launched this year the most significant restructuring in our recent history to consolidate our Civil Aerospace footprint and reduce our cost base. It was not a decision we took lightly. By the end of 2020, approximately 7,000 roles had been removed from the Group and we are well on track to achieve our target of at least a 9,000 reduction by the end of 2022.
- In addition, we reduced the size of our FX hedge book by \$11.8bn, reflecting the changed market outlook for Civil Aerospace which means that we now expect lower US dollar receipts in the medium term. This reduction resulted in an underlying finance charge of £1.7bn in 2020. This charge is already accounted for in reported results, as a result of them being presented on a mark-to-market basis (see note 4 on page 133). From a risk management perspective, we firmly believe this was the right action to take.

2021 Outlook

While the near-term outlook for Civil Aerospace remains uncertain and highly sensitive to the developments of the COVID-19 pandemic, we have the benefit of a broad and diverse portfolio, with Defence expected to remain resilient and Power Systems benefitting from its shorter-cycle industrial end market exposure.

We expect free cash outflow in the region of £(2.0)bn in 2021, based on engine flying hours recovering to around 55% of 2019 levels. The cash outflow is expected to be weighted towards the first half of the year and we expect to turn cash flow positive at some point during the second half. We aim to achieve positive free cash flow of at least £750m (excluding disposals) as early as 2022. This is based on engine flying hours exceeding 80% of 2019 levels. However, the exact timing and outturn of turning cash flow positive is dependent on the shape and timing of engine flying hours recovery along with the pace of delivery of our fundamental restructuring programme.

FINANCIAL REVIEW

As you know, I am leaving Rolls-Royce in March 2021 after four lively, often challenging, yet hugely rewarding and enjoyable years. I look back on the good progress we had been making before the impact of COVID-19 and am confident that, following completion of our

fundamental restructuring programme, the Group will once again be well positioned to return to delivering much improved financial returns in the future.

DEFINING OUR ALTERNATIVE PERFORMANCE MEASURES

Business performance is reviewed and managed on an underlying basis. These alternative performance measures reflect the economic substance of trading in the year, including the impact of the Group's foreign exchange activities.

The tables below and to the right summarise the adjustments between reported and underlying results for cash flow, revenue, and operating profit.

For more information on the reconciliation to statutory measures for:

- free cash flow, see note 29 on page 176; and
- revenue and operating profit, see note 2 on page 126.

Cash flow

£m	2020	2019
Reported measure		
Reported cash flow	(995)	(413)
Underlying performance measure		
Reported cash flow	(995)	(413)
Net cash flow from changes in short-term investments, borrowings & lease liabilities	(1,636)	1,385
Movement in net funds from cash flows	(2,631)	972
Exclude: Capital element of lease payments	(284)	(271)
Movement in net funds excluding lease liabilities	(2,915)	701
Rights issue	(1,972)	-
Payments to shareholders	92	224
Business acquisitions & disposals	119	(409)
Penalties paid on agreements with investigating bodies	135	102
Restructuring exceptional cash flow	323	216
Other underlying adjustments	33	39
Free cash flow	(4,185)	873

Revenue

£m	2020	2019
Reported measure		
Reported revenue	11,824	16,587

Underlying performance measure

Reported revenue	11,824	16,587
Derivative & FX adjustments	(61)	(1,137)
Underlying revenue	11,763	15,450

(Loss)/profit

£m	2020	2019
Reported measure		
Reported operating (loss)	(2,081)	(852)
Underlying performance measure		
Reported operating (loss)	(2,081)	(852)
Derivative & FX adjustments	(1,006)	(144)
Programme exceptional charges	(620)	1,409
Restructuring exceptional charges	489	136
Acquisition accounting	133	163
Impairments & asset write-offs	1,417	84
Pension past-service credit	(308)	-
Other underlying adjustments	4	12
Underlying operating (loss)/profit	(1,972)	808

GROUP TRADING SUMMARY

The commentary and income statement below describe underlying performance, with percentage and absolute change figures presented on an organic basis, unless otherwise stated.

Summary income statement

£m	2020	2019	Change ²	Organic ¹ change
Underlying revenue	11,763	15,450	(3,687)	(3,582)
Underlying OE revenue	5,887	7,456	(1,569)	(1,593)
Underlying services revenue	5,876	7,994	(2,118)	(1,989)
Underlying gross (loss)/profit	(512)	2,387	(2,899)	(2,872)
Gross margin %	(4.4)%	15.4%	(19.8)%pt	(19.9)%pt
Commercial and administration costs	(904)	(993)	89	63
Research and development costs	(735)	(696)	(39)	(43)
Joint ventures and associates	179	110	69	70
Underlying operating (loss)/profit	(1,972)	808	(2,780)	(2,782)
Underlying operating margin	(16.8)%	5.2%	(22.0)%pt	(22.2)%pt
Financing costs	(1,986)	(225)	(1,761)	(1,763)
Underlying (loss)/profit before taxation	(3,958)	583	(4,541)	(4,545)
Taxation	(39)	(277)	238	236
Underlying (loss)/profit for the period	(3,997)	306	(4,303)	(4,309)
Underlying (loss)/earnings per share³ (p)	(66.78)	5.44	(72.22)	(72.25)

¹ Organic change at constant translational currency (constant currency) by applying 2019 average rates to 2020 numbers, and excluding M&A. All commentary is provided on an organic basis unless otherwise stated.

² The impact of M&A was £147m on revenue and £6m on underlying operating loss.

³ 2019 earnings per share has been adjusted to reflect the 2.91 bonus element of the rights issue.

Note: 2019 transactions were translated at an achieved rate of £\$1.53, close to the average rate of our hedge book, whereas 2020 transactions were translated at £\$1.24 in the first half and £\$1.33 in the second half, due to not being able to utilise our hedge book in 2020.

Underlying revenue

Organic change of £(3.6)bn (23%) reflected a significant fall in both OE and services revenue largely due to the impact of COVID-19 on end-market demand. Civil Aerospace was the most impacted, down £(3.0)bn (37%) including £(1,061)m of COVID-related negative LTSA catch-ups. Power Systems was down £(530)m (17%) mostly due to lower OE revenue and ITP Aero was £(240)m lower (26%) with a reduction in OE partly offset by a small increase in services. Defence revenue increased by £125m (4%), showing continuity of demand from government customers and effective measures to minimise operational disruption from COVID-19.

Underlying gross loss

The loss of £(512)m was predominantly driven by a £(2.0)bn loss in Civil Aerospace (including £(1.3)bn of COVID-related charges), partly offset by savings from role reductions and cost mitigations. Power Systems, Defence and ITP Aero all contributed positively, with Defence achieving an increase on the prior year.

Commercial and administration costs

Reduced by £63m, reflecting some of the savings from the Group-wide focus on cost mitigations in response to COVID-19.

Research and development costs

An increase of £43m reflected lower capitalisation due to the maturity of key aero engine programmes, partly offset by a reduction in expenditure due to our cost mitigation efforts to re-phase non-critical spending.

Underlying operating loss

The loss of £(2.0)bn reflected the gross loss and a higher R&D charge, partly offset by higher profit from joint ventures and associates and a reduction in C&A costs.

Financing costs

Costs of £(2.0)bn included a one-off underlying finance charge of £(1.7)bn, mostly taken in the first half, to reduce the size of our USD hedge book by \$11.8bn in response to a lower medium-term outlook for US\$ cash receipts following COVID-19.

Taxation

The £(39)m tax charge (2019: £(277)m) reflected the tax on overseas profits together with the fact that we have not recognised any deferred tax on UK losses arising in 2020. In addition, £(51)m of the deferred tax previously recognised on UK losses was derecognised.

FINANCIAL REVIEW

GROUP REPORTED RESULTS

Consistent with past practice, we provide both reported and underlying figures. As the Group does not generally hedge account for forecast transactions in accordance with IFRS 9 *Financial Instruments*, we believe underlying figures are more representative of the trading performance by excluding the impact of period-end mark-to-market adjustments. In particular, the USD:GBP hedge book has a significant impact on the reported results. In 2020, the USD:GBP spot rate moved from 1.32 to 1.36 while the EUR:GBP rate moved from 1.18 to 1.11.

Underlying performance also excludes the effect of acquisition accounting and business disposals, impairment of goodwill and other non-current and current assets, and exceptional items. These are included in arriving at reported results. The adjustments between the underlying income statement and the reported income statement are set out in Note 2 to the Consolidated Financial Statements. This basis of presentation has been applied consistently.

Reconciliation between underlying and reported results

£m Year to 31 December	Revenue		(Loss)/profit before financing and tax		Net financing	
	2020	2019	2020	2019	2020	2019
Underlying						
1 Impact of settled derivative contracts on trading transactions	61	1,137	998	145	(324)	80
2 Unrealised fair value changes on derivative contracts held for trading	–	–	8	(1)	(85)	(6)
3 Unrealised net losses on closing future over-hedged position	–	–	–	–	1,503	–
4 Realised net losses on closing over-hedged position	–	–	–	–	202	–
5 Unrealised fair value change to derivative contracts held for financing	–	–	–	–	(86)	1
6 Exceptional programme credits/(charges)	–	–	620	(1,409)	(36)	–
7 Impact of discount rate changes	–	–	–	–	3	(40)
8 Exceptional restructuring charge	–	–	(489)	(136)	–	–
9 Impairments	–	–	(1,293)	(84)	–	–
10 Other write-offs	–	–	(124)	–	–	–
11 Effect of acquisition accounting	–	–	(133)	(163)	–	(8)
12 Pension past-service credit	–	–	308	–	–	–
Other	–	–	(4)	(12)	(6)	20
13 Gains/(loss) arising on the acquisitions and disposals of businesses	–	–	(14)	139	–	–
Total underlying adjustments	61	1,137	(123)	(1,521)	1,171	47
Reported	11,824	16,587	(2,095)	(713)	(815)	(178)

The most significant items included in the reported income statement, but not in underlying, are summarised below:

1. The impact of measuring revenues and costs and the impact of valuation of assets and liabilities using the period end exchange rate rather than the achieved rate or the exchange rate that is expected to be achieved by the use of the hedge book increased reported revenues by £61m (2019: £1,137m) and reduced loss before financing and taxation by £998m (2019: increased profit by £145m). Underlying financing excludes the impact of revaluing monetary assets and liabilities at the period end exchange rate.
2. The underlying results exclude the fair value changes on derivative contracts held for trading. These fair value changes are subsequently recognised in the underlying results when the contracts are settled.
3. In response to the deterioration in the medium-term outlook caused by COVID-19 and the related reduction in anticipated net US dollar cash inflows, the Group has taken action to reduce the size of the US dollar hedge book by \$1.8bn predominately by transacting offsetting foreign exchange forward contracts across 2020-2026, resulting in a £1,689m charge to underlying results. The £1,503m included in unrealised loss (shown above) is the net cost of closing out the over-hedged position in future years. The cost related to future years has been included within the underlying

performance. It is reversed in arriving at reported performance on the basis that, the cumulative fair value changes on these derivative contracts are recognised as they arise.

4. In 2020, the Group incurred a cash outflow of £186m as a result of closing out \$1.2bn of the \$11.8bn hedge book reduction and a cash outflow of £16m to settle an over-hedged jet fuel position. The realised loss of £202m is included in underlying financing costs.
5. Includes the losses on hedge ineffectiveness in the year of £11m (2019: losses £13m) and net fair value losses of £75m (2019: profit £14m) on any interest rate swaps not designated into hedging relationships for accounting purposes.
6. In 2019, abnormal wastage costs were recorded in respect of the Trent 1000, related to remediation shop visit costs, customer disruption costs and contract losses. During the year, the total estimated Trent 1000 abnormal wastage costs have reduced by £620m as a result of COVID-19 made up of £390m (a gross provision release of £560m, offset by the impact of expected actual exchange rates and the share of the costs borne by RRSAs) related to remediation shop visit costs and customer disruption costs and an improvement of £230m in the position on contract losses.
7. Discount rates have increased on exceptional contract loss provisions in relation to the Trent 900 and Trent 1000.

FINANCIAL REVIEW

8. At 31 December 2020, the Group recorded an exceptional restructuring charge of £489m following the announcement on 20 May 2020 to reshape and resize the Group due to the financial and operational impact of COVID-19 (see note 22 for more detail).
9. The Group has assessed the carrying value of its assets given the financial and operational impact of COVID-19 on the Group's future cash flow forecasts. Consequently, a number of impairments and write-offs have been recorded at 31 December 2020. Impairments comprise: intangible assets £567m, mainly related to programme intangibles; property, plant and equipment £318m (including £219m related to site rationalisation); right-of-use assets £384m, comprising engines of £311m, £69m of site rationalisation and £4m of other impairments; and a £24m impairment on the carrying value of investments held.
10. Other write-offs include £149m of participation fees in contract assets, £2m in provisions for site rationalisation, offset by £(27)m for RRSA deferred cost contributions in payables. These write-offs are primarily a result of the impact of COVID-19.
11. The effect of acquisition accounting includes the amortisation of intangible assets arising on previous acquisitions.
12. The Group recorded a past service gain of £308m (of which £248m was recorded at 30 June 2020) following changes to the pension benefits under the terms of the Rolls-Royce UK Pension Fund (RRUKPF), a defined benefit scheme. In respect of the £248m gain recorded at 30 June 2020, £127m was subsequently recognised as actuarial losses through other comprehensive income at 31 December 2020 – see note 2 and 23.
13. Gains/(losses) arising on the acquisitions and disposals of businesses includes the acquisition of Qinous GmbH (increasing the Group's shareholding from 24% to 100%), the sale of the North America Civil Nuclear business, the sale of the Knowledge Management Systems business and the sale of Trigno Energy Srl.

Tax affecting these adjustments resulted in a tax charge of £(220)m (2019: £(143)m). The charges in 2020 and 2019 are mainly due to the non-recognition of deferred tax on UK losses arising in those years. The charge in 2020 includes a tax credit of £160m in respect of the change in the UK tax rate and a tax charge of £(276)m relating to the derecognition of some of the deferred tax asset on UK losses previously recognised. The 2019 charge included £(86)m relating to the derecognition of UK deferred tax assets on foreign exchange and commodity financial assets and liabilities.

GROUP FUNDS FLOW

Summary funds flow statement¹

£m	Full-year to 31 December		
	2020	2019	Change
Underlying operating (loss)/profit	(1,972)	808	(2,780)
Depreciation, amortisation and impairment	951	1,068	(117)
Lease payments (capital plus interest)	(379)	(319)	(60)
Expenditure on intangible assets	(316)	(591)	275
Capital expenditure (PPE)	(579)	(747)	168
Change in inventory	588	(43)	631
Movement in receivables/payables/contract balances (excluding Civil LTSA)	(2,207)	492	(2,699)
Civil Aerospace net LTSA balance change	479	754	(275)
Of which: underlying change	(582)	654	(1,236)
Of which: impact of contract catch-ups	1,061	100	961
Movement on provisions	(195)	(506)	311
Cash flows on settlement of excess derivative contracts	(202)	–	(202)
Fees on undrawn facilities	(97)	–	(97)
Net interest received and paid	(75)	(73)	(2)
Trent 1000 insurance receipt	–	173	(173)
Other	(110)	41	(151)
Trading cash flow	(4,114)	1,057	(5,171)
Contributions to defined benefit pensions in excess of underlying PBT charge	160	(9)	169
Taxation paid	(231)	(175)	(56)
Group free cash flow	(4,185)	873	(5,058)
Shareholder payments	(92)	(224)	132
Rights Issue	1,972	–	1,972
Disposals and acquisitions	(119)	409	(528)
Exceptional Group restructuring	(323)	(216)	(107)
Payment of financial penalties	(135)	(102)	(33)
Other underlying adjustments	(33)	(39)	6
Movements in net funds from cash flows (excluding lease liabilities)	(2,915)	701	(3,616)
Capital element of lease repayments	284	271	13
Movements in net funds from cash flows	(2,631)	972	(3,603)
Movement in short-term investments	6	–	6
Net cash flow from changes in borrowings and lease liabilities	1,630	(1,385)	3,015
Reported cash flow	(995)	(413)	(582)

¹ The derivation of the summary funds flow statement above from the reported cash flow statement is included on page 176.

FINANCIAL REVIEW

Free cash flow

Group free cash outflow of £(4,185)m deteriorated from a £873m inflow in 2019. The key drivers of this outflow were significantly lower engine flying hour receipts as global travel dramatically declined and working capital outflows, including the decision to cease invoice discounting, as our OE and aftermarket volumes declined. Trent 1000 in-services cash costs were £(524)m (2019: £(578)m).

Key changes in the funds flow items are described below:

Depreciation, amortisation and impairments

The decrease of £(117)m was largely driven by lower overall additions across intangible assets and property, plant and equipment as a result of management actions to reduce cash expenditure and a £102m adjustment to residual value guarantees which is non-cash and increased underlying operating profit.

Lease payments (capital plus interest)

Lease payments were higher than prior year largely due to changes in FX achieved rates used to convert US dollar lease payments into GBP.

Additions of intangible assets

Expenditure included £(232)m capitalised R&D (2019: £481m), lower than 2019 due to completion of capitalisation of the Trent 1000 and Pearl 15 engine R&D, reflecting the maturity of these programmes, and no further capitalisation on the Pearl 700 programme.

Purchases of property, plant and equipment

Investment was lower than 2019 primarily as a result of management actions to reduce cash costs to mitigate the impact of COVID-19.

Decrease in inventory

The £588m decrease in 2020 (2019: £(43)m increase) was led by COVID-19 driven demand reductions as well as significant improvement measures delivered in Civil Aerospace, partly offset by certain actions to safeguard necessary parts supply in 2021.

Movement in receivables/payables/contract balances (excluding Civil Aerospace LTSA)

The £(2,207)m movement in 2020 reflected:

- £0.4bn increase in receivables reflecting the decision to cease invoice discounting (£1.1bn increase), partly offset by significantly lower trading activity especially in Civil Aerospace.
- £1.8bn reduction in payables reflecting lower amounts owed to suppliers, JVs and Risk and Revenue Share Partners (RRSPs) due to COVID-19 led demand reductions. In addition, reduction in OE deposits reflecting utilisation in Civil Aerospace. This was partly offset by new deposits in Defence and an increase in the Civil Aerospace OE engine concessions payable, due to aircraft delivery delays and associated concession payment deferrals.

Movement in underlying Civil Aerospace net LTSA balance

The LTSA net balance increased by £479m. There was a significant reduction in widebody and regional invoiced engine flying hour receipts during 2020 due to lower flying activity, resulting in a £(582)m underlying reduction to the net LTSA balance as revenues traded exceeded invoiced flying hour receipts. However, this was more than offset by the impact of £1,061m of contract catch-ups, principally driven by a forecast reduction in engine flying hour receipts due to the COVID-19 pandemic, which reduced revenue recognised during the year.

Movement on provisions

The £(195)m movement reflected a decrease in the provision balance driven by Trent 1000 provision utilisation during the period partly offset by new provisions charges (details on page 163), largely as a result of COVID-19 which include the impact from the up-front recognition of future losses on a small number of loss-making Civil Aerospace contracts.

Interest

The net payment of £(75)m in 2020 was £2m higher than prior year, reflecting movements in the overall total amount of debt and interest rates. £5.3bn of additional debt was raised during 2020. At 31 December 2020, £5.5bn of total debt was undrawn.

Contributions to defined benefit pensions

Cash contributions were £160m lower than the charge on the income statement (2019: £9m higher). The £169m year-on-year movement reflected early payment in 2019 of contributions due in 2020 and deferral of certain 2020 contributions into 2021.

Taxation

The cash tax payments in 2020 were £(231)m compared to £(175)m in 2019. The increase reflected higher payments in Germany, largely due to timing.

Payments to shareholders

The £(92)m interim dividend was announced in August 2019 and paid in January 2020. Reflecting the Group's financial priorities and the challenging macro environment, the Board did not recommend a final dividend in respect of 2019.

Rights issue

In November 2020, a 10:3 rights issue raised net proceeds of £1,972m.

Acquisitions and disposals

Net costs of £(119)m included the acquisitions of Qinous, Kinolt and Servowatch; offset by disposal proceeds related to Civil Nuclear North America, Knowledge Management Systems, Trigno, Exostar and a L'Orange earn-out adjustment and M&A costs.

Exceptional Group restructuring

Payments of £(323)m relating to the 2020 fundamental restructuring programme were made in 2020, of which £55m related to restructuring capital expenditure.

Payment of financial penalties

The penultimate payment of £(155)m relating to the deferred prosecution agreement (DPA) was made in January 2020.

Other underlying adjustments

Outflow of £(33)m includes timing of cash flows on a prior period disposal where the Group retains the responsibility for collecting cash before passing it on to the acquirer.

Net cash flow from changes in borrowings (excluding lease liabilities)

During the year, the Group issued £1,972m (\$1,000m, €750m and £545m) of bond notes as well as £300m of commercial paper under the Covid Corporate Financing Facility. The Group also repaid a maturing \$500m (£328m) bond.

BALANCE SHEET

£m	31 Dec 2020	31 Dec 2019 adj HfS ³	31 Dec 2019 as reported	Change adj HfS ³
Intangible assets	5,145	5,431	5,442	(286)
Property, plant and equipment	4,515	4,798	4,803	(283)
Right-of-use assets	1,405	2,001	2,009	(596)
Joint ventures and associates	394	402	402	(8)
Contract assets and liabilities	(8,922)	(8,736)	(8,745)	(186)
Working capital ¹	570	(1,243)	(1,136)	1,813
Provisions	(1,945)	(2,780)	(2,804)	835
Net debt ²	(3,627)	(1,020)	(993)	(2,607)
Net financial assets and liabilities ²	(3,111)	(3,275)	(3,277)	164
Net post-retirement scheme surpluses/(deficits)	(673)	(199)	(208)	(474)
Tax	1,295	1,130	1,136	165
Held for sale	60	123	3	(63)
Other net assets	19	14	14	5
Net liabilities	(4,875)	(3,354)	(3,354)	(1,521)
Other items				
US\$ hedge book (US\$bn)	25	37	37	(12)
Civil LTSA asset	726	1,086	1,086	(360)
Civil LTSA liability	(6,841)	(6,784)	(6,784)	(57)
Civil net LTSA liability	(6,115)	(5,698)	(5,698)	(417)

¹ Net working capital includes inventory, trade receivables and payables and similar assets and liabilities.

² Net debt includes £251m (2019: £243m) of the fair value of financial instruments held to hedge the fair value of borrowings.

³ 2019 adjusted for assets held for sale (HfS) (Bergen Engines AS and Civil Nuclear Instrumentation and Control business) to aid comparability.

Key drivers of balance sheet movements (adjusted for assets held for sale) were:

Intangible assets

Net decrease of £(286)m included impairments of £(579)m, mostly related to the impact of COVID-19. Additions of £364m primarily related to programme development in Civil Aerospace and investment in software applications. Acquisitions of Kinolt Group, Qinous GmbH and Servowatch Systems added £137m. There was a £137m FX impact and amortisation was £(323)m.

Property, plant and equipment

Net decrease of £(283)m included impairments of £(332)m and depreciation of £(489)m partly offset by £38m FX impact and additions of £553m. The additions were lower than the prior year as spending was limited to critical infrastructure projects.

Right-of-use assets

Net reduction of £(596)m was driven by impairments of £(386)m, primarily of lease engines in Civil Aerospace and land and buildings as part of our footprint consolidation. The depreciation charge was £(346)m. Additions were £135m, £92m lower than the prior year.

Contract assets and liabilities

The net liability balance increased by £(186)m, of which £(417)m related to the Civil Aerospace LTSA balance and included foreign exchange of £62m and negative LTSA catch-ups of £(1,061)m. The remainder largely covered reduction in deposits in Civil Aerospace partly offset by new deposits in Defence.

Working capital

The £570m net current asset position reflected a £1.8bn change on the prior year.

- Receivables increased by £0.4bn as a £1.1bn reduction in invoice discounting was partly offset by lower trading activity in Civil Aerospace.
- Payables reduced by £1.8bn primarily due to COVID-19 led demand reductions and comparatively stronger Q4 2019 trading activity.

– Inventory reduced by £0.5bn largely due to COVID-19 led demand reductions and parts rescheduling in Civil Aerospace partly offset by growth in Defence to protect 2021 deliveries and support the supply chain.

– The movement also included a financial penalty payment of £135m related to agreements reached with investigating authorities in January 2017.

Provisions

The £835m decrease reflected net restructuring charges of £(373)m, of which £206m was utilised in 2020 and Trent 1000 provisions utilisation and release of £541m and £560m respectively.

Net debt

Increased to £(3.6)bn (including lease liabilities) primarily driven by free cash outflow of £(4.2)bn partly offset by £2.0bn of rights issue proceeds.

Net financial assets and liabilities

The £164m change was primarily driven by the utilisation of derivatives of £246m partially offset by the fair value movement in currency exchange rates and other derivatives.

Net post-retirement scheme surpluses/deficits

The £(474)m movement was driven by reduction in the UK surplus reflecting changes to members' benefits as part of restructuring the UK pension, closure of the scheme and deferral of company contributions. There have also been changes in financial and demographic assumptions across both the UK and overseas schemes. See note 23.

US\$ hedge book

Due to the impact of COVID-19 on Civil Aerospace our forecast future US\$ receipts reduced significantly. As a result, we took the necessary decision to reduce the size of our hedge book by \$11.8bn to \$25bn. Our US\$ hedge book runs to 2028. The total cost of closing out the over-hedged position is £(1.7)bn, of which £(186)m was incurred in 2020. The remainder of the cash outflow will be incurred over the next six years.



CIVIL AEROSPACE

Civil Aerospace is a major manufacturer of aero engines for the large commercial aircraft, regional jets and business aviation markets. The business uses its engineering expertise, in-depth knowledge and capabilities to provide through-life support solutions for its customers.

UNDERLYING REVENUE

£5,089m

2019: £8,107m

UNDERLYING (LOSS)/PROFIT

£(2,574)m

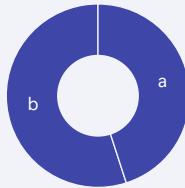
2019: £44m

ORDER BACKLOG

£42.4bn

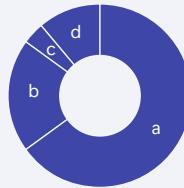
2019: £48.5bn

UNDERLYING REVENUE MIX



a. OE **45%**
b. Services **55%**

UNDERLYING REVENUE MIX BY SECTOR



a. Large Engines **65%**
b. Business Aviation **20%**
c. Regional **4%**
d. V2500 **11%**

Overview of 2020

Civil Aerospace was heavily impacted by COVID-19 in 2020. Large engine deliveries fell by 48% to 264 and large engine flying hours fell to 43% of 2019 levels as travel restrictions limited air traffic. Business aviation was less severely impacted, with engine deliveries down 16%. In response to the market impact, we have undertaken a fundamental restructuring of Civil Aerospace, which will substantially reduce our fixed cost base and position the business to deliver healthy profits and cash generation as the market recovers.

£m	2020	2019	Change	Organic change
Underlying revenue	5,089	8,107	(37)%	(37)%
Underlying OE revenue	2,298	3,246	(29)%	(29)%
Underlying services revenue	2,791	4,861	(43)%	(43)%
Underlying gross (loss)/profit	(2,005)	622	(422)%	(422)%
Gross margin %	(39.4)%	7.7%	(47.1)%pt	(47.1)%pt
Commercial and administration costs	(302)	(306)	(1)%	(2)%
Research and development costs	(436)	(374)	17%	16%
Joint ventures and associates	169	102	66%	66%
Underlying operating (loss)/profit	(2,574)	44	(2,618)	(2,612)
Underlying operating margin %	(50.6)%	0.5%	(51.1)%pt	(51.0)%pt

Key operational metrics

	2020	2019	Change
Large engine deliveries	264	510	(48)%
Business jet engine deliveries	184	219	(16)%
Total engine deliveries	448	729	(39)%
Large engine LTSA flying hours	6.6m	15.3m	(57)%
Large engine LTSA major refurb	272	306	(11)%
Large engine LTSA check & repairs	559	660	(15)%
Total large engine LTSA shop visits	831	966	(14)%

Financial overview

- Production cuts from airframer customers resulted in substantially fewer large engine deliveries in 2020. Business jet deliveries were resilient in the first half of the year but reduced during the second half as the airframers adjusted to the impact on demand from COVID-19.
- Large engine LTSA flying hours were 43% of 2019 level. Flying hour performance was significantly more robust in newer engine programmes than more mature types.
- Business aviation LTSA engine flying hours were resilient, however there was a significant reduction in both regional and V2500 flying hours.
- Large engine LTSA major service visits were 11% lower than prior year, particularly in the second half of the year when we saw a substantial reduction in activity.
- Roles reduced by approximately 5,500 (20%), with most of the departures taking place in the second half of 2020 as a result of the fundamental restructuring programme.
- Agreement reached with Airbus to extend Trent XWB-84 exclusive position on A350-900 to 2030.
- Underlying revenue reduced by 37% to £5.1bn (2019: £8.1bn). This decline was driven by the reduction in engine delivery volumes, particularly for large engines, lower aftermarket revenues reflecting fall in shop visit volumes, and included a £(1.1)bn impact from negative LTSA contract catch-ups.
- Underlying gross loss of £(2.0)bn, £(2.6)bn lower than 2019. This reflected:
 - £(1.3)bn of largely COVID-related one-time charges:
 - LTSA catch-ups: £(974)m impact to profit from negative LTSA catch-ups, mainly driven by a forecast reduction in engine flying hour receipts as a result of COVID-19 and principally impacting mature engine programmes;
 - up-front recognition of future losses: primarily due to COVID-19 certain contracts have either become loss-making or have seen an increase in expected losses, driving a £(213)m charge; and
 - £(86)m charge reflecting specific customer provisions due to the impact of COVID-19 on the civil aviation industry and our customers' financial positions.

- A material reduction in trading performance, primarily reflecting the impact of COVID-19:
 - a substantial reduction in large engine aftermarket, driven by lower shop visit volumes, adverse margin mix on LTSA shop visits, and reduced time & materials (T&M) profits;
 - lower OE profits from business aviation and reduced volumes of large spare engine sales, which offset the benefit from lower installed widebody engine volumes; and
 - a material impact in 2020 from under-recovery of fixed costs.
- Commercial and administration costs were relatively unchanged year-over-year, with cost reduction actions delivered in the year reflected more heavily in cost of sales and R&D spend.
- Research and development costs of £(436)m reflected a significant reduction in capitalisation during the period due to the maturity of key aero engine programmes partly offset by a reduction in expenditure due to the reducing investment burden on our new engine programmes and the rephasing of some R&D spending in light of COVID-19. Spending continued to shift towards next generation gas turbine technology and low carbon solutions such as electric and hybrid-electric aircraft.
- Underlying operating loss of £(2.6)bn reflected the fall in gross profit and slightly higher R&D charge, partly offset by an increase in profits from joint ventures and associates.
- Trading cash flow was a £(4.6)bn outflow during the year (2019: £419m inflow). This deterioration was driven by significantly lower engine flying hour receipts as well as a material working capital outflow, including the one-time impact from the cessation of invoice factoring in 2020.
- Trent 1000 and Trent XWB update: During 2020 in-service cash costs on Trent 1000 were in line with guidance at £(524)m and in June we reached our goal of zero aircraft on ground (AoG) due to the durability issues. There was a £620m exceptional credit reflecting a £390m net improvement in the outlook for future in-service cash costs, alongside a £230m improvement in expected future losses on our small number of loss-making contracts primarily due to the impact of COVID-19 on flying activity. Early identification and action regarding durability issues on the Trent XWB announced in August 2020 did not result in any grounded aircraft and it was not necessary to provide for any material additional costs in the year.

Operational and strategic review

The aviation industry was severely affected by the COVID-19 pandemic and the travel restrictions put in place by governments around the world in response.

After more than a decade of growth, commercial air traffic fell by 66% during 2020. While there was a gradual recovery, it was slower than expected and largely halted in December due to the impact of the second wave of COVID-19 across much of the world. Throughout the year, we worked tirelessly to ensure that our airline customers could continue to use their Trent engines – utilising new remote inspection techniques in order to abide with national restrictions on movement or working practices – or store them properly so they can be readily put back into service when restrictions ease.

Our airline customers also adopted various mitigating measures in 2020, including postponing investment in new aircraft. This led to a material reduction in large commercial aircraft production from both major airframers, Boeing and Airbus.

While business jet demand was more robust than widebody, it was not immune from the effects of the pandemic and travel restrictions. During 2020, we delivered the 8,000th engine from our site in Dahlewitz, Germany, and our BR725 engine, which powers Gulfstream's G650 business aircraft family, achieved one million flying hours.

The effects of COVID-19 are expected to be felt in our markets for a number of years. To respond to the new medium-term outlook and return the business to profitability, we launched a fundamental restructuring of our Civil Aerospace business. The programme includes:

- a significant reduction in Civil Aerospace headcount, representing a majority of the 9,000 roles to be removed across the Group by the end of 2022. This has been progressed at pace, with over 5,500 roles removed from Civil Aerospace during 2020, primarily through voluntary severance;
- a major footprint review to reduce fixed costs. This comprises a reduction from three widebody assembly and test facilities to one, as well as consolidating production facilities across a number of widebody components; and
- linked to this footprint review, we have announced plans to enhance the scope of ITP Aero. This involves the transfer of our engine structures activities in Barnoldswick, UK, into ITP Aero, as well as the transfer of our site and workforce in Hucknall, UK, which manufactures a range of aero-engine parts. These changes will deliver cost reductions for Civil Aerospace and increase the value of ITP Aero.

Outside our response to COVID-19, excellent progress was made during 2020 in resolving the Trent 1000 in-service issues. Partially aided by the lower aircraft utilisation due to the pandemic, we were able to meet our target to reduce the number of aircraft on ground to single-digits by mid-year, subsequently reaching zero. We now have a buffer of available engines to safeguard against any risk of future disruption.

Despite the COVID-19 pandemic, construction work on Testbed 80, the world's largest testbed, was completed during the year and in early 2021 we conducted our first test run on a Trent XWB engine.

Longer term, we continue to position ourselves for the transition to a low carbon future for commercial aviation. Our next generation gas turbine, UltraFan, will progress to final assembly in 2021. The parts for our first engine demonstrator went into production in 2020 including the power gearbox, fan blades and fan case.

In November, we undertook successful ground tests using 100% sustainable aviation fuel (SAF) for the first time in a Trent 1000 engine, with additional tests planned in 2021 using our Pearl 700 business jet engine. These tests aim to demonstrate that our engines can operate with 100% SAF as a 'drop-in' alternative to conventional jet fuel. This exceeds current certification requirements which limit SAF to a 50% blend. We believe SAF represents a vital solution to the challenge of decarbonising long-haul travel.

At the smaller end of the market, electric and hybrid-electric technologies are set to power a new generation of fixed-wing and vertical take-off aircraft, providing an opportunity for us to disrupt a new market. In the small propeller category, our first prototype of an electric propulsion unit to serve small propeller aircraft with two to four seats, the RRP70, gained an agreed certification plan with EASA; and in the commuter market we announced plans to work with leading general aviation manufacturers, Tecnam, to jointly develop an all-electric 11-seater aircraft. In the urban air mobility space, we provided the propulsion system for the CityAirbus demonstrator which successfully completed its flight test programme in 2020. Finally, work on our ACCEL all-electric aircraft programme continued in 2020 as we completed ground testing of the technology that will power what we hope will be the world's fastest all-electric plane, with a record breaking attempt planned for 2021.

Civil Aerospace outlook

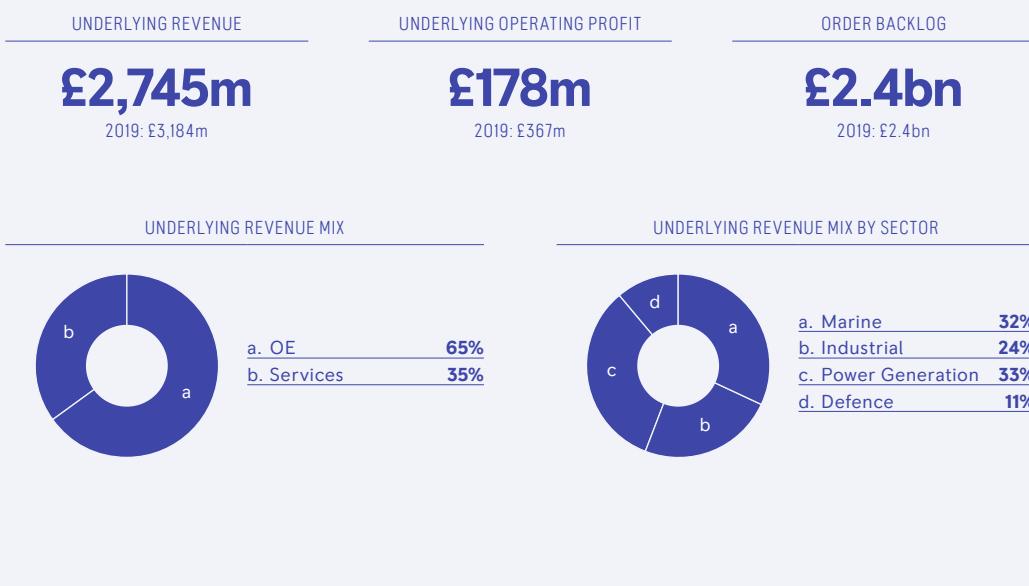
The near-term environment for Civil Aerospace remains highly uncertain. We continue to plan for a range of recovery scenarios, including the risk of further setbacks to the recovery in air travel caused by new strains of the COVID-19 virus. However, our central assumption is for a gradual market recovery in 2021, with a slow start to the year but accelerating in the second half as global vaccine roll-outs progress and travel restrictions ease.

We anticipate large engine flying hours of approximately 55% of 2019 levels in 2021 (2020: 43%), with a strong second-half weighting as the recovery accelerates, and approximately 80% of 2019 levels in 2022. Engine deliveries will remain low with 200 to 250 large engines and 100 to 150 business jet engine deliveries planned for 2021.

Our severe but plausible downside scenario assumes approximately 45% EFH in 2021 and 70% in 2022, both compared to the 2019 level. More details can be found on pages 52 to 54.

POWER SYSTEMS

Power Systems is a leading provider of high-speed reciprocating engines and complete propulsion and power generation systems. It serves the marine, defence, power generation and industrial markets.



Overview of 2020

Power Systems saw a varied impact from COVID-19, with significant reductions to industrial activities due to the weak economic environment but greater resilience in other areas, notably governmental marine. Despite COVID-19, we made significant progress against our medium-term strategy during 2020, expanding our power generation product portfolio, growing sales in China, and expanding our gas and low carbon offerings. While near-term conditions remain challenging, we believe Power Systems is positioned to recover relatively quickly when the macroenvironment improves.

£m	2020	2019 ¹	Change ²	Organic change
Underlying revenue	2,745	3,184	(14)%	(17)%
Underlying OE revenue	1,794	2,183	(18)%	(21)%
Underlying services revenue	951	1,001	(5)%	(6)%
Underlying gross profit	681	878	(22)%	(25)%
Gross margin %	24.8%	27.6%	(2.8)%pt	(2.7)%pt
Commercial and administration costs	(337)	(343)	(2)%	(6)%
Research and development costs	(167)	(166)	1%	(2)%
Joint ventures and associates	1	(2)	-	-
Underlying operating profit	178	367	(51)%	(52)%
Underlying operating margin %	6.5%	11.5%	(5.0)%pt	(4.9)%pt

¹ The underlying results for 2019 have been restated to reclassify Bergen Engines AS and the Civil Nuclear Instrumentation and Control business as non-core.

² The impact of M&A was £55m on revenue and £nil on underlying operating profit.

Financial overview

- Order intake of £2.7bn was 17% lower year-on-year, a book-to-bill of 1.0x during 2020. Commercial marine was impacted by lower tourism and yacht production facility closures, while economic uncertainty led to a deferral of capital spending across power generation and industrial customers. However, there were signs of recovery in order intake in the second half and the underlying demand in key areas including mission-critical back-up generation remained strong.
- Underlying revenue reduced by 17% to £2,745m. This reflected a fall in industrial and power generation revenues, with marine relatively stable due to strong governmental demand. OE revenue was down 21% while Services were more resilient, down just 6%.
- Underlying gross profit of £681m was 25% lower year-over-year. This reflects the lower sales, reduced factory utilisation, and an adverse mix effect due to the sharper fall in high-margin aftermarket spare parts.
- Commercial and administration costs fell 6% to £(337)m primarily reflecting management actions to mitigate costs.
- Research and development costs of £(167)m were focused on the investment in lower carbon areas across our portfolio. This includes our expanding gas engine family, electric and hybrid-electric solutions (supported by the acquisition of battery storage company Qinous), and hydrogen solutions, such as our new co-operation with Daimler on hydrogen fuel cells.
- Underlying operating profit of £178m with a margin of 6.5%, 4.9%pts lower than prior year, reflecting the drop in gross profit, partly offset by the improvements in C&A and R&D.

Operational and strategic review

COVID-19 substantially impacted Power Systems during 2020, with delays to certain large projects, as well as a drop in new orders and aftermarket sales. Industrial markets were most affected, as the impact of COVID-19 was compounded by low commodity prices in mining and oil & gas, while project delays weakened construction sales. Other areas of Power Systems were more resilient, notably the Chinese market and governmental marine sales.

Despite COVID-19, we reached major landmarks across all of our five key strategic opportunities during the year. These five opportunities are: capturing growth in power generation, increasing share in China, expanding our gas portfolio, enhancing services, and shifting towards integrated system solutions with a renewable energy focus.

In power generation, economic uncertainty impacted order intake during 2020 however, longer term, we continue to anticipate rising demand led by mission-critical back-up power solutions for data centres and hospitals.

In China, economic conditions recovered quickly and we continued to drive our strategy of partnerships and local production. In November, we announced a record level of provisional agreements at the China International Import Expo, for almost 1,000 MTU engines and systems. In addition, we signed two new strategic partnerships with Chinese companies from the marine, power generation and mining industries.

Our gas portfolio expansion continued with the launch of the new MTU Series 500 engine for power generation, which will initially be offered for operation with natural gas but from end 2021 will also be available for power by biogas. The 500 series is also hydrogen-ready, which means that the engines can be converted to hydrogen operation at a later date. In addition, 2020 saw the premiere of our twin 16-cylinder gas engines with Dutch shipping company Doeksen.

In July, we took a further step in enhancing our services platform, signing a memorandum of understanding with MAN Energy Solutions to collaborate on mya, an open asset and fleet management system.

Most importantly, we reached a number of milestones in our effort to transition towards complete system solutions and low carbon products. These milestones included:

- the creation of a new organisational unit called ‘Power Lab’ to focus on innovative energy solutions to support our net zero drive;
- significant advancements in battery storage products, beginning with the acquisition of a majority stake in storage specialist Qinous in January, which is now central to our microgrid solutions business. We also increased our capacity for producing battery containers with the announcement of a new production facility in Bavaria;
- the acquisition of Kinolt, a specialist in dynamic, uninterruptible power supply systems, completes our product offering in back-up power generation; and
- the announcement of a partnership with Daimler Truck AG on stationary fuel-cell generators, as CO₂ neutral emergency power generators for safety-critical facilities including data centres and hospitals.

Power Systems outlook

Uncertainty remains over the near-term economic outlook. However, based on Power Systems’ short-cycle exposures and the growth potential in key markets such as China, we expect an improvement in order intake during the first half of 2021, converting into a recovery in sales from the second half of the year with revenues returning to approximately 2019 levels in 2022. Longer term there are significant growth opportunities for Power Systems across both existing activities (notably in mission-critical back-up power and expansion in China) and in new low carbon solutions such as microgrids, hydrogen and hybrid-electric power solutions.

DEFENCE

Defence is a market leader in aero engines for military transport and patrol aircraft with strong positions in combat and helicopter applications. It has significant scale in naval and is the technical authority for through-life support of the nuclear power plant for the Royal Navy's submarine fleet.

UNDERLYING REVENUE

£3,366m

2019: £3,250m

UNDERLYING OPERATING PROFIT

£448m

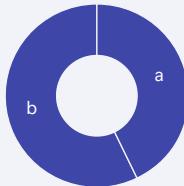
2019: £415m

ORDER BACKLOG

£7.5bn

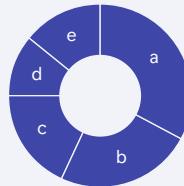
2019: £8.6bn

UNDERLYING REVENUE MIX



a. OE **43%**
b. Services **57%**

UNDERLYING REVENUE MIX BY SECTOR



a. Transport	33%
b. Combat	24%
c. Submarines	18%
d. Naval	11%
e. Other	14%

Overview

Defence had a strong year in 2020, growing underlying revenue and underlying operating profit despite COVID-19. Throughout the pandemic, Rolls-Royce has received support from its customer base with several government customers accelerating payments and programmes. All Defence facilities remained open throughout the year with decisive and early actions taken to protect employees and maintain the supply chain.

£m	2020	2019	Change	Organic change
Underlying revenue	3,366	3,250	4%	4%
Underlying OE revenue	1,436	1,461	(2)%	(1)%
Underlying services revenue	1,930	1,789	8%	8%
Underlying gross profit	686	669	3%	3%
Gross margin %	20.4%	20.6%	(0.2)%pt	(0.2)%pt
Commercial and administration costs	(151)	(158)	(4)%	(4)%
Research and development costs	(96)	(105)	(9)%	(9)%
Joint ventures and associates	9	9	–	–
Underlying operating profit	448	415	8%	8%
Underlying operating margin %	13.3%	12.8%	0.5%pt	0.5%pt

Financial overview

- Order intake was £2.4bn, representing a book-to-bill ratio of 0.7x. This follows on from a record order intake of £5.3bn in 2019 (1.6x book-to-bill) and an average book-to-bill ratio of 1.2x between 2015 and 2019. Order cover for 2021 is in excess of 90% and the healthy order book currently represents approximately 2.3 years of Defence sales.
- Underlying revenue increased by 4% to £3.4bn. This was largely driven by higher LiftSystem aftermarket revenues as the in-fleet service expands together with international sales of the EJ200 engine powering the Eurofighter Typhoon. Naval sales and UK parts sales also improved compared to the prior year.
- Underlying gross profit of £686m was 3% higher year-over-year. This reflects the higher sales volumes, with gross margin relatively stable at 20.4%.
- Commercial and administration costs were 4% lower year-on-year at £(151)m despite the underlying business growth.
- Research and development costs fell by £9m despite an increase in expenditure on key strategic programmes in the period to support new growth opportunities.
- Underlying operating profit increased by 8% to £448m, with margins 0.5%pts higher. This reflected the stronger gross profit and modestly lower C&A and R&D charges outlined above.

Operational and strategic review

2020 was another strong year for Defence with a healthy pipeline of orders and steady growth in revenue and profits. The business' resilient revenue growth with low cyclical and high cash conversion provided support for the Group.

Operations were largely unaffected by COVID-19, including the \$400m investment project to revitalise our Indianapolis facilities. The new building opened during 2020, with work now ongoing to demolish the previous site. Other milestones included the delivery of the 400th V-22 Osprey tiltrotor, which is powered by our AE 1107C engine, and further test flying for the MQ-25 Stingray aircraft, which will provide unmanned, carrier-based air-to-air refuelling.

Consistent demand for parts and services in Defence helped support the broader aerospace supply chain, particularly those suppliers suffering from reduced activity in commercial aviation. In addition, the growth opportunities in our Defence business enabled some of the experienced colleagues whose roles were removed in the Civil Aerospace restructuring to remain in the Group.

2020 has seen a number of notable orders. The German Air Force placed an order for 56 EJ200 engines and Rolls-Royce's MT30 engine was chosen by the Republic of Korea Navy for its FFX Batch III frigate. Additionally, the UK selected the Rolls-Royce nuclear propulsion system, Pressurised Water Reactor 3 (PWR3), as the preferred bidder for the next generation of attack submarines.

Progress was also promising on new opportunities in the US, including the B-52 re-engining competition and the Future Vertical Long Range Assault Aircraft (FLRAA). Combined, these two programmes have an estimated potential lifetime value for Rolls-Royce of over £7bn. For the B-52, we are proposing the F130 engine, which is based on the proven and efficient BR725 commercial engine. The outcome is expected to be announced in 2021. On the FLRAA competition, we reached agreement with Bell Textron in 2020 to provide the propulsion for the V-280 Valor aircraft as it moves forward in the competition. A final decision is expected by 2022. Finally, our LibertyWorks team completed rig testing on a new core design for a small engine, successfully executing a rapid prototyping plan from design to test in under a year; and delivered an upgraded thermal management and power system for directed energy applications to Lockheed Martin for integration and testing.

In the UK, the Tempest programme welcomed new partners in 2020. A trilateral memorandum of understanding was signed by the respective Defence Ministers of the UK, Sweden and Italy, and trilateral industry discussions were initiated with leading defence companies, in preparation for the formal launch of the concept and assessment phase in 2021. Work continued at pace on the programme, with our engineers developing advanced combustion system technology and exploring composite materials and additive manufacturing to produce lightweight, more power-dense components capable of operating at higher temperatures. Rolls-Royce is the leading propulsion company in Team Tempest, which is expected to secure our combat engine revenues and expertise for years to come.

We also announced a new strategic partnership agreement with Reaction Engines. This aims to develop high-speed aircraft propulsion systems and to explore the application of their thermal management technology within civil and defence aerospace gas turbine engines, as well as hybrid-electric systems.

Defence outlook

We anticipate another good year for Defence in 2021. Revenue is expected to be stable, with a strong level of order cover coming into the year. Operating margins are also expected to be broadly flat at approximately 13%. We continue to pursue large opportunities in the US which would drive a step-change in growth prospects for Defence, notably the B-52 engine replacement programme for the US Air Force and the Future Vertical Long Range Assault Aircraft competition for the US Army. We also continue to progress Project Tempest in UK air combat. Finally, we are investing in adjacent technologies such as small engines and directed energy power systems in order to drive further medium-term growth.

ITP AERO

ITP Aero is a global leader in aero-engine subsystem design. Alongside the development, manufacturing, assembly and testing of engine components, it provides MRO services for regional airlines, business aviation, industrial and defence applications.

UNDERLYING REVENUE

£705m

2019: £936m

UNDERLYING OPERATING PROFIT

£68m

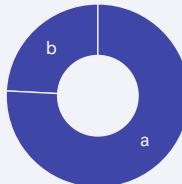
2019: £111m

ORDER BACKLOG

£0.8bn

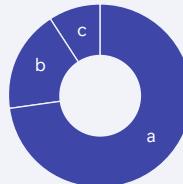
2019: £0.9bn

UNDERLYING REVENUE MIX



a. OE **76%**
b. Services **24%**

UNDERLYING REVENUE MIX BY SECTOR



a. Civil **73%**
b. Defence **18%**
c. In-Service Support **9%**

Overview of 2020

ITP Aero was materially impacted by COVID-19, with similar trends to those seen in Civil Aerospace. Due to the reduction in Rolls-Royce Civil Aerospace deliveries, demand for ITP Aero's widebody modules also reduced significantly, with more modest decreases in ITP Aero's business aviation and narrowbody activities. In response, a restructuring programme was launched and plans are also underway to enhance the scope of ITP Aero's activities. These actions should position ITP Aero for recovery and enhance the potential disposal value of the business.

£m	2020	2019	Change	Organic change
Underlying revenue	705	936	(25)%	(26)%
Underlying OE revenue	537	782	(31)%	(32)%
Underlying services revenue	168	154	9%	8%
Underlying gross profit	133	206	(35)%	(36)%
Gross margin %	18.9%	22.0%	(3.1)%pt	(3.2)%pt
Commercial and administration costs	(38)	(62)	(39)%	(40)%
Research and development cost	(27)	(33)	(18)%	(18)%
Underlying operating profit	68	111	(39)%	(39)%
Underlying operating margin %	9.6%	11.9%	(2.3)%pt	(2.1)%pt

Financial overview

- Underlying revenue was £705m, down 26% versus 2019, primarily reflecting lower engine (OE) volumes on civil programmes, particularly in widebody. Defence OE revenue was more resilient, supported by EJ200 orders. Service revenue increased 8%.
- Commercial and administration costs of £(38)m were 40% lower year-on-year, including some benefit from management actions to reduce discretionary costs, with headcount 13% lower at the year-end compared to 2019.
- Research and development costs were £6m lower in the period mainly due to phasing of projects.
- Underlying operating profit of £68m, 39% lower year-on-year, reflecting the lower OE revenues and under-utilisation of the fixed cost base.

Operational and strategic review

Similar to the trends seen in Civil Aerospace, ITP Aero's 2020 performance was materially impacted by COVID-19 as the majority of the business' sales relate to civil aviation. ITP Aero's largest exposure is on Rolls-Royce widebody programmes, however the business also has significant activities in the business aviation and narrowbody markets. This diversity was beneficial in 2020 as these markets were less impacted than widebody which relies on demand for long-haul travel. In the defence market, COVID-19 has had a limited impact, with the reduction in sales in 2020 largely driven by phasing on key programmes. In response to the impact of COVID-19 on ITP Aero's core markets, we launched a substantial restructuring programme which aims to reduce ITP Aero's global headcount by approximately 15% by the end of the first half of 2021. In addition, in conjunction with the footprint review in Civil Aerospace, we proposed an increase to the business' manufacturing, engineering, and supply chain capabilities. This involves the integration of Civil Aerospace's facility and workforce in Hucknall, UK, into ITP Aero, as well as the transfer of aero engines structures activities into ITP, currently carried out in Barnoldswick, UK. These actions will enhance ITP Aero's position as a major tier-one aerospace company. Our planned sale of ITP Aero is progressing well with ongoing conversations with a number of potential buyers.

Despite COVID-19, ITP Aero made further progress on future programmes in 2020, including the design and manufacture of the first intermediate pressure turbine (IPT) casing for the future Rolls-Royce UltraFan engine.

In defence, we formalised our participation as the leader of the engine technology pillar in Spain for the next generation weapon system/future combat air system (NGWS/FCAS). In November, the EUROJET consortium signed a contract to provide 56 new EJ200 engines for the German Air Force's new order of Tranche 4 Typhoon aircraft. ITP Aero is a member of the consortium alongside Rolls-Royce, MTU Aero Engines and Avio Aero.

ITP Aero outlook

We expect some stabilisation in 2021 followed by a recovery in our performance from 2022 onwards reflecting the wider recovery in commercial aerospace as well as the outcomes from our actions to reduce costs to improve profitability. We remain focused on cost savings, including the workforce capacity adjustment of approximately 15% globally from 2019 levels, which is already well underway and will be completed by the end of the first half of 2021. Our planned sale of ITP Aero is progressing well with ongoing conversations with a number of potential buyers.

SUSTAINABILITY

Our activities have a significant impact on society and the environment. We are committed to conducting our business in an environmentally, ethically and socially responsible manner to create value for us and our stakeholders.

As a leading industrial technology company, Rolls-Royce has a key role to play in creating a more sustainable future. Our sustainability approach is driven by an understanding of the impacts we have on society and the environment, and we seek to use that understanding to inform our strategy and decision-making.

Our global governance framework sets out how we govern our business, manage risk and opportunity, reward appropriately and maintain consistent operating standards across the Group. Sustainability is a core component of this.

Our approach

The most significant contribution Rolls-Royce can make to a more sustainable future is to reduce the carbon impacts of our product portfolio and to accelerate the decarbonisation of the sectors in which we operate. We are well positioned to play a crucial role in the transition to a low carbon global economy. We have recognised this in our commitment to reach net zero carbon by 2050, ratified through the UN Business Ambition for 1.5°C campaign, which builds on our existing 2030 target for operations and facility emissions. In 2021, we will produce our roadmap to achieve this, including setting interim targets and milestones. To support this, we are pivoting our R&D expenditure towards low carbon solutions including hybrid, hydrogen and electric power; in the short term, we intend to dedicate approximately 20% of our annual R&D expenditure to these technologies by 2023, an increase from 4% in 2019. The transition to low carbon must be coupled with a broader assessment of our impacts. This informs our sustainability approach. We work to create a more environmentally, ethically and socially responsible and resilient business.

The short-term impact of COVID-19 on our business has placed considerable strain on our workforce and has negatively affected progress against some of our key sustainability targets and measures, particularly those normalised by revenue. Yet our longer-term ambitions to be a sustainable business and play a key role in the transition to net zero carbon have not waned.

2020 Highlights

- Completed strategic review of our sustainability approach*
-
- Announced commitment to net zero carbon by 2050*
-
- Achieved second position in our sector in the DJSI*
-
- Introduced ESG metric into 2021 remuneration policy*

During 2020, we completed a strategic review of our sustainability approach, overseen by the Safety, Ethics & Sustainability Committee (page 101). This involved a review of our material non-financial issues, including a consideration of the potential impact and the extent of our ability to influence these issues, as well as the views from a range of stakeholders including employees, customers and investors. As a result, we have revised our sustainability materiality assessment, and identified our key contributions to the UN Sustainable Development Goals. This will help inform our sustainability-related focus going forward.

Introducing our sustainability framework

Sustainability remains a broad and complex topic. We have introduced a set of guiding principles, underpinned by our values and behaviours, to support the continued integration of sustainability into decision-making at all levels of the organisation:

- understanding and minimising our impact on the environment, particularly in the context of climate change;
- seeking opportunities to adopt circular business practices to promote responsible resource consumption;
- making a positive contribution to the communities within which we operate;
- acting with integrity and considering the potential and actual ethical implications of all business decisions;
- ensuring zero harm to the people who work for or with us and give them the best opportunity to be at their best; and
- reporting and communicating with our key stakeholders transparently and honestly.



For more information on our sustainability approach, including Group policies and performance data, see rolls-royce.com.

SUSTAINABILITY

UNITED NATIONS SUSTAINABLE DEVELOPMENT GOALS

Through our business strategy and activities, we make a material contribution to a more sustainable society. This can be articulated through our contributions to all the UN Sustainable Development Goals. Through a comprehensive mapping exercise, focused on impact at a target and indicator level, we have identified the Goals most pertinent to our business.

SDG	PRIMARY CONTRIBUTION	2020 PROGRESS
 GOAL 8 DECENT WORK AND ECONOMIC GROWTH	We have a responsibility to provide a safe and fair workplace for our people and those employed in our supply chain. We are committed to creating a working environment where everyone can be at their best.	– Formed Emergent Alliance to support global economic recovery from COVID-19.
 GOAL 12 RESPONSIBLE CONSUMPTION AND PRODUCTION	We are committed to promoting the responsible use of resources and minimising our environmental impacts across our manufacturing and production activities.	– Diverted 5.6 kilotonnes of waste from landfill compared with baseline year. – Introduced new recycling and resource efficiency target.
 GOAL 13 CLIMATE ACTION	As a global power company, operating in some of the most carbon-intensive sectors, we have a fundamental role to play in the transition to a net zero carbon future and to taking action to address climate change.	– Announced net zero carbon commitment. – Joined UN Business Ambition for 1.5°C campaign. – Participated in UN Race to Zero launch.
 GOAL 16 PEACE, JUSTICE AND STRONG INSTITUTIONS	Maintaining high standards of ethics and compliance are fundamental to our continued success. We have a responsibility to conduct our business responsibly and ethically, and with due consideration of the human impact of our activities, particularly in the application of defence products.	– Strengthened our anti-bribery due diligence. – Published Aletheia Framework supporting the ethics of artificial intelligence.

Non-financial information statement

The following chart summarises where you can find further information on each of the key areas of disclosure required by the EU Non-Financial Reporting Directive.

	Related Group policies	Related principal risks	Page
Environmental matters	– Health, safety & environment	– Climate change – Safety	35 to 39 and 205
Employees	– Security – People	– Talent and capability – Safety	40 to 45
Social matters	– Charitable contributions & social sponsorships	– Political risk	40 to 45
Human rights	– People – Human rights		45
Anti-bribery and corruption	– Anti-bribery & corruption	– Compliance	45

- Our business model provides an insight into the key resources and relationships that support the generation and preservation of value within Rolls-Royce. See pages 12 and 13.
- Non-financial key performance indicators allow us to assess progress against objectives and monitor the development and performance of specific areas of the business. These are set out on page 17.
- Further information on Group policies can be found on rolls-royce.com.
- Full details of the Group's principal risks can be found on pages 46 to 51.
- Disclosures based on the principles of Taskforce on Climate Related Financial Disclosures (TCFD) are detailed on page 38.

LEADING THE TRANSITION TO NET ZERO

To meet the demands of a growing, more connected society, the power that matters must be sustainable power. Our technology will play a fundamental role in enabling the transition to a low carbon global economy.

We are determined to use our position as a global power group to play a role in creating a resilient, inclusive, net zero carbon future. During 2020, we ratified this ambition by joining the UN Race to Zero and UN Business Ambition for 1.5°C campaigns.

Achieving net zero carbon will require a wholesale transformation of the systems that make up the backbone of our global economy, including power, transport and the built environment, the very sectors in which reducing emissions is the hardest. At Rolls-Royce, we believe there are technological solutions to decarbonising these vital parts of the economy. With the right policy, environment and public support, we have the potential to pioneer game-changing technology that will help deliver a net zero carbon future.

Our decarbonisation strategy

Through our decarbonisation strategy, we intend to become a net zero carbon company across our value chain. We have a target to achieve net zero greenhouse gas emissions in our operations and facilities (scope 1 + 2 emissions) by 2030, excluding product test emissions¹. By 2050, we aim to mitigate these remaining emissions, which play a key role in product development and safety programmes, to become a carbon neutral business. More fundamentally, we are determined to use our capabilities and expertise to achieve and accelerate the decarbonisation of the sectors we serve (namely scope 3 emissions associated with the use of sold products). By 2050, we intend to make all our products compatible with net zero carbon emission operations and we will pioneer new industrial technologies that connect, power and protect a net zero carbon economy. We have built upon previous work on climate scenario planning to assess the viability of this decarbonisation strategy. Lastly, we have considered the impact of our climate change plan in our financial statements (see page 114).

2020 Highlights

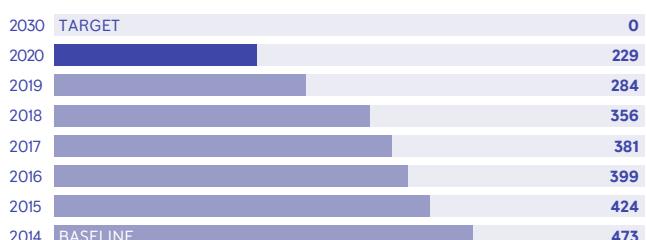
- Announced commitment to net zero carbon by 2050, joining the UN Race to Zero and UN Business Ambition for 1.5°C campaign
- Conducted first engine ground tests on 100% unblended SAF
- Progressed our SMR programme and secured further funding

Achieving carbon neutral operations and facilities

We have a target to achieve net zero greenhouse gas emissions in operations and facilities by 2030². This will be delivered through continued investment in onsite renewable energy installations; the procurement of renewable energy; and continued investment in energy efficiency improvements to reduce our overall energy demands and operating costs. We also have plans to expand the utilisation of Rolls-Royce technologies, such as microgrids, across our own estate.

During 2020, absolute emissions of GHG associated with our operations fell by 55 ktCO₂e to 229 ktCO₂e from 284 ktCO₂e in 2019. This represents a reduction of 52% since 2014. The year-on-year reduction was driven by lower operational activity as a result of COVID-19 and further decarbonisation activities across our European estate, including switching to renewable electricity suppliers at Oberursel and Dahlewitz, Germany, and an energy reduction campaign

across our larger sites. In 2021, we will concentrate on identifying renewable energy providers for our larger US sites.

ABSOLUTE GHG EMISSIONS (ktCO₂e)^{1,2,3,4}

¹ Emissions associated with product test and development, critical to ensuring product safety, are excluded from our GHG target. Statutory GHG emissions data, including emissions from these sources, are detailed on page 205.

² External assurance over the GHG data is provided by Bureau Veritas. See page 204 for the sustainability assurance statement.

³ Data has been reported in accordance with our basis of reporting, available at rolls-royce.com/sustainability. GHG data for previous years has been restated to reflect the disposal of the North American Civil Nuclear business and Trigno Energy. ITP Aero data is included from 2017.

Technologies for a zero carbon future

Rolls-Royce technologies can play a crucial role in the transition to a net zero carbon future. However, the complex nature of the sectors we operate in means that the transition towards net zero will not be easy or straightforward; it will require a combination of technology and policy levers to execute, including further fuel-efficiency gains, new technologies and transition to lower carbon fuels. These plans are built into our short and medium-term forecasting.

Efficiency gains and engine architecture

Carbon emissions are closely linked to fuel burn. By developing and implementing technologies to improve efficiency, we can substantially reduce the CO₂ impact of our products in operation. Despite the pressures of 2020, we have continued to progress our UltraFan design, which will deliver a 25% efficiency gain compared to early Trent engines, including reaching several design milestones during the year. We plan to progress to final assembly of UltraFan in 2021. Continued focus on engine efficiency gains will be critical given the significant costs associated with lower carbon alternative fuels.

Power Systems continues to focus on improving efficiency and performance to decrease emissions and noise. The engine evolution of our iconic 4000 series engine is 5% more efficient and emits 75% less NOx than its predecessor and has been designed for compatibility with gas and synthetic fuels including methanol. Increasingly, our reciprocating engine family will be integrated into systems solutions, such as hybrid trains, hybrid ship propulsion and microgrids.

Transition to lower carbon alternative fuels

Moving away from traditional fossil fuels and to low, ultimately zero, carbon fuels will make a significant contribution towards net zero carbon in both aviation and land-based power. Whilst the majority of our products are capable of running on synthetically derived low carbon fuels, industry faces shortages in demand based in part on the high costs associated with manufacturing such fuels. Rolls-Royce has a critical role to play in advocating and accelerating the availability of alternative fuels and we have worked in partnership with the fuels industry throughout 2020 to support this. We have also demonstrated our engines compatibility with new fuel types, ground testing 100% unblended sustainable aviation fuel (SAF) in a Trent engine at the end of the year. Similar tests have already been carried out in our Defence engine portfolio. In Power Systems, we are actively exploring opportunities in the fuel cell and power-to-x markets. Power-to-x refers to the conversion of electricity into other forms of energy, including hydrogen and synthetic or e-fuels. We will introduce the first demonstrator for a stationary fuel cell in Friedrichshafen, Germany, during 2021. This is designed as a smaller scale, decentralised power plant in which electricity from renewable energy is synthesised into e-fuel. We also envision a key role for our SMR technology in providing a reliable and low carbon energy source for synthetic fuel production.

Electrification and hybridisation

Hybrid and fully electric propulsion will play an exciting role in disrupting and decarbonising the personal mobility market. Through Rolls-Royce Electrical, our dedicated business unit, we are developing the capabilities and supply chain to capitalise on this technology. During 2020, we announced the conclusion of our partnership with Airbus on the E-Fan X programme. From that programme, Rolls-Royce has moved forward with the development of our Power Generation System 1 (PGS1) demonstrator, the most powerful hybrid-electric engine currently in development for aerospace. This programme will give us a greater understanding of delivering electrification in the MW category. We are also actively involved in a range of aircraft programmes in the kW class.

In early 2021, the first testing of a hybrid-electric rail service on the Chiltern railways line, UK, will commence, with the intent of entering public service in the later part of 2021.

Small modular reactors (SMRs)

We have been working with consortium partners and the UK Government to launch our SMR concept. SMRs are nuclear power stations, in the order of 440 MW (large enough to power a small city), designed to be low cost, low risk and quick to market. Rolls-Royce is ideally placed to exploit this technology bringing together the latest manufacturing technology with world-class nuclear expertise. SMRs can play a major role in decarbonising the energy grid, and can potentially be utilised for hydrogen and synthetic fuel production. During 2020, we secured further funding from the UK Government to move to the second stage in the development process.

Testing on 100% unblended SAFs

Towards the end of 2020, we conducted a series of ground tests on a Trent 1000 engine using 100% sustainable aviation fuel (SAF) for the first time. At present SAF is only certified for commercial use in blends of up to 50%. We carried out the tests in order to confirm that using an unblended fuel can make a significant contribution to improving the environmental performance of gas turbine engines and to gain valuable data on how the fuel performs in the engine. We intend to make lower carbon alternative fuels a regular part of our testing programme, including conducting a series of tests on a Pearl 700 business aviation engine in early 2021. This is part of our drive to accelerate the availability of SAF, demonstrate technology readiness, and supports our aim to decarbonise our engine testing regime, which plays a vital role in ensuring product safety.

DISCLOSURES ALIGNED TO TCFD RECOMMENDATIONS

We support the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) to enhance company reporting on climate-related strategy and risk management. The following table summarises our disclosures:

GOVERNANCE	<ul style="list-style-type: none"> – the Board oversees, through the Safety, Ethics & Sustainability Committee, our sustainability and climate approach receiving updates from subject matter experts at least three times a year (see page 101); – the executive-level environment & sustainability committee, is responsible for environmental and climate-related policy strategy and co-ordinating related activities; and – we have an independent environmental advisory board, comprising leading academics from environmental, materials and climate-related fields, which complements our in-house expertise. 	For more detail on our approach to corporate governance see pages 62 to 63.
STRATEGY	<ul style="list-style-type: none"> – climate change and its associated impacts will play a pivotal role in determining the long-term success of our organisation: it presents a variety of opportunities and risks that drive our strategic decisions; – the opportunity to pioneer industrial technologies that connect, power and protect a net zero economy by 2050 is driving our growth and innovation strategy (see page 37); and – we recognise and report on the potential impact that both transitional and physical risks associated with climate change pose to our business over the short, medium and long term including risks to product operations, regulatory risks and risks related to societal pressure. 	For more detail on our business model and strategy see pages 9 to 13.
RISK MANAGEMENT	<ul style="list-style-type: none"> – climate change, particularly due to the threat placed on our ability to generate future revenues, has been recognised as a principal risk (see page 48); – we have used scenario planning, including a scenario aligned to a 1.5°C transition, to identify key sensitivities, risks and opportunities associated with physical and transitional climate related impacts; – we integrate the management of climate change risks and opportunities into our enterprise risk management system, recognising the potential role of climate change in exacerbating and accelerating our other principal risks (see pages 46 to 51); and – the potential impact and associated costs of climate change are considered within our financial planning, including funding to achieve our 2030 operations target and R&D funding to progress our 2050 net zero target. Our financial statements and viability statements are published in accordance with our best view of the impacts climate change will have on future business performance. 	For more detail on our approach to risk see pages 46 and 47.
METRICS AND TARGETS	<ul style="list-style-type: none"> – GHG scope 1 & 2 emissions in line with the Streamlined Energy and Carbon Reporting (SECR) regulations are detailed on page 205; – target to achieve zero greenhouse gas emissions from operations and facilities by 2030 (see page 36); – commitment to net zero by 2050 ratified by the UN Business Ambition for 1.5°C. We will produce our roadmap to achieve this, including setting interim targets and milestones, in 2021; – we monitor GHG emissions related to the use of sold products (scope 3) and use this to inform our technology strategy to ensure compatibility with a 1.5°C future; and – introduced ESG metric into 2021 remuneration policy. 	For more detail on our climate-related targets see page 39.

For more detail on our approach to climate change, including our approach to climate risk management and details on scenario planning, see rolls-royce.com.

RESPONSIBLE CONSUMPTION

Understanding and managing the environmental impact of our operations is a key part of being a responsible and resilient business. We seek to consider and mitigate the environmental impact of our activities and major business decisions.

Our Group policies set out our commitment to be environmentally responsible and to minimise the negative impact of our business activities. The nature of the products often requires specific, and sometimes significant, demands on material and energy resources across a global supply chain. Ensuring responsible consumption of resources ensures we are a more resilient business and contributes towards a more sustainable society.

Moving towards a circular economy

The nature of our business model is well aligned to the principles of a circular economy. Through our business practices, including our revert program for high-value metal recycling, we are able to safeguard supplies of key materials, maximise resource efficiency and contribute significantly to the reduction of carbon emissions across our value chain. As part of our efforts to promote responsible consumption and minimise environmental impact, we have set stretching targets to reduce waste and increase resource efficiency. From the start of 2021, we have introduced a new target

2020 Highlights

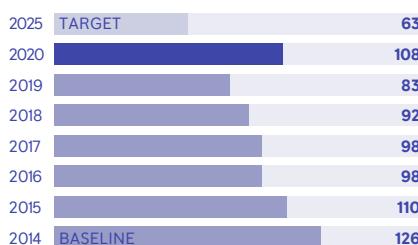
- Diverted 5.6 kilotonnes away from landfill compared with baseline year*
-
- Introduced new recycling and recovery target*
-
- Introduced new technology which reduced coolant waste by 480,000 litres*

to increase the recycling and recovery rate to 68% by 2025, whilst continuing to progress towards zero non-hazardous waste to landfill.

Progress against current targets

We have continued to make good progress against our environmental targets during the year. However, the financial impact of COVID-19 has negatively impacted progress against some of these targets, particularly those normalised by revenue, although the underlying data remains on track. Despite significant progress in diverting non-hazardous waste from landfill, a small number of waste streams continue to present significant technical and infrastructural challenges. This includes 1.8 kilotonnes of foundry sand from one of our casting operations. Notwithstanding these challenges, 88% of sites successfully transitioned to zero non-hazardous waste to landfill status. We will continue to implement landfill alternatives for the limited remaining sites as technology and infrastructure becomes available as part of our new recycling and recovery target.

ENERGY CONSUMPTION (MWh/£m)

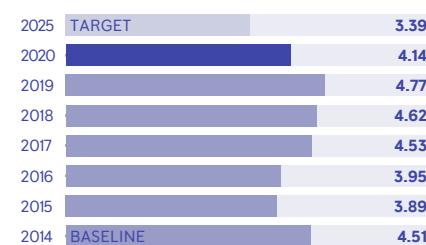


Target:

Reduce normalised energy consumption by 50% by 2025^{1,2,3,4}

We have made good progress to date towards our 2025 target, reducing absolute energy consumption by 218,916 MWh (15%) since 2014. This has been driven by energy efficiency improvements, behaviour change programmes, and improved baseload management and weekend reductions at our larger manufacturing sites. Absolute energy consumption reduced by 82,814 MWh in 2020 compared to 2019 due to lower operational activity, however normalised energy consumption increased by 30%.

TOTAL SOLID AND LIQUID WASTE (t/£m)

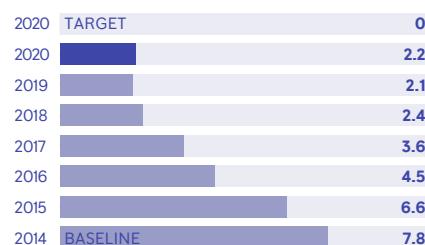


Target:

Reduce solid and liquid waste by 25% by 2025^{1,2,3,4}

We focus on opportunities to prevent and reduce the amount of waste we generate at source, reducing the costs and environmental impacts associated with processing and disposing of that waste. For example, our coolant waste reduction programme has mitigated over 480,000 litres of liquid waste, while providing cost savings of over £0.5m per year. The total amount of solid and liquid waste generated in 2020 was 48.7 kilotonnes. Normalised total liquid and solid waste was 4.14 kilotonnes/£m, an 8% reduction since 2014.

WASTE TO LANDFILL (000 tonnes)



Target:

Achieve zero waste to landfill by 2020^{1,2,3}

Over the course of the target, we have successfully diverted 25.4 kilotonnes of waste from landfill by reducing waste generation at source and identifying alternative treatment solutions. For example, collecting ceramic waste from casting processes and metals from grinding waste for recycling. We will continue work to identify landfill alternatives for the remaining waste streams currently sent to landfill as part of our new target.

¹ External assurance over the energy and waste data is provided by Bureau Veritas. See page 204 for the sustainability assurance statement.

² Data has been reported in accordance with our basis of reporting. More data charts and our basis for reporting is available at rolls-royce.com/sustainability.

³ Energy and waste data for previous years has been restated to reflect the disposal of the North American Civil Nuclear business and Trigono Energy. ITP Aero data is included from 2017. Data from ITP Aero is not included in our zero waste to landfill target.

⁴ Energy and total waste reduction targets are normalised by revenue.

PEOPLE AND CULTURE

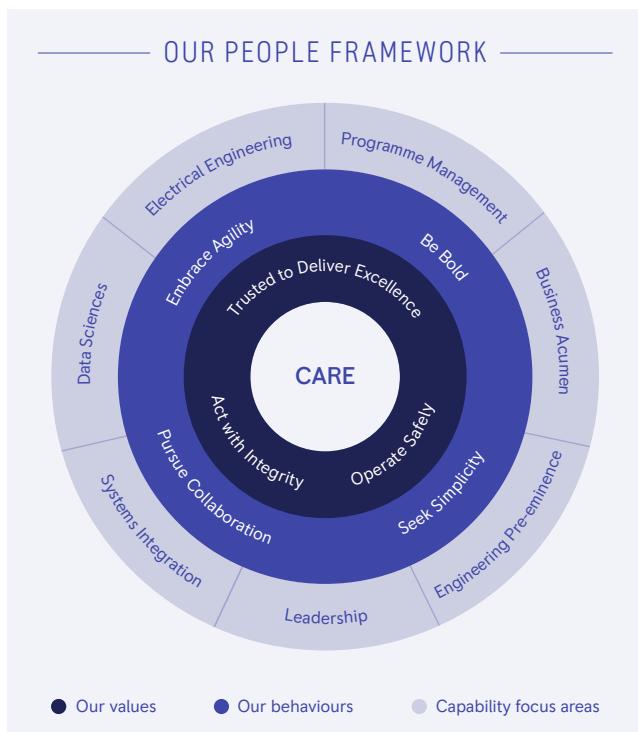
Our people create our value and we strive to release their potential to position Rolls-Royce as the leading industrial technology company, delivering sustainable business growth and solving vital power needs.

2020 Highlights

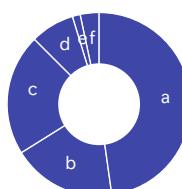
- Implemented strict safety measures to protect against the spread of COVID-19 at our sites around the world and increased our focus on health and wellbeing*
- Introduced pay and benefits changes to significantly reduce employment costs*
- Launched a fundamental business restructure including the reduction of at least 9,000 roles globally, of which we have removed around 7,000 in 2020*
- Established a redeployment talent hub to retain critical talent and capability within the business*

In the context of an extraordinary year dominated by the impact of COVID-19, we implemented some difficult employment-related changes. This included making substantial headcount and employment cost reductions, as well as consolidating our global manufacturing footprint. We worked hard to ensure our essential operations were able to continue, whilst also looking after our people. We implemented strict workplace safety measures and in some parts of the business introduced new ways of working.

We supported our people to work from home, where possible, and recognised this as an opportunity to further increase flexible working in the future. We continued to transform our culture and embed our values and behaviours focusing on leadership capability, performance enablement and employee engagement. We identified capability focus areas that will determine the success of our business now and in the future. Our approach to people and culture is underpinned by our people framework with our 'care promise' remaining central to everything we do – creating a working environment where everyone can be at their best.

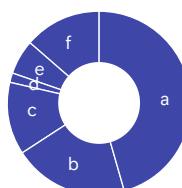


48,200 EMPLOYEES TOTAL (MONTHLY AVERAGE) *



a. Civil Aerospace	23,400
b. Power Systems	8,900
c. Defence	10,500
d. ITP Aero	3,800
e. Corporate	100
f. Non-core businesses	1,500

EMPLOYEES IN 45 COUNTRIES (MONTHLY AVERAGE) *



a. UK	22,000
b. Germany	9,800
c. USA & Canada	6,200
d. Nordics	700
e. Spain	3,000
f. Rest of World	6,500

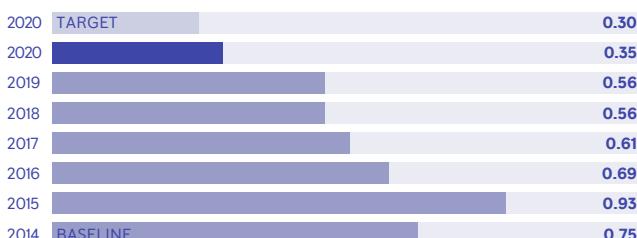
* Employee headcount data represents permanent employees and excludes contractors.

Health, safety and wellbeing

Ensuring the wellbeing of our people, and those who work with us, by providing a safe place of work and minimising potential exposure to harm, is a key component of our care promise. Whilst COVID-19 posed extra challenges this year, we acted swiftly to ensure the health and safety of our people and to safeguard our business operations. We used our pre-existing pandemic plan and risk frameworks to guide our response and support our people through the emerging crisis. We implemented strict workplace measures to protect against the spread of the virus at our sites around the world and increased our focus on employee mental health and wellbeing. In some facilities we introduced new ways of working, such as split shift patterns and alternating teams, with new booking systems to manage attendance patterns safely.

We utilised our incident support teams and accountable persons network to develop governance structures and global processes aligned with in-country requirements. We launched a COVID-19 intranet microsite, with regular communications and resources to help our people to protect themselves and others. We also continued to embed mental health as a Group priority through our global mental health strategy. We introduced a global mental health champion framework as an extension of our UK network, and trained in excess of 120 new champions this year. We made great progress with our LiveWell global accreditation scheme which recognises sites that have created environments to help people to lead healthier lives. In 2014, the LiveWell target was set for all sites with more than 50 people to become LiveWell accredited by 2020. We have significantly exceeded this target with more than two thirds (68%) of our sites going beyond bronze to reach silver, gold and even platinum levels of accreditation.

TOTAL REPORTABLE INJURY (TRI) RATE (PER 100 EMPLOYEES)¹



¹ Our TRI rate for previous years has been restated to reflect the disposal of the North American Civil Nuclear business and Trigno Energy. ITP Aero data is included from 2017. External assurance over the TRI data provided by Bureau Veritas. See page 204.

Our TRI rate in 2020 was 0.35 per 100 employees, just missing our stretching Group target of 0.30. There were a total of 173 TRIs, of these 15 resulted in major injuries with no fatalities. Although we missed our target this year, our current TRI rate represents a 53% reduction from our baseline year and a 38% year-on-year reduction (116 fewer TRIs per year). These improvements followed the implementation of focused actions plans in 2020, based on detailed analysis of our TRI data. As a result, all of our businesses improved their TRI performance. We will continue our improvement efforts and will be moving to a safety-index scorecard which will include a TRI measure.

New ways of working

In response to the impact COVID-19 on our business, we implemented changes to reduce employment costs in the short term and to reset our approach to rewarding people in the future. In the UK, the Government's job retention scheme was used from April onwards to support significant numbers of employees on furlough. In Germany, where appropriate, the Kurzarbeit or short-time working scheme was used, as well as introducing a two-week shutdown. Similar schemes were used in other countries in line with local legislation and business requirements. We introduced many changes to ways of working across the Group, according to local requirements and our agreements, including reduced hours working, adjustments to pay and various unpaid leave arrangements, as well as changes to some of our pension plans. We introduced a pay deferral for 2020, repaid in December 2020, and communicated there will be no 2020 bonus or 2021 pay review for most parts of the Group.

We tackled these difficult pay and employment-related challenges working closely with our employee representatives, often via frameworks that have had to be amended to meet the urgency of the COVID-19 pandemic. Due to the scale and nature of the necessary change this has been challenging, but overall our approach has remained collaborative with successful results. In response to our proposed site consolidation, we experienced a period of industrial action at our Barnoldswick, UK, site but this was resolved with a collaborative agreement overwhelmingly supported by the local workforce. We will continue to work closely with our employee representatives to maintain the sustainability and competitiveness of our cost base and reward frameworks for the future, ensuring that our performance measures are aligned with company priorities.

Many of our people needed to adapt swiftly to new ways of working through the COVID-19 pandemic, including working remotely or from home. We have supported this by enhancing our IT platforms, providing more digital learning and coaching our leaders on new ways of working. We have also taken this opportunity to emphasise our commitment to flexible working for the long term to enable our people to be at their best. We recognise that one size does not fit all and have developed tools to support our leaders to positively engage with their teams on a variety of different flexible working considerations. We will continue to develop and broaden our approach throughout 2021.

Fundamental restructuring

Our business restructuring has been dominated by two themes: short-term mitigation measures to secure liquidity and longer-term restructuring to resize the business whilst accelerating progress on culture and leadership.

Following the impact of COVID-19, we took significant steps to resize our business, focusing on Civil Aerospace where the impact was the greatest. We launched a strategic review of our facilities to help sustainably balance future load and capacity and to reduce our cost base. The review identified a range of actions including proposals to consolidate similar activity from multiple sites into fewer core sites.

Some of these have already been implemented and others are the subject of consultation with employees. In May, we proposed a major restructure, the largest in our recent history, which will see a reduction of at least 9,000 roles globally. Seeing our people leave the business is always difficult and we focused on doing this in the best way possible and treating everyone with dignity and respect. We have made strong progress this year removing around 7,000 roles, of which around 5,500 were from our Civil Aerospace business. The majority of people who left the business in the UK, left on voluntary redundancy. These difficult but necessary changes will help generate recurring operational benefits for the Group and our mitigating actions to preserve cash have significantly contributed to our in-year cost reduction targets.

Start of year headcount ¹	End of year headcount ¹	Number of roles removed ²
53,770	46,619	7,151

¹ Headcount includes contractors as well as permanent employees.

² Change based on year-end 2019 and year-end 2020 actuals.

Throughout our restructuring, we proactively focused on talent and made sure that, where possible, we did not lose capabilities critical to our future success, or negatively impact our diversity. This included establishing a redeployment talent hub to maximise the quality and quantity of critical talent retained in the business, and making some internal transfers of key capabilities.

UK defined benefit pensions review

In response to the impact of the pandemic on our business, we took further action with our pension arrangements for UK employees. Our UK pension plan closed to new hires in 2007 and in 2020 we agreed with the trustees to cease the further build-up of benefits for all remaining active members. This followed a consultation process covering over 7,500 employees. From 1 January 2021, all employees transferred to a defined contribution pension with benefits at the standardised level for other UK employees (i.e. a maximum employer contribution of 12% of salary). This change will support the Group's future financial position and ensure a more equal level of total reward for our people regardless of when they commenced employment.

Enabling our people

The impact of our short-term mitigating measures to counter the effects of COVID-19 created an even greater need to focus on supporting and developing our people this year. A significant element of our planned investment in leadership development and broader learning was paused in 2020, however, we have still made progress. Our investment in learning and development in 2020 was £13.5m (2019: £28.7m), delivering just over half a million hours of formal learning (2019: 1.4 million hours). In the future, we will report volumes of 'learning engagements' as well as costs and hours. This will provide data on our employees accessing online learning materials, which is not reflected in the above figures. We believe this will become a useful indicator of development, as we move to increasingly digital and virtual learning and development solutions. To support increased

remote working, our leadership programmes were re-developed in 2020 to be fully virtual offerings and we introduced our digital leadership toolkit. We also created a new brand for learning: a framework to link all of our learning resources. This is focused on continuous learning with a growth mindset and will be launched early in 2021 along with a new more personalised learning technology platform.

Our internal promotion and turnover rates in 2020 were negatively affected by the impact of COVID-19 and our fundamental restructuring programme. In 2020, 644 leaders were promoted internally (2019: 1,150) and our employee turnover was 15.3% (2019: 7.5%). We continue to focus on ensuring we have the right people, with the right skills, in the right roles to deliver organisational success.

Digital leadership toolkit

Available on any device, digital learning content can be accessed quickly and simply, at the point of need, to support our current and future aspiring leaders.

Through 2020, we released learning materials focused on relevant challenges such as 'leading in a crisis'; 'leading through restructure'; 'leading inclusively'; and more recently 'leading sustainably' and 'leading the transition to net zero'. In the first nine months to the end of 2020, utilisation reached 74,300 learning engagements, which is more than we could have achieved through more traditional classroom based methods.

Employee engagement

Employee engagement continues to be a priority and is a key measure in our annual bonus plans. We believe that positive engagement is the result of excellent leadership and a working environment where everyone can be at their best. Our approach remains a mix of locally-driven and Group-wide global engagement. We provide a variety of channels to communicate and engage our employees and their representatives including employee newsletters, magazines and team briefings, as well as our digital communication channels such as Yammer. Our Executive Team have held regular 'YamJams' this year where all employees can direct questions to our leaders who will provide a response live, or as a follow up, posted on Yammer. We also work closely with elected employee representatives through well-established frameworks including our European Works Council. Our incentive schemes and share programmes are made available to all our people. In 2019, we launched our new employee engagement survey in partnership with Gallup and this simplified framework is now embedded across the Group. We have set a target to achieve top-quartile scores by the end of 2023, and our current results show we are on track to do so. We ran our third Gallup survey this year and maintained a good participation rate of 72%. We achieved a meaningful increase of +0.16 reaching a company 'grand mean' of 3.68 which places us in the 31st percentile of manufacturing companies that partner with Gallup. This is an increase from the 13th percentile in 2019.



Our non-financial KPIs are on page 17. External assurance over the employee engagement scores is provided by Bureau Veritas (see page 204 for their sustainability assurance statement).

SUSTAINABILITY

Community and STEM Outreach

Our community investment activities build positive relationships in the communities around us and create engagement opportunities for our people. Whilst planned activities were significantly disrupted during 2020, we responded to the challenge by becoming more virtual. We moved our STEM education outreach resources online and shared additional resources to support learning from home, for example, through our digital academy's 'Helping You Prepare' programme and our many other education partnerships. We have reached one million people through our STEM programmes and are now 31% towards our target to inspire 25 million of tomorrow's pioneers by 2030.

Manufacturing supply chains were put to work to increase ventilator production and we produced 3D printed face masks as well as donating PPE for health care workers. Our people continued to be at the core of all of our activities and volunteered their own time and expertise to support initiatives as well as raising funds, and donating resources to support the communities in which we operate. In 2020, 36,487 hours of employee time was committed to STEM and community outreach activities (2019: 96,000).

Global charitable contributions totalled £4.8m in 2020 (£3.4m cash contributions). This included £0.9m raised by reclaiming and selling the shares of gone-away shareholders.* Most of the funds invested support STEM education outreach, particularly targeting under-represented groups. For example, the Agastya Project in India brings a mobile science lab to schools in rural communities; our work with Social Return Foundation in Germany helps migrant communities to gain the skills needed to enter further education or jobs in STEM; and projects in the UK and India specifically encourage and support women to pursue STEM pathways into work. A small proportion of funds has been donated to causes supporting one-time humanitarian events such as the initial outbreak of COVID-19 in China and the Aegean earthquake in 2020.

Continued focus on accelerating inclusion

In a year that required a change of direction to focus on COVID-19 mitigations, and the launch of our fundamental business restructuring, we continued to take deliberate action to create an inclusive and more representative employee population. This year, we developed a new strategy with an overarching principle of leaders role modelling inclusion and action plans focused on four key pillars: leadership & governance; attracting & recruiting; retention; and development.

Highlights in 2020 include:

- increasing women on business leadership teams – notably the appointment of the first female board member of Power Systems (CFO) as well as achieving a 50% female hiring ratio for our enterprise leadership group (ELG);
- Civil Aerospace signed up to IATA 25 – an initiative to advance gender diversity in the aviation industry;

- our graduate and intern selection processes were redesigned to remove barriers to ethnic minority candidates;
- in the US, we hired veterans in mid-career niche engineering roles to improve ethnic minority representation;
- globally, our female turnover remains lower than for males; and
- we created inclusive leadership development programmes and additional learning resources to be rolled out in 2021, along with new mandatory diversity & inclusion learning for all employees.

Of significant note has been our response to the 2020 Black Lives Matter movement. Our Chief People Officer and people director responsible for inclusion led listening sessions with our employee resource groups (ERGs) representing our black colleagues in both the UK and US. These sessions subsequently led to the evolution of our diversity & inclusion strategy, as outlined above.

In 2020, we maintained our focus on the diversity of external hires despite significantly reduced hiring due to the impact of the COVID-19 pandemic. We increased female hires globally at all grades from 18% to 19% and our apprentice hires were 22% female compared to 16% in 2019. Our early career intake was reduced to a quarter of the volume of previous years and we temporarily paused our business and functional programmes, which typically attract more females than our engineering programmes. The gender diversity of our graduate hires was particularly impacted by this, as well as our restructure activity and only 13% of our hires in 2020 were female compared with 32% in 2019. We remain focused on improving our diversity and any candidates delayed from joining this year have formed our talent pipeline for the future. We have provided career support and frequent communication to them throughout the pandemic.

We give full and fair consideration to all employment applications from people with disabilities. If an employee becomes disabled whilst working for us we take steps to support their continued employment including, wherever possible, making adjustments to ways of working. All employees can take advantage of our learning programmes, often available online, and promotion opportunities are open to all employees regardless of any disabilities.

Treating everyone with dignity and respect

We launched our anti-bullying and harassment programme in 2019 with a culture change goal of eliminating inappropriate behaviours from our workplaces.

In 2020, we focused on embedding knowledge and understanding, with all leaders, and our HR teams were required to complete online and face to face learning on the topic. We also continued to raise behavioural expectations and maintained focus on the topic through regular communications, real life case studies and interviews from our leaders.

* Shareholders the company has been unable to trace for 12 years, a change to the Company's Articles of Association approved by shareholders in 2017.

Progress against our diversity targets

We had 2020 Group targets in place to increase the representation of women at all levels which were also supported by local business and country targets to address local diversity challenges. Our progress against these targets can be seen below. We have missed some of these targets and acknowledge there is work to do in a number of areas. We have no female Executive Team members, however our succession pool is 42% female and we have increased representation of non-British nationalities from 50% in 2019 to 58% in 2020. The impact of the COVID-19 pandemic this year has made it challenging to make significant progress, but we have continued to focus on diversity throughout our fundamental restructuring, and we have set new challenging targets for 2025 for both gender diversity globally, and ethnic minority representation in the UK and US.

Employee turnover rate in 2020

	% of population
All employees	15.3
Male employees	15.7
Female employees	12.8

Diversity targets and 2020 actuals

	2020 Target	2020 Actuals	2025 Target
Female population			
Board	33%	31%	33%
ET	23%	0%	33%
ELG	25%	20%	35%
Senior Leaders*	21%	19%	30%
Leaders	20%	19%	30%
All employees	17%	17%	25%
Ethnic minority population			
UK	10%	10%	14%
US	19%	15%	20%

* Senior leaders defined as all leaders who are career level B, or equivalent global grade and above.

EXECUTIVE TEAM, COMPANY SECRETARY AND THEIR DIRECT REPORTS

2020	27 (30%)	63 (70%)	90
2019	21 (26%)	61 (74%)	82

■ Female
■ Male

FEMALE EMPLOYEE POPULATION¹

2020	TARGET	17.0%
2020	16.2% (7,800)	
2019	16.0% (8,300)	
2018	15.5% (8,300)	
2017	15.1% (7,400)	
2016	14.8% (7,400)	
2015	15.2% (7,700)	
2014	14.8% (8,000)	

FEMALE SENIOR MANAGER POPULATION²

2020	TARGET	25.0%
2020	19.6% (19)	
2019	20.2% (19)	
2018	14.7% (13)	
2017	13.6% (18)	
2016	11.4% (16)	
2015	7.3% (14)	
2014	6.7% (12)	

FEMALE GRADUATE POPULATION³

2020	TARGET	30%
2020	27%	
2019	30%	
2018	26%	
2017	23%	
2016	24%	
2015	26%	
2014	25%	

FEMALE HIGH POTENTIALS POPULATION³

2020	TARGET	30%
2020	27%	
2019	30%	
2018	26%	
2017	25%	
2016	25%	
2015	25%	
2014	24%	

¹ Employee headcount data is calculated as the average number of full time equivalents throughout the year. Certain joint ventures are classified as joint operations, 1,300 employees associated with joint operations are not included within our overall headcount or diversity data.

² Senior manager population for 2020, 2019 and 2018 is calculated as Executive Team and ELG population (2020 total:96, 2019 total:94, 2018 total:88), prior years data refers to the senior leadership team that was replaced by the ELG through restructuring in 2018.

³ The graduate and high potentials targets refer to the percentage of employees on these development programmes as at 31 December each year.

ETHICS AND COMPLIANCE

Maintaining high standards of ethics and compliance is fundamental to our continued success. We work hard to create a working environment where everyone at Rolls-Royce and those we work with can be at their best.

We are committed to maintaining the highest ethical standards and have a suite of Group policies and processes in place to help us avoid any potential complicity in misconduct. Our Code of Conduct (Our Code) and associated policies set out the values and behaviours we expect everyone to demonstrate. They also provide guidance on how to apply these principles in our daily decisions.

In 2020, our mandatory ethics training focused on making decisions. This comprised of team discussions on real-life cases where people had their decision influenced by an authority figure, the group, time pressure or optimistic bias. 92% of in-scope employees completed the training (2019: 97%) by the year-end deadline. An extension to early 2021 was agreed with the European Works Council for employees based in Germany. 99% of managers certified their commitment to adhere to the principles set out in Our Code (2019: 99%). We flow these principles to our suppliers through our Supplier Code of Conduct. All suppliers are contractually required to adhere to this, or a mutually agreed alternative.

We actively encourage speaking up in the event of a question or concern and provide a variety of channels through which colleagues may do so. During the year, as working patterns changed due to COVID-19, we continued to highlight the channels available to everyone if they had a concern. In addition, the ELG were prompted to be vigilant in ensuring business be conducted in line with our values and behaviours, Our Code and Group policies.

We have a zero tolerance approach to misconduct of any kind and will take disciplinary action, up to and including dismissal, in the event of a breach of Our Code. In 2020, 63 employees (2019: 85) left the business for reasons related to breaches of Our Code.

Anti-bribery and corruption

Our Code and associated policies clearly set out our commitment not to tolerate bribery or corruption in any form. In 2020, we strengthened our anti-bribery and corruption due diligence, including introducing revised procedures and a new supporting system. This also involved introducing further targeted training for key users of these procedures. In addition, for occasional users we made available a series of podcasts to explain the revised procedures. We conduct extensive due diligence into potential joint venture partners as well as supporting existing joint ventures in their ethics and compliance programmes.

2020 Highlights

- Introduced strengthened anti-bribery & corruption due diligence*
- *92% employees completed annual ethics training*
- *Initiated review of human rights policy and associated due diligence*
- *Published Aletheia Framework*

Human rights and anti-slavery

Our human rights policy sets out our commitment to protecting the human rights of our employees, and those who may be impacted by the operations, products and services in our value chain. We operate in accordance with human rights and humanitarian law through strict compliance to strategic export laws in the countries where we operate, particularly in the sale of products with dual use or defence application. Our due diligence activities to identify, assess, mitigate and prevent human rights related risks are embedded within our enterprise risk management system (see page 46) and global governance framework. Compliance is devolved to the relevant business functions and expertise, including export control, procurement and human resources.

During 2020, we initiated a review of our human rights policy and associated due diligence procedures, including a comprehensive benchmarking of industry practice, potential emerging legal requirements and voluntary guiding frameworks. Through this, we have identified four focus areas for future activity: rights of employees; communities local to operations; business relationships in the supply chain; and the sale and use of products and services. We expect to publish an updated human rights policy during 2021.

- ❑ Find more information on our anti-slavery and human trafficking statement; Group policies & materials stewardship page at rolls-royce.com
- ❑ For more information on our ethics approach see the Safety, Ethics & Sustainability Committee report on page 101 or view 'At our Best: Our Approach' document available at rolls-royce.com

Building trust in artificial intelligence with our Aletheia Framework

Rolls-Royce has developed an ethics for artificial intelligence (AI) framework, which could help gain society's trust of AI technology and accelerate the next generation of industrialisation, known as industry 5.0. This is a method that any organisation can use to ensure the decisions it takes to use AI in critical and non-critical applications are ethical, including the first step-by-step process for ensuring the outcomes of AI algorithms can be trusted. We have made the Aletheia Framework publicly available for the benefit of other companies and organisations, including subject matter experts and not-for-profits, to support increased use and public trust in AI.

PRINCIPAL RISKS

COVID-19 created exceptional circumstances in civil aviation in 2020. Consequently, we reviewed the principal risks and how we manage them in light of COVID-19 at both the half-year and year-end. In our 2019 Annual Report, we identified infectious disease as a root cause of our Business Continuity risk and a reduction in air travel and customer disruption as root causes of our Market and Financial Shock risk. As a result, additional actions and controls have been identified and implemented to mitigate the impact to the Group and protect our people and businesses.

Our approach to emerging risks has also been dominated by COVID-19 and our response to the pandemic. We have considered many emerging risks as a result of COVID-19, with regard to the changing risk landscape and the most appropriate response.

Our risk and internal control system

The Board has established procedures to manage risk and oversee the risk management system (RMS). The Board has also established procedures to determine the nature and extent of the principal and emerging risks the Group is willing to take in order to optimise its commercial opportunities and achieve its long-term strategic objectives. The Audit Committee reviews the Group's internal financial controls which form a subset of the broader set of controls. Financial reporting controls are identified and subject to periodic review by the Group's internal control team. The Audit Committee, on behalf of the Board, performs an annual review of the RMS and its effectiveness. During the year, the Board completed a robust assessment of both our principal and emerging risks. Our RMS 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.

How we manage risk

Risks are identified by individuals across all businesses and functions and at many layers of the organisation by considering what could stop us achieving our strategic, operational or compliance objectives or impact the sustainability of our business model. Risk owners assess the risks, likelihood and impact, taking into account current mitigating control activities, identifying where additional activities may be needed to bring the risk within our risk appetite. Risk owners consider the effectiveness of current mitigating control activities in their assessment, supported by different assurance providers including internal audit. These considerations are recorded using a variety of systems and tools depending on the risk area. In managing the identified risks, judgement is necessary to evaluate the risks facing the Group in achieving its objectives, determine the risks that are considered acceptable, determine the likelihood of those risks materialising, assess the Group's ability to reduce the impact of risks that do materialise and ensure the costs of operating particular controls are proportionate to the benefit provided. Risk owners bring the results of their assessment, current risk status and action plans to business, function and other management review forums as often as is required depending on the nature of the risk, for support, challenge and oversight. These forums include the monthly Executive Team and regular Board and Board committee meetings.

At least once a year the Audit Committee, on behalf of the Board conducts a review of the effectiveness of the RMS and where required identifies areas for improvement (more details of this review can be found on page 79).

For key compliance and safety risks, the Group has a set of mandatory policies and training which set out the expectations on employees and the controls in place. Every employee is required, annually, to complete training and confirm that they will comply with the mandatory policies. The consequences of non-compliance are addressed via performance management systems that are linked to remuneration.

During the year, we simplified our policies and guidance and provided support to risk owners in assessing the effectiveness of mitigating controls and on our current risk level relative to our risk appetite. We conducted a Group-wide review into our response to COVID-19 and, as part of this review, we reassessed our risks.

In 2021, we will seek to build on our work this year and embed more of the lessons learned from COVID-19 in our business-as-usual approach. We will continue to improve the quality of our risk assessment and management activities in relation to our restructuring programmes, financial planning and critical decision-making.

COVID-19 and changes in our principal risk levels

The scale and impact of the pandemic and actions taken to control its spread have resulted in some increased risks to and uncertainty in our operations.

Risk level unchanged: We have concluded no change for Product Safety or Compliance given no significant changes to our operational or regulatory landscape during 2020, supported by the output from our relevant assurance and incident reporting frameworks in these areas. We have concluded no change for Climate Change or Cyber given the priority that was already placed on mitigating these risks to our business. Our climate change risks are managed in the same way as other risks. Given the events of 2020, we have concluded that the most critical risk is the impact of our products and services on the environment and have revised our principal risk description accordingly as set out on page 48. More detail on our approach to climate change can be found on page 34. Given the criticality of protecting our business against cyber threat, additional mitigations, including the strict safeguards required to be in place to enable more of our employees to work from home, were carefully considered as part of our COVID-19 response.

Increased risks: COVID-19 itself, subsequent changes to our ways of working in our facilities and from home, and indirect changes due to our restructuring have increased our People Safety and Talent and Capability risks. Business Continuity increased as our supply chain may face difficulties in fulfilling requirements due to the pandemic. COVID-19 has caused us to reconsider the nature of our Competitive Environment and the likelihood and impact of a Financial or Market Shock. Our Political risks have increased due to changes in a various geopolitical environments across the globe both independent of and related to the pandemic. We have reset our restructuring targets as a result of COVID-19, which may be harder to meet than previously assessed.

PRINCIPAL RISKS

Other specific risks

Human capital: our approach to human capital risks forms part of Enabling our People on page 42. More detail is included in our People and Culture section on pages 40 to 44.

Human trafficking and slavery: our approach is set out under the human rights and anti-slavery section on page 45.

Principal risks

Our principal risks are identified and managed in the same way as other risks. Principal risks are owned by at least one member of the Executive Team and subject to a review at an Executive Team meeting at least once each year, before a review by the Board or a Board committee.

Changes were made at the half-year to our principal risks due to COVID-19 and these changes remain relevant at the year-end. In particular: Market and Financial Shock were split into two separate risks, and Major Product Programme Delivery has been incorporated

within Competitive Environment. Our current principal risks (including those most significantly impacted by COVID-19) together with how we manage them, how we assure them (by activities and functions other than internal audit) and the Board and Board committees providing oversight are set out in the table below.

Emerging risks

We continue to review additional emerging risks that could significantly impact or challenge our current strategy and business model. Any emerging risks identified have been recorded in our RMS and are being managed and monitored alongside our existing risks.

Following the UK's exit from the European Union on 31 January 2020 and the trade deal announced in December 2020, we continue to review the details of the agreement and to ensure there is no interruption in our service to customers. We continue to work closely with the UK Government and relevant trade bodies to ensure they are aware of our priorities.

Change in risk level in 2020 (last 12 months including changes to risk level resulting from COVID-19 and our response):

↑ Increased ↔ Static ↓ Decreased + New risk

HOW WE MANAGE PRINCIPAL RISKS

RISK	CONTROLS	ASSURANCE ACTIVITIES AND PROVIDERS	OVERSIGHT FORUM	CHANGE
Safety Failure to: i) meet the expectations of our customers to provide safe products; or ii) create a place to work which minimises the risk of harm to our people, those who work with us, and the environment, would adversely affect our reputation and long-term sustainability.	<p>Product:</p> <ul style="list-style-type: none"> – Our product safety management system includes activities designed to reduce our safety risks as far as is reasonably practicable and to meet or exceed relevant company, legal, regulatory and industry requirements. – We verify and approve product design. – We test adherence to quality standards during manufacturing. – We validate conformance to specification for our own products and those of our suppliers. – We mandate safety awareness training. – We use engine health monitoring to provide early warning of product issues. – We take out relevant and appropriate insurance. <p>People:</p> <ul style="list-style-type: none"> – Our HSE management system includes activities designed to reduce our safety risks as far as is reasonably practicable and to meet or exceed relevant company, legal, regulatory and industry requirements. – We reinforce our journey to Zero Harm. – We use our crisis management framework. 	<p>Product:</p> <ul style="list-style-type: none"> – Product safety assurance team – Technical product life cycle audits <p>People:</p> <ul style="list-style-type: none"> – Safety case interventions – HSE audit team 	<ul style="list-style-type: none"> – Safety, Ethics & Sustainability Committee – Product safety boards 	↔
				↑

PRINCIPAL RISKS

RISK	CONTROLS	ASSURANCE ACTIVITIES AND PROVIDERS	OVERSIGHT FORUM	CHANGE
Business continuity The major disruption of the Group's operations, which results in our failure to meet agreed customer commitments and damages our prospects of winning future orders. Disruption could be caused by a range of events, for example: extreme weather or natural hazards (for example earthquakes, floods); political events; financial insolvency of a critical supplier; scarcity of materials; loss of data; fire; or infectious disease. The consequences of these events could have an adverse impact on our people, our internal facilities or our external supply chain.	<ul style="list-style-type: none"> – We invest in capacity, equipment and facilities, dual sources of supply and in researching alternative materials. – We provide supplier finance in partnership with banks to enable our suppliers to access funds at low interest rates. – We hold safety stock. – We plan and practise IT disaster recovery, business continuity and crisis management exercises. – We undertake supplier diligence. – We take out relevant and appropriate insurance. 	<ul style="list-style-type: none"> – Investment reviews – Supplier strategy and sourcing reviews – Group security and resilience team 	– Audit Committee	↑
Climate change We recognise the urgency of the climate challenge and have committed to net zero carbon by 2050. The principal risk to meeting these commitments is the need to transition our products and services to a lower carbon economy. Failure to transition from carbon-intensive products and services at pace could impact our ability to win future business; achieve operating results; attract and retain talent; secure access to funding; realise future growth opportunities; or force government intervention to limit emissions.	<ul style="list-style-type: none"> – We invest in i) reducing carbon impact of existing products; and ii) zero carbon technologies to replace our existing products. – We balance our portfolio of products, customers and revenue streams to reduce our dependence on any one product, customer or carbon emitting fuel source. – We acknowledge and communicate our role in the problem and the solution, and the actions we are taking to enact a credible plan of action in line with societal expectations. 	<ul style="list-style-type: none"> – Strategic planning – Innovation hub activities – Investment reviews – Group sustainability team 	<ul style="list-style-type: none"> – Safety, Ethics & Sustainability Committee – Science & Technology Committee 	↔

PRINCIPAL RISKS

RISK	CONTROLS	ASSURANCE ACTIVITIES AND PROVIDERS	OVERSIGHT FORUM	CHANGE
Competitive environment Existing competitors: the presence of competitors in the majority of our markets means that the Group is susceptible to significant price pressure for original equipment or services. Our main competitors have access to significant government funding programmes as well as the ability to invest heavily in technology and industrial capability. Existing products: failure to achieve cost reduction, contracted technical specification, product (or component) life or falling significantly short of customer expectations, 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. New programmes: failure to deliver an NPI project on time, within budget, to technical specification or falling significantly short of customer expectations would have potentially significant adverse financial and reputational consequences. Disruptive technologies (or new entrants with alternative business models): could reduce our ability to sustainably win future business, achieve operating results and realise future growth opportunities.	<ul style="list-style-type: none"> – We review product life cycles. – We make investment choices to improve the quality, delivery and durability of our existing products and services and to develop new technologies and service offering to differentiate us competitively. – We protect our intellectual property (e.g. through patents). – We monitor our performance against plans. – We scan the horizon for emerging technology and other competitive threats, including through patent searches. 	<ul style="list-style-type: none"> – Strategic planning – Innovation hub activities – Investment reviews 	<ul style="list-style-type: none"> – Board – Science & Technology Committee 	↗
Compliance Non-compliance by the Group with legislation, the terms of DPAs or other regulatory requirements in the heavily regulated environment in which we operate (for example, export controls; data privacy; use of controlled chemicals and substances; anti-bribery and corruption; and tax and customs legislation). This could affect our ability to conduct business in certain jurisdictions and would potentially expose the Group to: reputational damage; financial penalties; debarment from government contracts for a period of time; and suspension of export privileges (including export credit financing), each of which could have a material adverse effect.	<ul style="list-style-type: none"> – We continuously develop and communicate a comprehensive suite of mandatory policies and processes throughout the Group. – We undertake third party due diligence. – We encourage, facilitate and investigate speak up cases. – We investigate potential regulatory matters. – Our financial control framework activities are designed to reduce financial reporting risks. – We classify data to meet internal and external requirements and standards. 	<ul style="list-style-type: none"> – Compliance teams 	<ul style="list-style-type: none"> – Safety, Ethics & Sustainability Committee 	↔

PRINCIPAL RISKS

RISK	CONTROLS	ASSURANCE ACTIVITIES AND PROVIDERS	OVERSIGHT FORUM	CHANGE
Cyber threat An attempt to cause harm to the Group, its customers, suppliers and partners through the unauthorised access, manipulation, corruption, or destruction of data, systems or products through cyberspace.	<ul style="list-style-type: none"> – We deploy web gateways, filtering, firewalls, intrusion, advanced persistent threat detectors and integrated reporting. – We test software. – We use our crisis management framework. 	<ul style="list-style-type: none"> – Group cyber security team and security operations centre 	<ul style="list-style-type: none"> – Data security committee 	
Market shock The Group is exposed to a number of market risks, some of which are of a macroeconomic nature (e.g. economic growth rates) and some of which are more specific to the Group (for example, reduction in air travel or defence spending, or disruption to other customer operations). A large proportion of our business is reliant on the civil aviation industry, which is cyclical in nature. Demand for our products and services could be adversely affected by factors such as current and predicted air traffic, fuel prices and age/replacement rates of customer fleets.	<ul style="list-style-type: none"> – We monitor trends, market demand and future market forecasts and make investment choices to maximise the related opportunities. – We incorporate trends, demand and other dependencies in our financial forecasts. – We balance our portfolio with the sale of original equipment and aftermarket services, providing a broad product range and addressing diverse markets that have differing business cycles. 	<ul style="list-style-type: none"> – Annual target setting and strategic planning – Investment reviews 	<ul style="list-style-type: none"> – Board 	
Financial shock The Group is exposed to a number of financial risks, some of which are of a macroeconomic nature (for example, foreign currency, oil price, interest rates) and some of which are more specific to the Group (for example, liquidity and credit risks). Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness and our ability to access funding. This would affect operational results or the outcomes of financial transactions.	<ul style="list-style-type: none"> – Our financial control framework activities are designed to reduce financial reporting risks. – Group strategic planning process. – We incorporate trends, demand and other dependencies in our financial forecasts. – We analyse currency and credit exposures and include in sourcing and funding decisions. – We develop, review and communicate treasury policies that are designed to hedge residual risks using financial derivatives (covering foreign exchange, interest rates and commodity price risk). – We raise finance through debt and equity programmes. – We hedge with reference to volatility in external financial markets. 	<ul style="list-style-type: none"> – Annual target setting and strategic planning – Finance risk committee 	<ul style="list-style-type: none"> – Audit Committee 	

PRINCIPAL RISKS

RISK	CONTROLS	ASSURANCE ACTIVITIES AND PROVIDERS	OVERSIGHT FORUM	CHANGE
Political risk 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. Examples include: changes in key political relationships; explicit trade protectionism, differing tax or regulatory regimes, potential for conflict or broader political issues; and heightened political tensions.	<ul style="list-style-type: none"> – We develop Group and country strategies and consider associated dependencies. – We horizon scan for political implications and dependencies including around Brexit. – We include diversification considerations in our investment and procurement choices. 	<ul style="list-style-type: none"> – Strategic planning – Brexit steering group – Investment reviews – Supplier sourcing and strategy reviews – Government relations teams 	– Board	
Restructuring Failure to deliver our restructuring, including changing our behaviours could result in: missed opportunities; dissatisfied customers; disengaged employees; ineffective use of our scarce resources; and increasing the likelihood of other principal risks occurring. This could lead to a business that is overly dependent on a small number of products and customers; failure to achieve our vision; non-delivery of financial targets; and not meeting investor expectations.	<ul style="list-style-type: none"> – We develop, implement and review status of restructuring programme and project plans including on M&A, transformation and restructuring activities. – We maintain knowledge management systems. – We simplify the processes in our management systems whilst ensuring we comply with our legal, contractual and regulatory requirements. 	<ul style="list-style-type: none"> – Strategic planning – Executive Team restructuring and transformation reviews 	– Board	
Talent and capability Inability to identify, attract, retain and apply the critical capabilities and skills needed in appropriate numbers to effectively organise, deploy and incentivise our people would threaten the delivery of our strategies.	<ul style="list-style-type: none"> – We undertake succession planning and monitor the talent pipeline. – We survey employee opinion. – We develop, implement and review strategic resourcing plans. 	– People leadership team	– Nominations & Governance Committee	

GOING CONCERN AND VIABILITY STATEMENTS

GOING CONCERN STATEMENT

Overview

The Group operates an annual planning process. The Group's plans and risks to their achievement are reviewed by the Board and once approved, are used as the basis for monitoring the Group's performance, incentivising employees and providing external guidance to shareholders.

The processes for identifying and managing risk are described on pages 46 to 51. As described on these pages, the risk management process, and the going concern and viability statements, are designed to provide reasonable but not absolute assurance.

Given the economic uncertainty of the COVID-19 pandemic, and taking into account the recent guidance issued by the FRC, the Directors have undertaken a comprehensive going concern review over an eighteen-month period to September 2022, considering the forecast cash flows of the Group and the liquidity headroom available over that eighteen-month period. The Group has modelled two scenarios in its assessment of going concern which have been considered by the Directors, along with a likelihood assessment of these scenarios, being:

- base case, which reflects the Directors' current expectations of future trading; and
- severe but plausible downside scenario, which envisages a 'stress' or 'downside' situation.

Further details, including the analysis performed and conclusion reached, are set out below.

Background

The COVID-19 pandemic has had a significant impact on the Group, with the Civil Aerospace and ITP Aero businesses being the most significantly impacted. Uncertainty remains over the severity, extent and duration of the disruption caused by the COVID-19 pandemic and therefore the timing of recovery to pre-crisis levels. Safeguarding the health and wellbeing of our people and protecting our business have been at the heart of our decision-making from the outset of this pandemic. During 2020, we have taken decisive action to reduce cash expenditure and maintain liquidity through the following measures:

- A number of proactive steps starting in March 2020, to conserve cash, which delivered more than £1.0bn in-year cash cost savings compared to our pre COVID-19 cash costs in 2020. These savings were delivered through cutting non-critical capital expenditure, minimising discretionary costs, including projects, consulting spend, professional fees and sub-contractor costs, reviewing and rephasing R&D spend, together with a temporary 10% salary

reduction for our senior management, and making use of the UK Government's Coronavirus Job Retention Scheme.

- The final shareholder payment in respect of 2019 was not recommended and there will be no shareholder payment in respect of 2020.
- In May 2020, the Group launched a major restructuring programme to reshape and resize the Group and in particular, the Civil Aerospace business. This will remove at least 9,000 roles across the Group, with forecast annualised savings of over £1.3bn by the end of 2022. At 31 December 2020, approximately 7,000 roles had been removed across the Group.
- In August 2020, the Group secured a £2bn term-loan facility, 80% of which is guaranteed by UK Export Finance (UKEF). This is repayable in August 2025.
- In October 2020, the Group launched a rights issue which was completed in November 2020, raising £2bn of proceeds.
- In October 2020, the Group completed a £2bn bond issuance with maturities in 2026 and 2027 and secured a new £1bn loan facility that matures in October 2022.

Whilst vaccination programmes are now underway across the globe, uncertainties remain in respect of more contagious variants of the virus and the potential impact of this on the timing of recovery of demand, in particular in relation to the civil aviation industry. The actions we have taken during 2020 have been necessary to right-size the business to achieve a longer-term sustainable cost base that is fit for purpose in a post COVID-19 environment, as well as securing additional funding to provide sufficient liquidity headroom for the Group.

Going concern assessment

In assessing the adoption of the going concern basis of accounting in the Company and Consolidated Financial Statements, the Directors have considered the FRC Company Guidance (updated 20 May 2020) (COVID-19), which has encouraged companies to assess current forecasts with more vigour, and to consider the impact of different potential scenarios along with a likelihood assessment, taking into account both the uncertainty and the likely success of any realistic mitigations. In adopting this more vigorous approach, the Directors have assessed the Group's future financial performance, cash flows and liquidity headroom available over an eighteen-month period to September 2022, taking into account a base case and a severe but plausible downside scenario. The Directors have paid attention to the impact of the COVID-19 pandemic on the Group, particularly on the Civil Aerospace and ITP Aero businesses, which have been the most significantly impacted, recognising the challenges of reliably estimating and forecasting the effects of COVID-19 on the civil

GOING CONCERN AND VIABILITY STATEMENTS

aviation industry, as well as the extent and timing of recovery to pre-crisis levels. Key areas of estimation uncertainty include:

- The magnitude of the impact on EFHs and consequently cashflows from the aftermarket business. The estimates in respect of EFHs and future recovery are influenced by assumptions in respect of:
 - the roll-out of vaccination programmes across the globe and their ability to deal with different variants of the COVID-19 virus;
 - the extent and timing of the easing of restrictions on cross-border movement, including quarantine rules; and
 - the recovery rate of flying hours with a potential growth in the number of people holidaying in their home country, and the increased use of video conferencing reducing the need for business travel.
- The extent of the impact of the pandemic on our customers, and consequently the purchase new aircraft, and/or renew of after-market contracts in the future.
- A shift towards more efficient, lower-cost aircraft as airlines look to recover post COVID-19, leading to a risk of higher aircraft retirements in the future.
- Right-sizing the business is underpinned by the assumed size needed to meet future demand.

Given these estimation uncertainties, the Directors believe it is appropriate to provide additional disclosure of the key COVID-19 related assumptions underpinning the base case and severe but plausible downside scenario, as set out below.

Base case scenario

The Group's base case scenario assumes a deep impact on the Civil Aerospace and ITP Aero businesses, with a slow and gradual recovery in demand in 2021. Whilst new variants of the COVID-19 virus create some uncertainty, vaccination programmes are successfully rolled out and/or mass airport testing is introduced to alleviate quarantine restrictions in place across many countries. Widebody flying hours returns to 55% of the pre-crisis baseline in 2021 and approximately 80% in 2022, with slower growth to a full recovery to 2019 levels of widebody activity by the end of 2024 based on industry data.

The Civil Aerospace and ITP Aero forecast assumes:

- **flying hours of widebody aircraft** are 55% of 2019 level in 2021 recovering to 80% of 2019 level in 2022 (based on year averages);
- **flying hours of business aviation** are 2% above 2019 level in 2021 and increase to 10% above the 2019 level in 2022 (based on year averages);
- **widebody OE engine sales** reduce from 450 in 2019 to 187 in 2021 (42% of 2019 level) before increasing to 204 in 2022 (45% of 2019 level);
- **widebody spare engine sales** are 80% of 2019 level in 2021 and 75% of 2019 level in 2022;

- **business aviation engine sales** are 54% of 2019 level in 2021 increasing to 88% of 2019 level in 2022;
- **newer aircraft fleets** (A350, A330neo and 787) recover at a faster pace than older fleets due to the economics and investment value of the aircraft;
- **older aircraft fleets** (A330, A380 and 777) recover on a slower, more varied profile taking into account regional market recovery and unique market dynamics; and
- **the pressure on the transitions market**, driven by new aircraft delivery and volume of surplus assets, results in an elongation in transition time to ~24 months.

Severe but plausible downside scenario

As noted above, due to the inherent uncertainty over the extent and duration of the disruption caused by the COVID-19 pandemic and therefore the timing of recovery of civil aviation to pre-crisis levels, the Directors have also considered a severe but plausible downside scenario.

This severe but plausible downside is based in principle on a general assumption that recovery remains subdued due to ongoing infection rates and an increase in new variants of the COVID-19 virus, with a slower recovery in demand compared with the base case. Restrictions on travel between countries remain in place across many parts of the world during the first part of 2021, with a gradual recovery of the global economy and the Group taking place once those restrictions are lifted.

The resulting key underlying COVID-19 specific assumptions included in the severe but plausible downside scenario in relation to each of the Civil Aerospace and ITP Aero businesses are as follows:

- **flying hours of widebody aircraft** are 45% of 2019 level in 2021, recovering to 70% of 2019 level in 2022 (based on year averages);
- **flying hours of business aviation** are 1% above 2019 level in 2021 and increase to 8% above 2019 level in 2022 (based on year averages);
- **widebody OE engine sales** are 28% of 2019 level in 2021 before falling to 26% of 2019 level in 2022;
- **widebody spare engine sales** are 20% of 2019 in 2021 and remain at 20% of 2019 in 2022;
- **business aviation engine sales** are 54% of 2019 level in 2021 increasing to 80% of 2019 level in 2022;
- **newer aircraft fleets** (A350, A330neo and 787) recover at a faster pace than older fleets due to the economics and investment value of the aircraft;
- **older aircraft fleets** (A330, A380 and 777) recover on a slower, more varied profile taking into account regional market recovery and unique market dynamics; and
- **the pressure on the transitions market**, driven by new aircraft delivery and volume of surplus assets, results in an elongation in transition time to ~24 months.

Liquidity and borrowings

At 31 December 2020, the Group had liquidity of £9.0bn, including cash and cash equivalents of £3.5bn and undrawn facilities of £5.5bn.

The Group's committed borrowing facilities at 31 December 2020, March 2021 and September 2022 are set out below. None of the facilities are subject to any financial covenants or rating triggers which could accelerate repayment.

(£m)	31 Dec 2020	March 2021	September 2022
Issued Bond Notes ¹	4,634	4,634	3,995
Bank of England Commercial Paper ²	300	–	–
Other loans	87	87	61
UKEF Loan ³	2,000	2,000	2,000
Revolving Credit Facility ⁴	2,500	2,500	2,500
Bank Loan Facility ⁵	1,000	1,000	1,000
Total committed borrowing facilities	10,521	10,221	9,556

¹ The value of Issued Bond Notes reflects the impact of derivatives on repayments of the principal amount of debt. A €750m (£639m) bond matures in June 2021, a €550m bond matures in May 2024, and the remainder of the bonds mature between October 2025 and May 2028.

² The £300m CCFF facility matures in March 2021.

³ The £2,000m UKEF loan matures in August 2025 (currently undrawn).

⁴ The £2,500m Revolving Credit Facility matures in April 2025 (currently undrawn).

⁵ The £1,000m bank loan facility matures in October 2022 (currently undrawn).

Taking into account the maturity of borrowing facilities the Group had committed facilities of £10.5bn at 31 December 2020, £10.2bn at the end of March 2021 and £9.6bn will be available throughout the period to September 2022.

Under both of the scenarios modelled by the Directors (as detailed above), the projections indicate that the Group will continue to operate within its available committed borrowing facilities for the next eighteen months to September 2022 whilst maintaining a sufficient level of liquidity headroom when taking into account debt maturities across this eighteen-month period.

Mitigating actions

Mitigations that are within the control of the Directors and deliverable over the short term have been considered by the Directors. Such mitigations include the restriction of capital and other expenditure to only committed and essential levels, reduce or eliminate discretionary spend, reinstate the implementation of pay deferrals and undertake further restructuring.

Other mitigations that could be considered in more severe circumstances, which are not directly in the control of the Directors, include raising other new funding through the bond or bank markets, pursuing a £1bn increase in the existing £2bn UKEF-backed loan and raising further equity. The anticipated £2bn proceeds from business disposals announced in August 2020 have not been included when assessing the going concern, although completion of these disposals is anticipated during 2022 and within the eighteen-month period being considered. Further potential business disposals could be considered if required.

Conclusion

After due consideration of the matters set out above, the Directors consider that the Group has sufficient liquidity headroom to continue in operational existence for a period of at least eighteen months from the date of this report and are therefore satisfied that it is appropriate to adopt the going concern basis of accounting in preparing the financial statements.

GOING CONCERN AND VIABILITY STATEMENTS

VIABILITY STATEMENT

Viability

The viability assessment considers solvency and liquidity over a longer period than the going concern assessment. Our downside scenario uses the same assumptions as the going concern statement and in 2023 to 2025 assumes a slower recovery back to 2019 level than assumed in our base case. The analysis excludes proceeds from disposals and additional funding which have not yet been agreed but, if and when realised, will increase liquidity at least £2bn.

Consistent with previous years, we have assessed our viability over a five-year period which is in line with our five-year annual target setting process. We continue to believe that this is the most appropriate time period to consider as, inevitably, the degree of certainty reduces over any longer period.

In making the assessment, we have used the same base case and severe but plausible downside scenarios and existing committed borrowing facilities as set out in the going concern assessment, with the analysis extended over five years. We have combined additional severe but plausible scenarios that estimate the potential impact of additional principal risks arising over the assessment period, for example: the loss of a key element of the supply chain, a compliance breach, a trade war between major trading blocs, failure to deliver the expected benefits from our restructuring activities, the impact of climate change or a significant product safety event. The impact on viability of some of the risks modelled, such as Business Continuity and Political risk, has reduced compared to last year due to falling OE volumes and lower EFHs.

The cash flow impacts of these scenarios were overlaid on the five-year forecast to assess how the Group's liquidity and solvency would be affected.

The scenarios assume an appropriate management response to the specific event which could be undertaken and also consider specific activities to improve liquidity such as raising additional funds, reducing expenditure and divesting non-core businesses.

Reverse stress testing has also been performed to assess the severity of scenarios that would have to occur to exceed liquidity headroom, including a scenario where existing borrowing facilities could not be refinanced as they mature.

On the basis described above, the Board confirms that it has a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the next five years. In making this statement, the Directors have made the following key assumptions:

- the Group is able to refinance maturing debt facilities and draw-down existing available facilities as required;
- the Group has access to global debt markets and expects to be able to refinance these debt facilities on commercially acceptable terms;
- the Group's medium and long-term financing plans are designed to allow for periods of adverse conditions in world capital markets but not a prolonged period (e.g. 12 months) where debt markets were effectively closed to the Group;
- that implausible scenarios do not occur. Implausible scenarios include either multiple risks impacting at the same time or where management actions do not mitigate an individual risk to the degree assumed; and
- that in the event of one or more risks occurring (which has a particularly severe effect on the Group) all potential actions (such as but not limited to, restricting capital and other expenditure to only committed and essential levels, reducing or eliminating discretionary spend, reinstating the implementation of pay deferrals, raising additional funds through debt or equity raises, executing disposals and undertaking further restructuring) would be taken on a timely basis. The Group believes that it has the early warning mechanisms to identify the need for such actions and, as demonstrated by our decisive actions in 2020, has the ability to implement them on a timely basis if necessary.

s172 STATEMENT

The Board believes that, individually and together, they have acted in the way they consider, in good faith, would be most likely to promote the success of the Company for the benefit of its members as a whole having regard to the stakeholders and matters set out in s172(1)(a)-(f) of the Companies Act 2006 in the decisions taken during the year ended 31 December 2020. This statement sets out the Board's approach to decision-making, its stakeholder engagement, why its stakeholders matter and some key decisions made during 2020. To give greater understanding to this, we have provided clear cross-referencing to where more detailed information can be found in this Annual Report.

When making key strategic decisions, the Board considers for each matter the likely consequences of any decision in the long term, identifies stakeholders who may be affected, and carefully considers their interests and any potential impact as part of the decision-making process. The areas the Board focused on during the year and the key decisions made are set out on pages 70 and 71 and our report on stakeholder engagement during the year is on pages 72 to 73.

THE BOARD'S APPROACH

We remain a particularly active Board, with a heightened degree of oversight and scrutiny during the COVID-19 pandemic to ensure we are aware of the impacts on all our stakeholders.

Purpose, vision and strategy (see page 9)

- purpose refined during the year to reflect our sustainability ambitions
- we have a clearly articulated purpose recognising our role in society
- our key focus in the near term was refined in response to COVID-19
- corporate narrative aligned with both vision and strategy

Group policies (see page 45)

- annual review of Group policies
- mandatory ethics training focused on decision-making

Culture and people (see page 40)

- oversight of implementation of strict safety measures to protect against the spread of COVID-19 at our sites around the world (see pages 40 to 41)
- increased our focus on health and wellbeing (see pages 40 to 41)
- tracked progress and sought feedback on our people framework throughout the restructuring activity in 2020 through reports from the management team and the Employee Champions (see pages 41 to 44)
- Code of Conduct clearly communicated and enforced (see page 45)

Risk and internal control framework (see page 46)

- additional actions and controls have been identified and implemented to mitigate the impact of COVID-19 on the Group and to protect our people and businesses (see page 46 to 51)
- COVID-19 created exceptional circumstances in civil aviation in 2020. Consequently we reviewed all risks and mitigating actions at both the half-year and year-end (see pages 46 to 51)
- reviewed process for the preparation of both going concern and viability statements (see pages 52 to 55)

Board structure (see page 62)

- role of the Board and its matters reserved reviewed annually
- clear focus of the Board's Committees, annual review of terms of reference
- clearly defined roles and responsibilities for Board members and the Company Secretary

'freedom within a framework' (see page 63)

- communication of freedom within a framework culture

OUR PURPOSE

At Rolls-Royce, we pioneer the power that matters to connect, power and protect society

DELIVERED WITH INTEGRITY

We discuss how we maintain high standards of ethics and compliance and their fundamental importance to our continued success on page 45

— OUR STAKEHOLDER ENGAGEMENT —

Our activities are global and complex. Touching upon a wide variety of stakeholders, we aim to create trusted relationships to understand the needs of all our stakeholders so we can continue to deliver value and build a resilient business. This was important in a challenging year for our end markets and for civil aviation in particular.

See pages 72 to 73 for the Board's engagement with our stakeholders and page 12 for our business model.

Customers

In a year of significant impact, particularly in the civil aviation industry but also in other end markets, we had continuous dialogue with our customers. Focusing on the needs of our customers is critical to the success of our business. We maintain a high degree of customer intimacy in order to anticipate and understand the future power needs of our customers, building on our years of experience in delivering for our markets. We collaborate and innovate with our customers to improve product performance and value and to promote best practice in the industry to combat issues such as climate change.

Investors

It was critical that our existing and potential institutional investors, retail shareholders and bond holders understood our strategy and rationale as we sought their support for our rights issue and bond issuance in 2020. Continued access to capital is vital to long-term performance of our business. We work to ensure that our investors and investment analysts have a strong understanding of our strategy, performance, ambition and culture.

Employees

Employee engagement is critical to our success. During the fundamental restructuring in the year we continued to work to create a diverse and inclusive workplace where every employee can reach their full potential and be at their best. We engage with our people to ensure we are delivering to their expectations, supporting wellbeing and making the right business decisions. This ensures we can retain and develop the best talent.

Partners and suppliers

Our external supply chain and our suppliers are vital to our performance. We engage with them to build trusting relationships from which we can mutually benefit and to ensure they are performing to our standards and conducting business to our expectations. Business continuity discussions formed a vital part of the dialogue this year.

Communities

We were challenged in our traditional activities and sought new ways to enhance engagement with young people and disadvantaged groups who have been significantly impacted by disruption to education and social activities this year. We are committed to building positive relations with the communities in which we operate. We support communities and groups, local and relevant to our operations.

Governing bodies and regulators

Considerable engagement was undertaken with governments and regulators in this unprecedented year and we continue to work with them as we prepare for recovery in the civil aviation sector. We engage with national governments, national/transnational agencies and key politicians and regulators to ensure that we can help shape policy, have licence to operate, attract funding, enable markets and ultimately win business. We work with governments globally where we have operations or future business opportunities.

— OUR PRINCIPAL DECISIONS IN 2020 —

More discussion on these decisions can be found in the Corporate Governance Report on Board focus on pages 70 to 71.

Redefining the strategy

The COVID-19 pandemic had a sudden and material impact on the Group and on our markets globally and this led the Board to refine the strategy during the year. This is further explained in the Chairman's statement and Chief Executive's review (see pages 4 to 8) and also articulated in our purpose, vision and strategy (see pages 9 to 11). The Board considered all stakeholders as part of these considerations and received reports from the Executive Directors on their discussions with and feedback from employees, customers, suppliers & partners, governments and advisers. As part of these discussions the Board strengthened the Group's commitment to combatting climate change recognising that we have a key role to play in creating a more sustainable future.

COVID-19 and rebuilding the balance sheet

The sudden and material impact of the COVID-19 pandemic resulted in a sharp deterioration in the financial performance of Civil Aerospace and, to a much lesser extent, in Power Systems. The Board committed to undertake a number of significant actions to mitigate the financial and operating impact in order to strengthen the financial position of the Group and in doing so considered the long-term interests of employees, customers, suppliers & partners and future and current investors.

Fundamental restructure and cost savings

The Board had oversight of the decisions by the Executive Team to fundamentally restructure the Group and of the impact these decisions had on employees and local communities in particular – noting discussions with UK Trade Unions and the European Works Council as well as with Government Ministers and Members of Parliament. The review of the UK defined benefit pensions scheme was also noted (see page 42), the decision supported the Group's future financial position and ensured a more equal level of total reward going forward.

Strategic acquisitions

The Group made two acquisitions to accelerate the delivery of its electrification strategy. Both acquisitions remain in line with the Group's net zero emissions and post-pandemic recovery strategy.

Payments to shareholders

The Board made the difficult decision, in light of the uncertain macroeconomic outlook resulting from the COVID-19 pandemic, to not recommend a final payment to shareholders nor an interim shareholder payment. Further information on this can be found on pages 5 and 211.

Strategic Report
signed on behalf of the Board

Warren East
Chief Executive

11 March 2021

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GOVERNANCE REPORT

COMPLIANCE WITH THE UK CORPORATE GOVERNANCE CODE 2018

The Company is subject to the principles and provisions of the UK Corporate Governance Code 2018 (the Code), a copy of which is available at www.frc.org.uk.

For the year ended 31 December 2020, the Board considers that it has complied in full with the provisions of the Code, with the exception of provision 38 regarding pension contribution rates for Executive Directors and those of the wider workforce, as these were not aligned throughout 2020. As we previously reported, we committed to reduce the rates over a period of time for our existing Executive Directors to ensure alignment by 2022. However, to ensure compliance in 2021, existing and new Executive Directors will now receive a pension contribution rate aligned with the wider workforce from 1 January 2021 (see pages 82, 86 and 90).

COMPOSITION, SUCCESSION AND EVALUATION

We have a clear process when considering appointments to the Board and operate effective succession planning (see pages 75 and 76).

Our Board demonstrates a combination of skills, experience and knowledge (see pages 64 to 66 and 68).

In 2020, Belinda Hudson Limited carried out an annual evaluation of the Board. The methodology and progress can be found on page 74.

BOARD LEADERSHIP AND COMPANY PURPOSE

The Board has delivered a heightened degree of oversight and scrutiny during the pandemic to ensure the long-term sustainable success of the Company. Our Governance report provides examples of our leadership and engagement with our stakeholders (see page 72).

- We refined our corporate narrative as we are determined to play a fundamental role in pioneering a resilient, inclusive, net zero carbon future (see page 70).

- To ensure we have the right resources and skills to execute our strategy, we have undertaken a number of significant actions to mitigate the impact of COVID-19 (see pages 7 and 8).

- Our Code and associated policies ensure our workforce can meet our expected values and behaviours. We encourage our people to speak up (see pages 45 and 70).

AUDIT, RISK AND INTERNAL CONTROL

We recognise the importance and benefits of ensuring the internal audit function and the external auditors remain independent (see pages 79 to 80).

- The Board presents a fair, balanced and understandable (FBU) assessment of the Company's position and prospects (see page 78).

- Our risk and control environment is reviewed by the Audit Committee. The Board considered both emerging and principal risks during the year (see page 70).

DIVISION OF RESPONSIBILITIES

We clearly define the roles of the Chairman and the Chief Executive and fully support the separation of the two roles.

- The Board believes it operates effectively with the appropriate balance of independent Non-Executive Directors (NEDs) and Executive Directors (see pages 64 to 66).

- The Board regularly considers time commitments of Directors. Prior Board approval is required for Directors' external appointments to ensure there is no compromise on time commitment (see page 75).

- The quality of information and resources available to the Board has enabled us to operate effectively and efficiently during a year in which we held a considerable number of additional Board and Committee meetings and calls.

REMUNERATION

Our remuneration policy has been revised this year and will be put to the shareholders for approval at our 2021 AGM. Key changes are set out on page 81 and clear links to our KPIs can be found on page 84.

- The Remuneration Committee, comprising only NEDs, is responsible for developing the policy and determining executive and senior management remuneration (see page 82).

- No Director is involved when deciding their own remuneration outcome.

CHAIRMAN'S INTRODUCTION

As a Board, we very quickly changed the way we worked in response to the COVID-19 environment. We still have a lot to achieve and deliver in 2021 but your Board is as committed as I am to see us through the current period.

In previous years, I have stated here that our approach is to have innovative governance that fits the needs of the business and ensures that we add value in all that we do. This stood us in good stead for 2020 as we flexed our governance structures to meet our needs as a Board and as a business and found they stood up well under pressure. As a Board we very quickly changed the way we worked as we moved to weekly Board calls and management updates on key metrics, particularly for Civil Aerospace, and impacts on our people, customers, partners & suppliers and other stakeholders. As with much of the rest of the world, all our meetings since March 2020 have been virtual, including our AGM and the General Meeting held in October to approve our rights issue.

I would like to thank the Board for all the time they have given during the course of the year. As you can see on page 69, not only did we hold a high number of additional Board meetings and calls but each of the Committees also held additional meetings to ensure focus on specific areas such as product safety; wellbeing; diversity & inclusion and talent retention throughout the significant restructure; and financial resilience in a time of cost pressure and macroeconomic uncertainty. The Non-Executive Directors also reduced their fees by 10% in line with the senior management team for nine months of the year and the impact of COVID-19 on the aerospace sector led the Remuneration Committee to review our remuneration policy. A revised, bespoke policy which is tailored to our specific challenges is set out on pages 85 to 91 and will be put to shareholders at our AGM in May 2021.

Culture

Our Employee Champions, Irene Dorner and Beverly Goulet, were joined by Lee Hsien Yang who was appointed this year as the Board's Employee Champion for the Asia Pacific region, and together they reached out to all our people to hear what was on their minds. The Board noted progress against our 2020 diversity & inclusion targets and agreed targets for 2025. These are detailed on page 44. We recognise that there is still significant work to do, particularly at Executive Team level. We ensured that there were females on the shortlist for the CFO role and that the succession pools for all Executive Team roles have increasing representation both from females and from non-British nationalities.

We took time to understand the impact of COVID-19 on employee resilience and noted good progress with our injury rates. We continued to receive feedback on the anti-bullying and harassment programme as well as other training.

Board developments

In February 2020, we announced extensions to the terms for both Lewis Booth and Sir Frank Chapman as Non-Executive Directors, until the 2021 AGM at the latest. In light of the COVID-19 pandemic, Lewis remained as the Chair of the Audit Committee during the year with his intended replacement, Nick Luff, continuing as a Non-Executive Director and member of the Audit Committee. I would like to thank Lewis for his continuing support through a challenging time. He has continued in his role to see us through the 2020 financial year and will step down as Chair of the Audit Committee with effect from the date of this report when Nick Luff will take over as we had previously planned. Sir Frank has been a tremendous support and source of advice for our product safety team in particular during his tenure and has also been a guiding voice as we have developed our sustainability agenda to this point. Jasmin Staiblin will also stand down from the Board at the 2021 AGM, along with Lewis and Sir Frank, as she will have served nine years on the Board at that time. I would like to thank all of them for their tremendous support during their tenure. Dame Angela Strank, who joined the Board in May 2020, will take over as chair of the Safety, Ethics & Sustainability Committee following Sir Frank's departure – a role we had in mind for her when she was recruited to the Board.

I would also like to welcome Paul Adams who will join the Board on 11 March 2021 and will also join the Nominations & Governance Committee, Safety, Ethics & Sustainability Committee and the Science & Technology Committee. Paul's biography can be found on page 64.

I would also like to thank Stephen Daintith who has been a highly valued member of the Board and the management team. He has made a huge contribution to the business, not least in response to the pandemic by taking rapid action to strengthen our liquidity. On behalf of the Board, I would like to thank him for his hard work, resilience and energy. I am delighted to welcome Panos Kakoullis who will join the Board in May as our Chief Financial Officer.

Looking forward

I will look to Sir Kevin Smith, as Senior Independent Director, to start to look for my successor during 2021 as I approach the end of my tenure as Chairman. However, we still have a lot to achieve and deliver and I know that your Board is as committed as I am to see us through the current period.

Sir Ian Davis
Chairman

CORPORATE GOVERNANCE

THE BOARD

THE ROLE OF THE BOARD

The Board is ultimately responsible to shareholders for the direction, management, performance and long-term sustainable success of the Company. It sets the Group's strategy and objectives and oversees and monitors internal controls, risk management, principal risks, governance and viability of the Company. In doing so, the Directors comply with their duties under section 172 of the Companies Act 2006 (see pages 56 to 57).

The Board has established certain principal committees to assist it in fulfilling its oversight responsibilities, providing dedicated focus on particular areas, as set out below. The chair of each committee reports to the Board on the committee's activities after each meeting.

In addition to the Board's principal committees, it has established a sub-committee of Directors who each hold an appropriate level of UK national security clearance for the purpose of receiving and considering, on behalf of the Board, any UK classified information relating to the Group's programmes and activities. Beverly Goulet, a US national and independent Non-Executive Director, also sits on the board of Rolls-Royce North America Holdings, Inc. to create a link between the Board and the Group's North American governance structure.

- KEY MATTERS RESERVED FOR THE BOARD -

The Group's long-term objectives, strategy and risk appetite	Changes to the corporate or capital structure of the Company
The Group's organisation and capability	Annual Report and financial and regulatory announcements
Stakeholder engagement	Significant changes in accounting policies or practices
Overall corporate governance arrangements including Board and Committee composition, committee terms of reference, Directors' independence and conflicts of interest	Annual budgets and financial expenditure and commitments above levels set by the Board
Internal controls, governance and risk management frameworks	Overview of speak up programme and cases reported through the Ethics Line

THE BOARD COMMITTEES

NOMINATIONS & GOVERNANCE COMMITTEE



See page 75

AUDIT COMMITTEE



See page 77

REMUNERATION COMMITTEE



See page 81

SAFETY, ETHICS & SUSTAINABILITY COMMITTEE



See page 101

SCIENCE & TECHNOLOGY COMMITTEE



See page 102

Roles and responsibilities

The roles of the Chairman and Chief Executive are clearly defined and the Board supports the separation of the two roles. The Chairman is responsible for the leadership and effectiveness of the Board. The Chief Executive is responsible for the running of the Group's business and leads the Executive Team which comes together to communicate, review and agree on issues and actions of Group-wide significance.

Non-Executive Directors support the Chairman and provide objective and constructive challenge to management. The Senior Independent Director (SID) provides a sounding board for the Chairman and serves as an intermediary for the Chief Executive, other Directors and shareholders when required.

The Company Secretary makes sure that appropriate and timely information is provided to the Board and its Committees and is responsible for advising and supporting the Chairman and Board on all governance matters. All Directors have access to the Company Secretary and may take independent professional advice at the Company's expense in conducting their duties.

Directors' independence

We continue to monitor and note potential conflicts of interest that each Director may have and recommend to the Board whether these should be authorised and if any conditions should be attached to such authorisations. The Directors are regularly reminded of their continuing obligations in relation to conflicts and are required to review and confirm their external interests at least annually. This helps us to determine whether each of them continues to be considered independent.

In 2020, the Board considered the independence of both Lewis Booth and Sir Frank Chapman who both completed their nine years as Non-Executive Directors in May and November 2020 respectively, and recommended their re-election at the 2020 AGM. Further information can be found on page 75.

Following due consideration, the Board determined that all Non-Executive Directors continued to be independent in both character and judgement.

CORPORATE GOVERNANCE

Freedom within a framework

The Executive Team has defined the framework in which the businesses have the maximum freedom, responsibility and accountability for their performance.

The framework sets out how we are organised as a Group. Having the framework in place enables us to manage risk, drive critical business decisions and maintain standards across the Group. It means we can act with pace and confidence in a way that meets the expectations of our stakeholders.

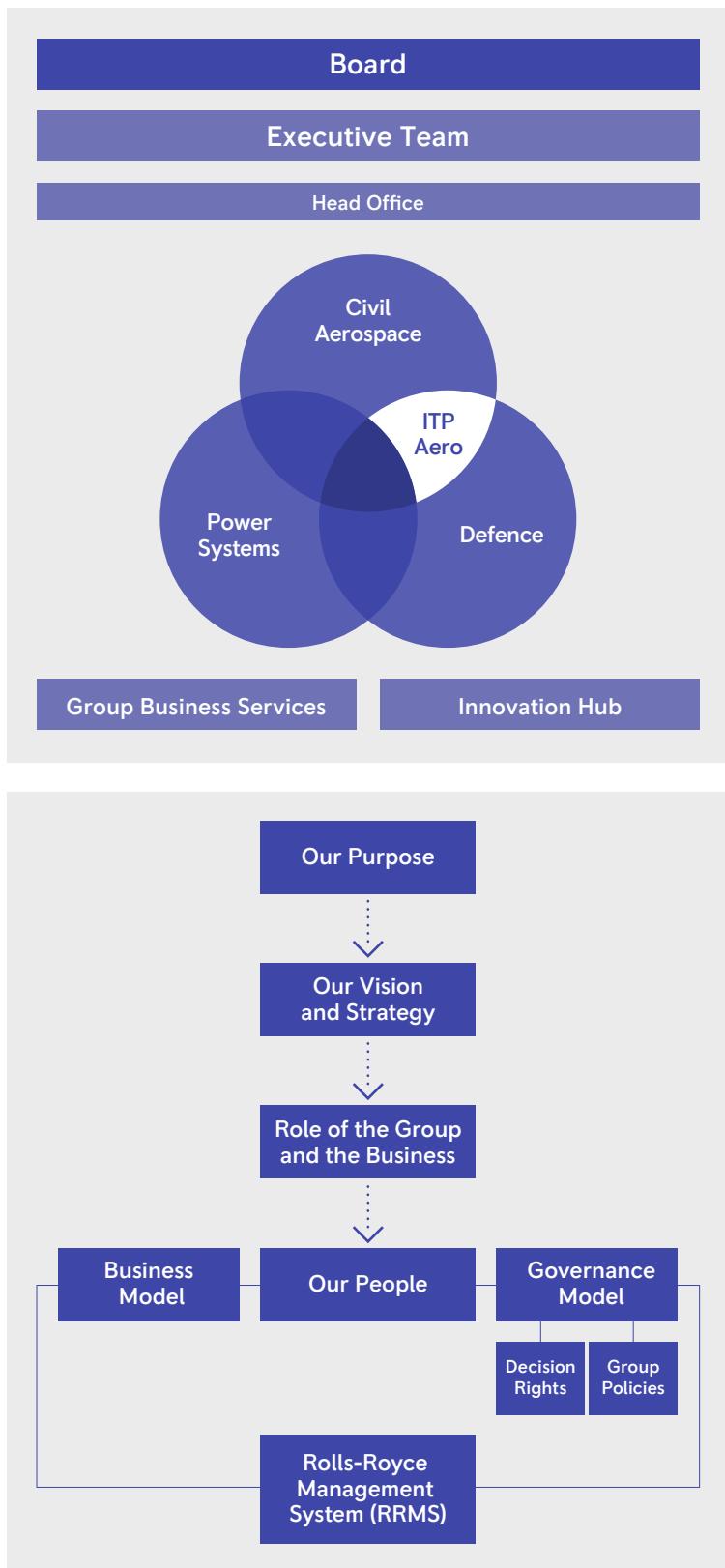
The framework sets out the roles of the businesses, as well as head office, group business services and the innovation hub and defines what we mean by empowered businesses.

Our people section sets out the capabilities, behaviours, competencies and values which enable us to deliver our strategy.

The governance model clarifies decision-making rights and points of accountability and includes an online support tool for all key decision-makers. It includes details of all governance bodies and decision-making committees within the Group that the decision-makers may need to consult or seek approval from. It also provides access and an overview of our mandatory Group policies which define the requirements for all our people when they are carrying out their day-to-day activities as well as sets out our risk management and internal control systems and assurance activities.

The Rolls-Royce management system (RRMS) promotes end-to-end value stream processes that standardise and simplify the way we deliver products and services across the Group. It is an important strand in our governance of product safety.

Together, these are set within the context of our vision and strategy and also link to our business model. All our people can see how everything joins together and how they are contributing to one of the world's leading industrial technology companies, connecting, powering and protecting society.



BOARD OF DIRECTORS

Position	Board skills and competencies	Key external appointments
 SIR IAN DAVIS Chairman of the Board Chair, Nominations & Governance Committee Appointed to the Board on 1 March 2013 and as Chairman on 2 May 2013	Sir Ian brings tremendous financial and strategic experience. He has worked widely with global organisations and companies, enabling him to draw on his knowledge of diverse issues and outcomes. Sir Ian's wealth of business knowledge as well as his global experience means that he makes a considerable contribution to the Board, the Company's stakeholders and its future.	Current – Johnson & Johnson Inc., non-executive director – McKinsey & Company, senior partner emeritus Past – BP p.l.c., senior independent director (2010 to 2020) – Cabinet Office, non-executive board member (2015 to 2016) – McKinsey & Company, various executive roles (1979 to 2010)
 WARREN EAST CBE Chief Executive Appointed to the Board on 1 January 2014 and as Chief Executive on 3 July 2015	Warren is a chartered engineer and has an outstanding record as a chief executive officer. He has a deep understanding of technology and developing long-term partnerships. He has proven strategic and leadership skills in a global business and a strong record of value creation. Warren harnesses the Company's world-class engineering skills and its proud record of innovation and delivery.	Current – ASML Holdings N.V., member of the supervisory board Past – ARM Holdings plc, chief executive (2001 to 2013)
 STEPHEN DAINTITH Chief Financial Officer Appointed to the Board on 7 April 2017 Resignation announced on 27 August 2020. To step down from the Board on 19 March 2021	Stephen has a deep understanding of international business across various sectors and an appreciation for looking beyond the numbers to help improve performance. His change management experience allows him to make a significant contribution to the long-term growth of the business and the increasing demand for its technology.	Current – 3i Group plc, non-executive director Past – Daily Mail and General Trust plc, CFO (2011 to 2017) – British American Tobacco plc, various executive roles (1996 to 2005)
 PANOS KAKOULLIS Chief Financial Officer To be appointed to the Board on 3 May 2021	Panos has over 30 years of experience working with a wide range of significant multinational corporations, leading audits and advising on M&A transactions and turnarounds. He has been credited as one of the most highly regarded Big Four audit partners globally. Delivering significant transformation programmes throughout his career at Deloitte, he brings strong leadership and an appetite for innovation, collaboration and simplification.	Past – Deloitte LLP, various partner and leadership director roles (1989 to 2019)
 PAUL ADAMS Independent Non-Executive Director Appointed to the Board on 11 March 2021	Paul has deep experience across the aerospace industry and in engine manufacturing in particular, gained from over 30 years of leadership experience in the aviation industry. He has a passion for engineering and broad, sector-specific operational experience. His industry focus is undoubtedly a great asset to both our Safety, Ethics & Sustainability Committee and our Science & Technology Committee.	Current – OC Oerlikon Corporation AG, Pfäffikon, board member – Aerion Corporation, board member Past – Precision Castparts, chief operating officer (2016 to 2018) – Pratt & Whitney, various executive roles (1999 to 2016)
 LEWIS BOOTH CBE Independent Non-Executive Director Chair, Audit Committee Appointed to the Board on 25 May 2011. To step down from the Board on 13 May 2021	Lewis has considerable financial expertise with a strong international perspective having worked in Europe, Asia, Africa and the US. He has been credited as one of the strongest and most experienced international leaders within the motor industry and as such makes a significant contribution to the Board and to his role as Chairman of the Audit Committee.	Current – Mondelez International, Inc., director – Ford Innovation Fund Advisory Board, chair Past – Gentherm, Inc., director (2013 to 2018) – Ford Motor Company, various executive roles (1978 to 2012)



Full biographies of our Directors can be found at rolls-royce.com

BOARD OF DIRECTORS

Position	Board skills and competencies	Key external appointments
 SIR FRANK CHAPMAN Independent Non-Executive Director Chair, Safety, Ethics & Sustainability Committee Appointed to the Board on 10 November 2011. To step down from the Board on 13 May 2021	Sir Frank has a life-long passion for engineering and innovation and a deep understanding of technology, together with an outstanding record of business achievement. His significant industrial and safety experience, gained through his distinguished career, have proved invaluable to Rolls-Royce and particularly in his role as Chairman of the Safety, Ethics & Sustainability Committee.	Current – NextDecade Corporation, non-executive director – Myeloma UK, vice-chair – Zap Energy, Inc., independent director Past – Golar LNG Limited, chairman (2014 to 2015) – BG Group plc, chief executive (2000 to 2013)
 GEORGE CULMER Independent Non-Executive Director Appointed to the Board on 2 January 2020	George has a strong track record as a senior finance professional with significant experience gained in large, international, highly regulated groups and has proven business leadership credentials. With this experience, together with his strengths in change leadership and transformation gained from within complex groups, George makes a significant contribution to the Board.	Current – Aviva plc, chairman Past – Lloyds Banking Group plc, chief financial officer (2012 to 2019) – RSA Insurance Group plc, group financial officer (2004 to 2012)
 IRENE DORNER Independent Non-Executive Director Chair, Remuneration Committee Employee Champion Appointed to the Board on 27 July 2015	Irene has held a number of varied international roles during her career, including risk management and human resources, and draws on her considerable experience as Chairman of the Remuneration Committee. As a passionate advocate of diversity and inclusion, Irene has embraced the role of Employee Champion and ensures the views of the workforce are properly reflected in the Board's discussions.	Current – AXA SA, director – Taylor Wimpey plc, chair – Control Risks Group, chair Past – HSBC, various executive roles (1986 to 2014)
 BEVERLY GOULET Independent Non-Executive Director Rolls-Royce North America Holdings, Inc., board member Employee Champion, North America Appointed to the Board on 3 July 2017	Having spent a considerable amount of her career in the airline industry, Bev brings valuable knowledge and operational experience to the Board. She has significant expertise in finance, treasury, strategy, legal and governance matters. She has the expertise and experience to be able to confidently contribute to decision-making and actively take part in developing and strengthening our businesses.	Current – Xenia Hotels & Resorts, Inc., director – American Airlines Federal Credit Union, chair Past – American Airlines, Inc., various executive roles (1993 to 2017)
 LEE HSIEN YANG Independent Non-Executive Director Employee Champion, Asia Pacific Appointed to the Board on 1 January 2014	A Singaporean national, Hsien Yang combines a strong background in engineering with extensive international business and management experience in our most important growth markets. Through his varied career history, Hsien Yang has gained significant industrial and financial skills which have proved invaluable in his current committee memberships.	Current – INSEAD South East Asia Council, president Past – Civil Aviation Authority of Singapore, chairman (2009 to 2018)
 NICK LUFF Independent Non-Executive Director Appointed to the Board on 3 May 2018	Nick is an experienced finance executive having been CFO of a number of listed companies across a variety of industries. He has broad financial skills and a track record of driving business performance. His extensive non-executive and audit committee experience, together with both financial and accounting expertise and a passion for engineering, is invaluable to the Board.	Current – RELX plc, chief financial officer Past – Lloyds Banking Group plc, non-executive director (2013 to 2017) – QuinetiQ Group plc, non-executive director (2004 to 2010)

BOARD OF DIRECTORS

Position	Board skills and competencies	Key external appointments
 SIR KEVIN SMITH CBE Senior Independent Director Chair, Science & Technology Committee Appointed to the Board on 1 November 2015	Sir Kevin has extensive industrial leadership experience and a deep knowledge of global engineering and manufacturing businesses, as well as the aerospace industry. As Chairman of the Science & Technology Committee, Sir Kevin has been able to draw on his extensive experience and make a significant contribution to development and growth of key strategies.	Current – L.E.K. Consulting LLC, european advisory board member Past – Unitas Capital PTE LTD, partner & chairman (2012 to 2015) – GKN plc, group chief executive (2003 to 2011)
 JASMIN STAIBLIN Independent Non-Executive Director Appointed to the Board on 21 May 2012. To step down from the Board on 13 May 2021	Jasmin combines a strong background in advanced engineering and a deep understanding of technology with extensive international business experience. She has a track record in leading strategic repositioning and growth, restructuring and major transformations. Her background is dominated by science and technology and Jasmin is able to make a significant contribution to the Board and Science & Technology Committee.	Current – George Fischer AG, board member – Zurich Insurance Group Ltd, non-executive director – NXP Semiconductors N.V., non-executive director Past – Alpiq Holding AG, chief executive officer (2013 to 2018) – ABB Switzerland Ltd, CEO (2006–2012)
 DAME ANGELA STRANK Independent Non-Executive Director Appointed to the Board on 1 May 2020	Dame Angela brings a proven track record in managing engineering operations and driving technology, digital research and sustainability programmes. She brings a wealth of corporate experience to the Board, having served on the executive team at BP and being one of the most senior female executives in the energy industry, as well as having non-executive experience.	Current – Severn Trent plc, non-executive director – SSE plc, non-executive director Past – BP p.l.c., various executive roles (1982 to 2020)
 PAMELA COLES Chief Governance Officer/ Company Secretary Appointed as Company Secretary on 1 October 2014	Pamela is an expert in corporate governance and company law with a pragmatic approach to how the Governance Team supports the business. Pamela is instrumental in supporting the Chairman and the Non-Executive Directors to build strong relationships with the management team and has been able to offer advice and guidance on a wide range of topics.	Current – E-Act, non-executive director

Board committee membership (as at 11 March 2021)

	Nominations & Governance	Audit	Remuneration	Safety, Ethics & Sustainability	Science & Technology
Sir Ian Davis					
Paul Adams					
Lewis Booth					
Sir Frank Chapman					
George Culmer					
Irene Dorner					
Beverly Goulet					
Lee Hsien Yang					
Nick Luff					
Sir Kevin Smith					
Jasmin Staiblin					
Dame Angela Strank					

Member Chairman

BOARD OF DIRECTORS

Board induction and development

The Chairman and Company Secretary arrange a comprehensive, tailored induction programme for newly-appointed Non-Executive Directors, which includes dedicated time with the Executive Team and senior management and scheduled trips to business operations. The programme is tailored based on experience and background and the requirements of the role.

All Directors visit the Group's main operating sites as part of their induction and are encouraged to make at least one visit to other sites each year throughout their tenure. However, as a result of COVID-19, all visits were postponed during 2020. These will resume as soon as possible as we regard these site visits as an important part of the induction process as well as for continuing education. They help Directors understand the Group's activities through direct experience of seeing processes in operation and by having discussions with a range of employees.

Dame Angela Strank was appointed to the Board in May 2020 and at that time joined the Nominations & Governance, Safety, Ethics & Sustainability and Science & Technology Committees. Since her appointment, she has embarked on her induction programme and met virtually with members of the Executive Team. Angela will be visiting Civil Aerospace in Derby, UK, Defence in Bristol, UK, and Power Systems in Friedrichshafen, Germany, as soon as it is possible.

It is important that the Directors continue to develop and refresh their understanding of the Group's activities. More detail of the Board's engagement with its stakeholders is set out on pages 72 to 73.

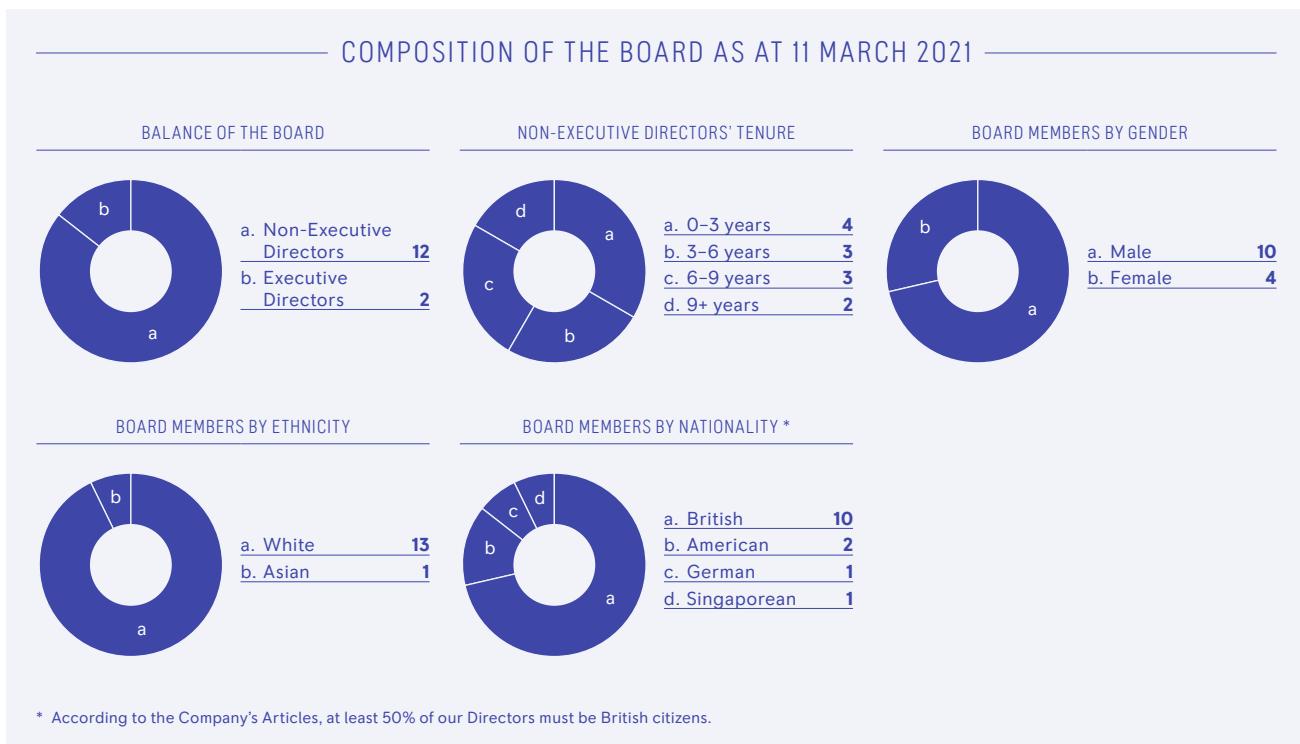
It is also important that the Directors regularly refresh and update their skills and knowledge and receive relevant training when necessary. Members of the Board also attend relevant seminars, conferences and training events to keep up-to-date on developments in key areas.

BOARD INDUCTION PROGRAMME FOR DAME ANGELA STRANK

TIMING	PEOPLE TO MEET	KEY TOPICS COVERED
Within first three months	Chairman	<ul style="list-style-type: none"> – Overview of the Board – Nominations & Governance Committee
	Chairs of the Committees	<ul style="list-style-type: none"> – Overview of Committees – Plan of work for the year – Current issues
	Chief Executive	<ul style="list-style-type: none"> – Business model – Current strategic priorities – Opportunities/risks – Current issues
	Chief Financial Officer	<ul style="list-style-type: none"> – Finance, treasury, M&A and tax overviews – Budget – Accounting issues
	Chief Governance Officer	<ul style="list-style-type: none"> – UK Corporate Governance Code and directors' duties – UK listed company requirements – Rolls-Royce framework – Board arrangements and meeting dates
	Executive Team members and senior management	<p>Overview of each area of responsibility and current priorities, including:</p> <ul style="list-style-type: none"> – markets and competition – operational and financial performance including KPIs – functional leadership – employee engagement – culture and diversity – sustainability strategy
	Internal and external auditors	<ul style="list-style-type: none"> – Audit report and findings – Financial and non-financial controls – Accounting judgements

BOARD COMPOSITION

The Board brings a wide range of experience, skills and backgrounds which complement the Group's strategy.



Non-Executive Directors' skills and experience

Non-Executive Director	Business experience									Global experience			
	Health & Safety	Sustainability & Environment	Engineering, Science & Technology	Company Leadership	Finance	Audit & Risk Management	Remuneration	Transformation	Legal & Regulation	Sector Specific	Europe	USA	Asia & Middle East
Sir Ian Davis		■		■	■						■	■	■
Paul Adams	■	■	■	■						■	■	■	■
Lewis Booth	■	■	■	■	■	■	■	■		■	■	■	■
Sir Frank Chapman	■	■	■	■				■		■	■	■	■
George Culmer					■	■	■	■	■	■	■	■	■
Irene Dorner		■		■	■	■	■	■	■	■	■	■	■
Beverly Goulet					■	■	■	■	■	■	■	■	
Lee Hsien Yang			■	■	■	■				■			■
Nick Luff					■	■	■	■	■	■	■	■	■
Sir Kevin Smith	■	■	■	■				■		■	■	■	■
Jasmin Staiblin	■	■	■	■	■			■		■	■	■	
Dame Angela Strank	■	■	■	■			■	■		■	■	■	

CORPORATE GOVERNANCE

Directors' attendance at Board and Committee meetings in 2020

	Board 9 scheduled (13 additional)	Nominations & Governance 5 scheduled (1 additional)	Audit 6 scheduled (9 additional)	Remuneration 7 scheduled (4 additional)	Safety, Ethics & Sustainability 3 scheduled (1 additional)	Science & Technology 3 scheduled (1 additional)
Sir Ian Davis	9 (13)	5 (1)	–	–	–	–
Warren East	9 (13)	5 (1)	–	–	–	–
Stephen Daintith	9 (13)	5 (1)	–	–	–	–
Lewis Booth	9 (12)	5 (1)	6 (9)	7 (4)	–	–
Sir Frank Chapman	9 (11)	5 (1)	–	–	3 (1)	2 (1)
George Culmer	8 (11)	5 (1)	5 (9)	–	2 (1)	–
Irene Dorner	9 (10)	5 (1)	–	7 (4)	3 (1)	–
Beverly Goulet	9 (13)	5 (1)	6 (9)	7 (4)	–	–
Lee Hsien Yang	8 (13)	5 (1)	6 (9)	–	3 (1)	–
Nick Luff ¹	9 (11)	5 (1)	6 (9)	–	2 (0)	–
Sir Kevin Smith	9 (13)	5 (1)	–	7 (4)	–	3 (1)
Jasmin Staiblin	9 (11)	5 (1)	–	–	–	3 (1)
Dame Angela Strank ²	6 (12)	4 (1)	–	–	2 (1)	2 (1)

¹ Nick Luff stepped down from the Safety, Ethics & Sustainability Committee in July 2020.

² Dame Angela Strank joined the Board in May 2020.

Figures in brackets indicate attendance at an additional meeting.

The table above sets out the Directors' attendance at Board and Committee meetings throughout 2020, both scheduled and additional. Most scheduled meetings end with a private discussion of the Non-Executive Directors led by the Chairman of the Board or Committee, without the Executive Directors or members of the Executive Team or management present.

Dame Angela Strank joined the Board as a Non-Executive Director in May and was appointed to the Nominations & Governance, Safety, Ethics & Sustainability and Science & Technology Committees. In February, the Company announced Nick Luff's appointment as Chair of the Audit Committee. However, in light of COVID-19, Lewis Booth resumed chairing the Audit Committee on an interim basis and provided continuity of support through 2020. Nick will resume his role as Chair of the Audit Committee from March 2021. Nick stepped down from the Safety, Ethics & Sustainability Committee after its meeting in July.

Additional meetings and sub-committee meetings

To ensure the Board's response to COVID-19 remained current and in step with the unfolding developments both in the business and globally, the Board held weekly update calls from March to June and a series of additional meetings during 2020. There was also one additional meeting of the Nominations & Governance Committee to consider Directors' external appointments. The Audit Committee held nine additional meetings to support the finance team and our external auditors in view of the heightened workload and the challenges with remote working brought about by COVID-19. Four additional meetings of the Remuneration Committee were held to consider a revised Remuneration Policy specific to the challenges facing

Rolls-Royce as a result of the pandemic. The Safety, Ethics & Sustainability Committee held one additional meeting to consider the impacts of the pandemic on our safety, ethics and sustainability agendas. The Science & Technology Committee held one additional meeting to review the Group's engineering technologies, capabilities and skills post-restructuring.

In addition to the meetings set out above, the Board delegated authority to a sub-committee to approve certain matters specifically in relation to the rights issue. This sub-committee met four times during September to November. A sub-committee of the Remuneration Committee was also convened in November to consider share plan adjustments in relation to the rights issue.

In support of the Committees' work, where there is a requirement for greater, in-depth discussion, we hold deep dives into specific areas of focus outside the meeting schedule. In November, the Audit Committee reviewed in detail the finance transformation programme while the Safety, Ethics & Sustainability Committee held a deep dive into the safety management system. This was the second of three sessions on the topic, the first being held as part of a scheduled meeting and the third to be held in 2021.

Non-attendance

Board members' attendance was high in 2020 and our Directors attended an unprecedented number of meetings called at short notice. However, where Directors were unable to attend, this was solely due to other business commitments and they communicated their responses to the matters for consideration via the Chairman of the Board and the Committee Chairs, where relevant.

BOARD FOCUS THROUGH 2020

The COVID-19 pandemic had a sudden and material impact on the Group. The Board focused on the health, safety and wellbeing of our people and the financial resilience of the Group. We also provided oversight of the management team as they materially reduced the cost base and restructured the Group's operations.

AREA OF FOCUS	KEY MATTERS CONSIDERED	OUTCOME
Strategy	Impact of the pandemic	<p>COVID-19 and its impact on the Group and our markets globally led the Board to refine the strategy during the year (see page 9):</p> <ul style="list-style-type: none"> – to restore financial performance in order to improve returns and build a more resilient and more appropriate balance sheet; – to drive growth and maximise value from our existing capabilities; and – to position the Group to benefit from new technologies, with a focus on sustainable power.
	Review of the business	<p>In light of the impact of COVID-19 on the Group, the Board regularly discussed the appropriateness of the Group's strategy and, in June, held an in-depth strategy meeting with the Executive Team focused on operational and financial progress against the Group's short and long-term plans. The regular dialogue throughout the year was imperative given the operational environment and in view of the Board's focus to rebuild the balance sheet and increase financial resilience which was key to positioning the Group for the future (see pages 6 to 11).</p>
	Acquisitions and disposals	<p>During the year, we made three acquisitions to accelerate our strategy to enhance the Group's position as an enabler of net zero emissions whilst ensuring alignment with post-pandemic economic recovery: a majority stake in electricity storage specialist Qinous, to enhance our microgrid offering; Kinolt, a dynamic uninterruptible power supply system business; and Servowatch Systems, an international supplier of integrated marine automation solutions for navies, commercial vessels and large yachts. Following a strategic review, we announced the sale of our Bergen Engines business in early 2021, which is not core to our future strategy. During the year, we also signed an agreement to sell our Civil Nuclear Instrumentation & Control business, and completed the sale of our Civil Nuclear North America Services business (see pages 11 and 174).</p>
Group purpose	Corporate narrative	<p>Our Group purpose remains – to connect, power and protect society. However, during the year we refined our strategic pillar of 'champion electrification' to encompass a wider range of net zero carbon technologies under the banner 'champion sustainable power'. This is in recognition of the increasing importance of ensuring that economic recovery and growth is achieved in a manner compatible with combatting climate change. We are determined to play a leading role in pioneering a resilient, inclusive, net zero carbon future.</p>
Culture	Review of the culture change agenda	<p>The Board sought ways to track progress and seek feedback on the areas articulated in our people framework (see page 40) throughout the significant restructuring activity in the year through reports from the management team and through the Employee Champions on:</p> <ul style="list-style-type: none"> – diversity & inclusion, talent and succession and the leadership learning, performance management and career frameworks; – progress report on the anti-bullying and harassment campaign and training (see page 43); – engagement with the UK Trade Unions and European Works Council and their reactions to the 2020 restructuring proposals; – the continued delivery of the safety agenda; – the Ethics Line programme, including the review of the operation of the speak up procedures, statistics, types of cases raised and the average completion time; and – outcome from the employee surveys.
Risk	Review of risk appetite and principal risks	<p>The sudden and material effect of the COVID-19 pandemic influenced the discussions at each Board meeting and the risk and impact to the Group were considered. The Board received weekly updates on the COVID-19 position from the Chief Financial Officer.</p>

CORPORATE GOVERNANCE

AREA OF FOCUS	KEY MATTERS CONSIDERED	OUTCOME
Risk continued	Review of risk appetite and principal risks	During the year, the Board completed a review of the principal risks and how we manage them in light of COVID-19. The principal risks are set out on pages 47 to 51. In addition, the Board reviewed and approved the effectiveness of the Group's risk management system, following an update from the Audit Committee. The implications of Brexit were kept under review. For more information on our approach to emerging risks (see page 47).
Operational performance/ challenges	Civil Aerospace, Defence and Power Systems	An update on each business was presented at every Board meeting in the form of a business review including progress against key operational milestones. The Board was kept appraised of the outcomes of the inspection programme on the Trent XWB-84 engines. For further information on the performance of each business, see pages 25 to 33.
Financial performance	COVID-19	The sudden and material impact of the COVID-19 pandemic resulted in a sharp deterioration in the financial performance of our Civil Aerospace business and, to a much lesser extent, in our Power Systems business. In 2020, the Board committed to undertake a number of significant actions to mitigate the financial and operating impact of COVID-19 in order to strengthen our financial position and seek to ensure we can deliver improved future returns. They continue to review the ongoing significant uncertainty over the precise shape and timing of the recovery in air traffic and its impact on the Group.
	Balance sheet review	The Board recognises the material uncertainties resulting from COVID-19 on the Group's immediate future and the need to rebuild the Group's balance sheet for the longer term. We approved a £2bn rights issue, completed in November. We are confident that, despite the more challenging near-term market conditions, the Group is well positioned for the future to capitalise on the long-term opportunities in all the Group's markets.
	Payments to shareholders	The Board made the difficult decision, in light of the uncertain macroeconomic outlook resulting from the COVID-19 pandemic, to not recommend a final payment to shareholders in respect of the financial year ended 31 December 2019. In addition, for the financial year ended 31 December 2020, an interim shareholder payment was not made and a final payment was not recommended, see page 5.
	Capital allocation	The Board continued to review the primary capital allocation priority, to strengthen the Group's balance sheet. The Board recognises the importance of a strong balance sheet due to the Group's long-term customer relationships and the cyclical nature of civil aviation and remains committed to its ambition of an investment grade credit profile in the medium term and a return to a net cash position.
	Finance transformation	Throughout the year, the Board was updated on the finance transformation programme, in particular, whether the final deliverables and outputs of the programme were fit for purpose and would address the current issues and risks faced by the Group. The Board recognised that the benefits of the finance transformation programme have other additive measures to the Group as a whole, including better provision of data which can be used by the business to support not only financial reporting, but also operational decision-making, future scenario reporting, etc.
Governance	Stakeholder engagement and governance	Details on the Board and Executive Team's engagement with stakeholders can be found on pages 72 and 73 and referenced in our s172 statement on pages 56 and 57. The Board also reviewed investor commentary following our full and half-year financial results as well as from our engagement with our investors as part of the rights issue programme. In addition, the Board received feedback from the Ethics Line, payment practices for the Group's subsidiaries, gender pay gap reporting and the Group's modern slavery statement.
	Non-financial controls	The Board considered the framework and concluded it remained appropriate. This articulates our freedom within a framework culture (see page 63).
Succession and leadership	Succession planning	During the course of the year, the Board considered the principal risk relating to Talent and Capability and reviewed succession at the most senior levels of the business (see page 75) as well as ensuring there was a robust emergency succession framework in place during the pandemic for members of the Executive Team and the business leadership teams. The Company announced the resignation of Stephen Daintith as Chief Financial Officer and Executive Director. The Board immediately began a process to identify and appoint a successor. It was announced in February 2021 that Panos Kakoullis would join the Company as Chief Financial Officer and Executive Director in May 2021.
	Effectiveness of the Board, Chairman and Chief Executive	A light touch external evaluation was undertaken, following on from the comprehensive evaluation in 2018, and it concluded that the Board continued to operate effectively in 2020 (see page 74). The Chairman and Chief Executive received constructive feedback on their respective performance.

STAKEHOLDER ENGAGEMENT

At Rolls-Royce, we understand that who we are and how we behave matters not only to our people but to the many stakeholders who have an interest in our business.

We believe that stakeholder engagement remains vital to building a sustainable business and we interact with many stakeholders at different levels of the organisation. Engagement is carried out by those most relevant to the stakeholder group or issue.

The table below identifies some of our stakeholders and how both the Company and the Board engage with them. There has been continuous dialogue with our stakeholders throughout the year and this has become part of our governance framework. We believe we have a clear responsibility to all our stakeholders to return the Group to strength with a sustainable and right-sized cost base, aimed at ensuring the Group's future success and the Board intends to take all appropriate actions to secure this outcome.

The Board considers the different stakeholder groups and our engagement programmes and identifies opportunities for strengthening both its relationships and understanding to facilitate the decisions and contributions made by the Board to the success of the business.

Customers	<p>The Board recognises that the quality of the Group's customer relationships is based on mutual trust as well as its engineering expertise. We recognise that as we recover from the impact of the pandemic, we must retain and strengthen our focus on playing a leading role in the transition to a net zero carbon global economy by creating the sustainable power that our customers require. In light of COVID-19, the Company and the Board have been regularly engaged with customers. Warren East reported on his meetings with Singapore Airlines, COMAC the aircraft manufacturer in China, and the Chairman of Gulf Air as well as a number of interactions he and Stephen Daintith had with our aircraft manufacturing customers. The Board regularly receives operational updates, including customer metrics and feedback, from each of the businesses with the business presidents regularly presenting to the Board. During the challenges faced as a result of COVID-19, the Board has kept very close to our customer engagement throughout the year and received specific feedback from each of the business presidents on the issues and mitigation plans including the impacts on our customers, which greatly influenced the Board's deliberations and support for the Executive Team when considering our strategy.</p>
Investors	<p>The investor relations team is the key interface between the investment community and the Board, providing frequent dialogue and feedback. The Chairman and members of the Board make themselves available to meet with institutional investors and seek to understand and prioritise the issues that matter most. In addition, the Chief Executive and Chief Financial Officer, supported by members of the Executive Team and investor relations, interact regularly with investors, most notably after our financial results, at conferences as well as at key points throughout the year. With 2020 being an unprecedented year, and as the COVID-19 pandemic took hold, the need for clear and effective communication with our investors became more important than ever and we adapted our investor engagement to suit an online environment. In May, unable to meet in person as usual at our AGM, we provided a virtual update on the business and encouraged shareholders to submit questions to the Board. In August, our Chief Executive and Chief Financial Officer communicated our half-year results in a webcast format. Crucially, in the second half of the year our Executive Team, supported by our Chairman, held a virtual roadshow with our equity and debt investors to gain the support required to successfully achieve a rights issue and bond issuance, which further supplemented the additional liquidity provided by the UK Government. We also conducted a remuneration consultation process with our largest shareholders. More than ever we recognise the importance of our investors as key stakeholders in our discussions and endeavour to ensure that we are able to create confidence in our Company through financial performance and the economic impact of our decisions, robust governance and transparency of reporting and delivering a sustainable, stable and predictable performance.</p>
Employees	<p>The Board recognises that it is through our people that we fulfil our potential, achieve our vision and execute our strategy. During 2020, the Board ensured that the safety and wellbeing of our employees remained at the heart of our decision-making. Our employees were provided with regular video messages on the Group's intranet from the Executive Team and were kept up to date on the rapidly changing environment and the impact of COVID-19 on our business. Following any decisions, communications were sent to all employees with FAQ sections and employees were invited to Q&A sessions held by the Executive Team via webcast. In addition to this, we took time to understand the impact of COVID-19 on employee resilience and continued to note progress with our injury rates.</p> <p>We take the role of Employee Champion very seriously to ensure there is a voice of the employees in the boardroom. Irene Dorner has continued in her role as Employee Champion for a fourth year and where possible meets with employee groups and attends employee stakeholder engagement meetings. Irene also has regular dialogue with the Chief People Officer and together they review the outcomes from the employee surveys and Ethics Line reports. Irene can be contacted by any employee by email. Beverly Goulet also continued in her role as the Board's Employee Champion for our North American employees and Lee Hsien Yang has been appointed this year as the Board's Employee Champion for Asia Pacific. The Employee Champions are supported by an employee stakeholder engagement group where we discuss what we have learnt and plan future schedules. The Employee Champions provide regular feedback to the Board on employee topics of interest and/or concern.</p>

CORPORATE GOVERNANCE

Employees (continued)

The direct link that they provide between the employees and the Directors is proving to be extremely valuable, particularly through a period of extensive change. Our Employee Champions recorded a video message to all employees in July 2020 and invited them to complete a survey suggesting other methods of engagement of benefit to them during such uncertain times and requested information on specific topics they want to discuss. A follow-up communication from our Employee Champions was made available to all employees on our internal website. Further engagement sessions have been scheduled for 2021 as a result of the survey, with a focus on diversity & inclusion as a topic employees sought to discuss with our Employee Champions. We believe that these methods of engagement with our employees are effective in building and maintaining trust and communication. They also act as a platform for employees to influence change in relation to matters that affect them.

During 2020, Irene attended the European Works Council Select Committee with the most senior employee representatives across Europe, chaired by our head of employee relations. In November, Irene attended a Global D&I Council meeting and, together with Beverly and Hsien Yang, a people leadership team meeting chaired by the Chief People Officer. As can be read in the People and Culture and Ethics and Compliance reports (pages 40 to 45) and the Committee reports, the Board reviews both the behaviours and statistics on safety and diversity & inclusion as well as the talent management agenda at all levels across the Group. The Board also continued to receive feedback on the anti-bullying and harassment programme and other training. Furthermore, the Employee Champions ensured that the employee voice remained at the heart of Board debate on the fundamental restructuring.

Many of our employees are also our shareholders and we encourage their participation in a variety of share plans. Recognising the complexity of a rights issue, we developed bespoke, clear and simple communications to create awareness and understanding of the transaction so that our employees could make informed decisions.

Suppliers and partners

The Group's global supply chain is a vital contribution to its performance, with significant investment in resources to ensure the complex global supply chain is resilient and efficient. The interests of both our suppliers and partners are considered as part of the Board's discussions on manufacturing strategy and when reviewing specific projects. The Board supports our Executive Team who work collaboratively with our suppliers and partners to continue to improve operational performance through various means. There are of course a number of critical suppliers to the Group who, like us, have been materially impacted by COVID-19. As part of the assessment of the business continuity risks, the Audit Committee has focused on business continuity and the supply chain during 2020 when reviewing the individual business' risk management programme.

Communities

COVID-19 has significantly impacted our planned community investment and education outreach activities during 2020. Many planned events were cancelled, and projects delivered with schools and other community-based partners severely disrupted. However, we have worked with our partners to sustain engagement by adapting events, programmes and activities to virtual events wherever possible. In our STEM education outreach programme, we sought new opportunities to enhance engagement with young people and disadvantaged groups who have been significantly impacted by disruption to education and social activities. For example, our digital academy shared resources to help people of all ages around the globe to digitally upskill and we partnered with Scouts in the UK to share a library of educational activities with home-schooling parents. In addition, we introduced the 2020 Armed Forces Association (AFA) National Teacher of the Year at the virtual AFA annual conference in the US and created new STEM content for virtual delivery with many partners around the globe.

We responded to a variety of the challenges presented by COVID-19 so our 2020 contributions would be enhanced by a specific and rapid response to a dynamic situation. These contributions have been largely non-financial and include: manufacturing capability, including VentilatorChallengeUK Consortium to help increase the UK's supply of ventilators; local community involvement wherever Rolls-Royce has a footprint, including donations of hand sanitisers in China, to food banks in Derby, surplus PPE to Bristol NHS, and a policy change to encourage employees, furloughed or not, to become community volunteers at test centres etc, and providing our technical expertise, for example, some of our HSE personnel were seconded into Derby & Burton Hospitals Trust to assist in strategy planning.

Governing bodies and regulators

The Board recognises the importance of governments and regulators as stakeholders. Not only are governments across the world customers but they also support the Group's investment in infrastructure and technology. The General Counsel provides regular updates to the Board on compliance with regulators and the Safety, Ethics & Sustainability Committee reviews how the business engages with airworthiness regulators as well as receiving updates on the continuing dialogue and co-operation with prosecutors, regulators and government agencies. The Board is updated on the Group's engagement with the tax authorities and the related regulatory landscape is discussed by both the Board and the Audit Committee.

In addition, meetings with ministers and senior officials are held as relevant throughout the year. During 2020, the Chairman, Chief Executive and Chief Financial Officer met senior UK Government officials to discuss the financial status of the Company. The Chairman also met with the President, European Council (representing 27 member states), to discuss competitiveness issues, as well as decarbonisation and digitalisation challenges for our industry. He participated in a call with the President of the European Commission on the COVID-19 situation and the EU green deal, and in a virtual meeting with the EU Commissioner for Jobs and Social Rights to discuss an action plan for skills. Since then, we have been involved in the EU pact for skills for the aeronautic sector. The Chief Executive met senior government ministers during the COVID-19 crisis to explain the impact of the pandemic on the Group and the restructuring of the Civil Aerospace business. He also met with groups of MPs who are local to our facilities in the UK. The Group is also involved with the Aerospace and Defence Industries Association in Europe and the European Round Table for Industry.

BOARD EFFECTIVENESS

Review of Board and Committees

In 2018, having undertaken both benchmarking and tender exercises, Belinda Hudson Limited (BHL), experts in enhancing board effectiveness, was appointed for a three-year term to undertake our externally-facilitated effectiveness reviews. BHL's appointment was based on cultural fit, the research that BHL had undertaken which highlighted the areas that needed addressing, and commercial competitiveness. BHL had no other connection with the Company nor its Directors.

Following a comprehensive review in 2018, slightly less in-depth reviews were conducted in 2019 and 2020. As in 2018, they covered Board composition and dynamics, the Board's role and the Board at work but with particular focus on those areas identified as requiring further development during the previous years' reviews.

The effectiveness of each of the Board's Committees was taken into account as part of the evaluation.

In 2020, the review took the form of confidential one-to-one discussions between BHL and members of the Board, Executive Team and senior management. BHL discussed the findings with the Chairman and the Company Secretary who, together with the Senior Independent Director, are refining an action plan for 2021. BHL has reviewed and agreed this disclosure of Board effectiveness.

In addition to BHL's review, during a private meeting of the Non-Executive Directors, the Senior Independent Director, led a review of the Chairman's performance without the Chairman present. The Nominations & Governance Committee also met without any management present to discuss the performance of the Chief Executive. Constructive feedback was shared with each of the Chairman and Chief Executive.

AREA OF FOCUS	2020 FOCUS IDENTIFIED IN 2019	PROGRESS IN 2020	FOCUS FOR 2021
Board composition and dynamics	The Board could be clearer in the communication of their priorities and expectations with the Executive Team	The impact of COVID-19 drew close alignment on the priorities to restore the Group to financial health	Board succession is important as a number of Directors and the Chairman reach their nine-year terms in 2021 and 2022
The Board's role	Continued close scrutiny of the plans and risks relating to the transformation programme. There is scope for the Board to add more value as there is increased focus on strategic issues and opportunities	There was clear identification and good oversight of the priorities for restructuring and targeted disposals	To ensure delivery on the commitments made to investors in 2020
The Board at work	Continued support and linkage between the work of the Executive Team and the Board to ensure they are aligned for success	The Board remained agile and flexible in their approach as demonstrated by the number of meetings held during the year and the pace of decision-making	To remain agile to ensure the Group remains appropriately sized, resourced and placed to take advantage of the recovery in the commercial aviation sector

STAGES OF THE BOARD EFFECTIVENESS REVIEW



NOMINATIONS & GOVERNANCE

Key areas of focus in 2020

- Board appointments
- CFO succession
- Culture and behaviour
- Talent & leadership through restructure
- Diversity & inclusion

Key areas of focus for 2021

- Board succession
- Culture and behaviour
- Diversity & inclusion through continued restructure

Activities and overview of 2020

Board and committee composition

The Committee is responsible for keeping the structure, size and composition of the Board and its Committees under review.

We have recently announced the appointment of Paul Adams as a Non-Executive Director, who joined the Board on 11 March 2021 and will stand for election by shareholders at the 2021 AGM. Paul is a member of the Nominations & Governance, Safety, Ethics & Sustainability and Science & Technology Committees. His full biography can be found at rolls-royce.com.

George Culmer and Dame Angela Strank both joined the Board in 2020 as Non-Executive Directors. Further information on George and Dame Angela's Committee appointments can be found on page 66, and information on Dame Angela's induction programme can be found on page 67. George's induction programme was reported in the 2019 Annual Report and Accounts. You can read the full biographies for George and Dame Angela at www.rolls-royce.com.

Prior to making any new appointments to the Board, the Committee considers the skills and attributes required and, together with the Chairman, agrees a profile. The Committee also provides input into a shortlist of candidates. Members of the Committee were involved in the interview process for Paul and the Committee recommended the appointment to the Board. MWM Consulting was appointed to lead the search; they have signed up to the voluntary code of conduct for executive search firms and had no other connection to the Company or its Directors during the year. The Company Secretary ensures that new Directors have a thorough and appropriate induction programme. More detail about inductions and continuing development can be found on page 67.

At the 2020 AGM, on the recommendation of the Board, shareholders approved the re-election of both Lewis Booth and Sir Frank Chapman as Non-Executive Directors for a further term, although both Directors completed nine years on the Board in 2020. The Board carefully considered the extension of their terms and acknowledged that both Lewis and Sir Frank continued to provide constructive challenge and scrutiny of Board and Committee matters. Neither Director had served simultaneously with an Executive Director for the full nine years. For this reason, the Board concluded that both Lewis and Sir Frank remained independent. Lewis and Sir Frank will step down from the Board in May 2021 and will not stand for re-election at the 2021 AGM. In addition, Jasmin Staiblin will have completed nine years on the Board in May 2021 and will not stand for re-election at the 2021 AGM.

In June 2020, the Committee considered the reappointment of Beverly Goulet for a further three years and recommended this to the Board. This was Bev's second three-year term and the Committee considered her effectiveness and commitment together with her attendance and time allocation to Rolls-Royce matters.

Directors' conflicts of interest

As required under the Code, any additional external appointments taken up by Directors during the year are considered by the Committee and approved by the Board prior to the Directors accepting further appointments. The Committee considers any conflicts that may arise as a result of any external appointments taken up by the Directors and the Board monitors the extent of those interests and the time commitment required to fulfil them to ensure that effectiveness is not compromised. As part of the Committee's discussions, the external appointments are considered against the parameters set by ISS. The Committee has found this to be a useful gauge when discussing whether there is potentially any impact on Directors' time commitments when taking on additional external appointments.

In 2020, the Directors demonstrated a strong commitment to the Company, as shown by their almost total attendance at all our meetings, whether scheduled or additional (see page 69). During the year, the Board considered, amongst others, the external appointments of Dame Angela Strank to SSE plc as a non-executive director, George Culmer to Aviva plc as chairman and Jasmin Staiblin as a board member of Ammann Group Holding AG and Enerim OY. The Board considered Warren East's appointment to ASML Holding N.V as a significant appointment in view of his position as Chief Executive and considering that ASML is a Dutch-listed company. The Board approved this appointment and took into consideration the fact that, as part of their ongoing development, the Executive Directors may seek one external non-executive role on a non-competitor board.

Succession planning

As part of the succession planning, the Committee considers the current skills, experience and tenure of the Directors and assesses future needs against the longer-term strategy of the Group.

The Committee regularly reviews succession planning at Board, Executive Team and senior management levels. This year, the Board considered the principal risk relating to talent and capability and reviewed emergency succession in light of COVID-19 in particular focusing on crisis governance and succession across the Executive Team and business leadership teams. Sharpening our talent management strategy and process has been a priority since 2018 and we

have improved succession planning by implementing systematic talent reviews, consistently assessing potential and closely monitoring the successors' development plans and proactively looking at external talent to improve the quality and diversity of our succession plans.

The Committee plays a vital role in promoting effective Board and leadership succession, making sure it is fully aligned to the Group's strategy. Following the announcement in August 2020 that Stephen Daintith had resigned as Chief Financial Officer and an Executive Director, the Committee was regularly appraised by the Chief People Officer on progress to identify and appoint a successor. In February 2021, the Committee recommended to the Board the appointment of Panos Kakoullis as Chief Financial Officer and as an Executive Director.

Diversity & inclusion

In 2020, the Committee continued to oversee the development of a diverse pipeline for succession. D&I continues to be an area of focus for the Board and for the Group as a whole. We support and monitor Group activities to increase the percentage of senior management roles held by women and other under-represented groups across the organisation. During the year, the Committee was updated on the Group's approach to diversity & inclusion and agreed the 2025 targets.

Our Board diversity policy remains unchanged and we continue to ensure it remains in line with best practice. The policy is available at www.rolls-royce.com. We continue to promote an inclusive and diverse culture and the Committee reaffirmed our aspiration to meet and exceed the recommended voluntary target of 33% of Board positions being held by women, while recognising that we will fall short of this target for a temporary period as Jasmin Staiblin steps down from the Board. We have always recognised that there may be periods of change on the Board where we may fall short of our stated aim for periods of time while the Board is refreshed.

The Parker Review, first published in 2017, made a series of recommendations aimed at improving ethnic diversity on FTSE 100 boards. Our Board has one person of colour and we are therefore compliant with the Parker Review recommendations and the Committee will continue its work to maintain a balance on the Board of individuals representing a wide cross-section of experience, cultural backgrounds and specialisms.

We fully recognise that diversity in our Executive Team needs to be improved and there is a continued focus on improving this through succession planning. The Committee continued to support and monitor Group activities to increase the percentage of women and other under-represented groups in the senior leaders population. Last year, the Group's target was to achieve 21% by 2020 and 30% by 2025 (see page 44).

Improving D&I remains a priority and we continue to track progress. We are particularly pleased to note that, despite COVID-19, we have been able to increase female representation globally and increased the number of females in the ELG year-on-year. (See People and culture on page 44).

More on our progress against our 2020 and 2025 diversity & inclusion targets can be found on page 44.

Principal risk review

The principal risk of Talent and Capability was considered throughout the 2020. The Board met in full to review Talent and Capability as development of our leaders is critical to ensuring the right culture and behaviours are embedded across the Group and to ensure we maintain the right skills and capability for future growth.

Corporate governance

We strive to take an innovative approach in all that we do and that includes our approach to governance. We have always promoted good governance at Board level and, as we addressed the challenges presented by the global pandemic, we found that our governance was indeed appropriate at a time of crisis and needed no further change. Throughout 2020 we have continued to keep up-to-date through ensuring agendas were reflective of the current issues and information provided to the Board was always current and timely. It was encouraging that our approach to governance, when tested, was able to evolve and adapt as we remained flexible in a changing and uncertain external environment.

We have kept under review the enhancements put in place in 2018 to ensure we meet both the regulation and the spirit of the revised Code. This includes the Group's governance framework which is also applied to our subsidiary companies and is our response to the Wates principles. Extracts from the framework are available on the website at rolls-royce.com. You can read more about our framework on page 63.

Engagement with shareholders

Together with the Chief Governance Officer, I have met with investors and proxy advisers during the year to discuss our governance arrangements. Conversations were largely focused on the impact of COVID-19 on our ESG agenda and succession planning.

Role of the Committee

The Committee ensures that the composition of the Board is appropriate and relevant so that the Board is in the best position to oversee operational performance and to drive the Group's strategy. The Committee also keeps the Group's corporate governance arrangements under review.

Membership of the Committee

All members of the Committee are independent Non-Executive Directors. Our biographies are on pages 64 to 66 and meeting attendance is on page 69. No Director attends discussions relating to their own appointment. In addition to the members of the Committee, the Chief Executive attends when it is considered appropriate.

The Committee's responsibilities are outlined in its terms of reference which can be found at www.rolls-royce.com. We review these annually and refer them to the Board for approval. No changes have been made in 2020.

Sir Ian Davis

Chair of the Nominations & Governance Committee

AUDIT

Key areas of focus in 2020

- Impact of COVID-19 on the Group's assumptions and judgements
- Impact of decreased US dollar net cash flows on the US dollar hedge book
- Going concern and viability scenario planning
- Finance transformation programme
- Internal controls, in particular in light of increased remote working

Key areas of focus for 2021

- Impact of COVID-19 on accounting assumptions and judgements
- The risk management and internal control environment in relation to the restructuring programme
- The continuing finance transformation programme
- Developments with the audit reforms in the UK
- Changes to the internal control framework influenced by the Brydon review
- Impact of climate change on assumptions

I am pleased to present the 2020 report of the Audit Committee which describes how the Committee has carried out its responsibilities during the year. In light of COVID-19, I continued chairing the Audit Committee on an interim basis and provided continuity of support through 2020. Nick Luff will assume his role as Chair of the Audit Committee from March 2021. Unfortunately, it was not possible for us to meet with our shareholders in person in 2020. However, we look forward to our 2021 AGM, where we will be able to answer any questions regarding this report.

This report sets out the work of the Committee in 2020. The Committee recognised both the heightened workload and the challenges of remote working during 2020 and, therefore, reviewed the Company's reporting timetable. We recommended to the Board that the half-year announcement be delayed by several weeks and we introduced a series of additional, shorter meetings to support the finance team and our external auditors with meeting the revised schedule. So successful was this, we have adopted the same process for the 2020 full-year results and will continue to do so through 2021.

We also supported the Board in its preparations for the rights issue, keeping under regular review the working capital report which underpinned the rights issue together with the internal financial controls review and reporting. During the year, the Committee received individual business presentations focused primarily on the governance and control framework together with a review of the risk and assurance system. Each business has its own risk and audit committee and members of the Committee are invited to attend their meetings. We also received a detailed review from the Group's tax director, setting out the main drivers of the Group's tax position including the key areas of tax risk. Towards the end of the year, we held a separate meeting to carry out a deep dive review focused on the Group's finance transformation programme.

The Committee has played an active role in the succession of the Chief Financial Officer following the resignation of Stephen Daintith. Stephen has brought significant expertise and provided strong guidance to the Committee during his tenure and we wish him every success for the future.

Membership of the Committee

In addition to myself, members of the Committee during 2020 were George Culmer, Beverly Goulet, Lee Hsien Yang and Nick Luff, all Independent Non-Executive Directors. For the purposes of the Code and DTR 7.1, George Culmer, Beverly Goulet, Nick Luff and I have recent and relevant financial experience. The Board has confirmed that it believes that the Committee as a whole has competence

relevant to the Company's sector. Our biographies are on pages 64 to 66 and our meeting attendance is shown on page 69. In addition to the members of the Committee, the Chairman, Chief Executive, Chief Financial Officer and all Non-Executive Directors may attend one or more meetings at my invitation. The Committee is supported by the General Counsel, the corporate governance director, the group financial controller, the director of risk and internal audit and the external auditors.

Role of the Committee

The Committee is responsible for recommending to the Board the financial reporting, focusing on accounting policies, judgements and estimates; disclosures; compliance with regulations; and whether the Annual Report is fair, balanced and understandable.

We monitor the effectiveness of the risk management and internal control environment and review concerns of financial fraud. The Business Continuity and Financial Shock principal risks are considered by the Committee while the Cyber principal risk is reviewed by our data security committee.

In addition, the Committee provides oversight in respect of the scope, resources, results and effectiveness of internal audit. We are responsible for the relationship with and the effectiveness of the external auditor as well as approving their terms of engagement and fees.

The Committee's responsibilities are outlined in its terms of reference, available at rolls-royce.com. We review these annually and refer them to the Board for approval. No changes have been made in 2020.

Financial reporting

The Group has complex long-term contract accounting and every year the Committee spends much of its time reviewing the accounting policies and judgements implicit in the Group's financial results. In 2020, in addition to our scheduled workload, we focused much of our time on the assumptions in respect of the recovery of civil aviation, in particular the implications of changes in Civil Aerospace engine flying hours (EFHs), and all areas impacted by this, such as going concern, impairments, long-term contract accounting, potential onerous contracts and customer losses.

We have ensured that the disclosures in respect of all key areas of judgement are appropriate and balanced. In light of the increased regulatory guidance on enhancing disclosures, we have provided additional information with regard to the sensitivity of the estimates to changes in key assumptions which are summarised in note 1 of the Consolidated Financial Statements on page 116.

In November 2020, the Financial Reporting Council (FRC) concluded their review of the Group's 2019 Annual Report. Their role is to consider compliance with reporting requirements; their review does not provide assurance that the 2019 Annual Report was correct in all material aspects. The principal areas where the FRC required further information were in relation to distributable profits; provision for Trent 1000 costs; and free cash flow and the summary funds flow statement. The Committee reviewed all correspondence in this regard and in December 2020, the Company received a final letter from

the FRC confirming their satisfaction with the responses provided and the closure of their enquiries. We welcome the FRC's engagement and have incorporated improvements in our 2020 Annual Report based on their observations and extended disclosures where these have been considered material and relevant.

A summary of the principal matters we considered in respect of the 2020 Consolidated Financial Statements is set out below.

Significant issues relating to the 2020 financial statements:

AREA OF FOCUS	CONSIDERATIONS
Alternative Performance Measures (APMs)	The Committee reviewed the clarity of the definitions and the reconciliations of the APM to its statutory equivalent. The Committee concluded that the refined definitions and full reconciliations ensured there was not undue prominence to APMs in the Annual Report (see notes 1, 2 and 28 to the Consolidated Financial Statements).
Accounting for Trent 1000 in-service issues	The Committee considered the key judgements and estimates in accounting for the Trent 1000 in-service issues and provisions made in respect of customer loss-making contracts and expected wastage costs. We are satisfied that the provision held in respect of the future expected wastage costs and customer claims is appropriate and therefore the exceptional wastage credit that has been excluded from underlying (see notes 2 and 20 to the Consolidated Financial Statements).
Consideration of onerous contracts	In light of the impact of COVID-19 on our Civil Aerospace business and the significant reduction in EFHs, the Committee paid particular attention to the drivers of the onerous contracts. We reviewed the nature of the costs included in the assessment of onerous contracts, the discount rates applied in calculating the charge and the sensitivity analysis performed. We ensured the outcome was included in the underlying performance and the disclosures were appropriate (see notes 2 and 20 to the Consolidated Financial Statements).
Deferred tax assets	The Committee reviewed the basis for the recognition of UK deferred tax assets and considered the judgements and estimates necessary to assess the recoverability of the UK deferred tax assets. We confirmed the approach adopted and the additional disclosures included in note 5 to the Consolidated Financial Statements.
Carrying value of intangible and tangible assets	The Committee assessed the carrying value and the recoverability of tangible and intangible assets, with a specific focus on programme intangible assets in Civil Aerospace and the carrying value of the investments the Company holds in the underlying Group. We confirmed that the basis on which management assesses the risk of impairment, the methodology for calculating the recoverable amount, including the basis for the key assumptions, the discount rates and the long-term growth rates was appropriate. Additionally, we reviewed the sensitivity disclosures made in respect of goodwill and programme intangible assets. (See note 12 to the Consolidated Financial Statements).
Going concern and viability disclosures	In light of COVID-19, we undertook an enhanced review of the going concern and viability position of the Group in both our 2020 half-year and full-year results, including the basis for assessing the going concern assumption for the business and the principal risks of the Group and how these were modelled in the viability scenarios. We confirmed our agreement with the basis of the assessments and agreed the appropriate disclosures. See pages 52 to 55.
US dollar hedge book	The Committee focused on the Group's hedge book position, in light of the impact of COVID-19 on our actual and forecast US dollar net cash flows. We considered the risk of potential further over-hedged positions in the event of further reductions in forecast US dollar net cash flows. We confirmed the approach adopted, the accounting treatment in the Group's underlying results and the associated disclosures (see notes 2 and 4 to the Consolidated Financial Statements).

Fair, balanced and understandable

As part of its review of the 2020 Annual Report, the Committee considered whether the report, taken as a whole, was fair, balanced and understandable and that it provided the information necessary for shareholders to assess the Company's position, performance, business model and strategy. In so doing, the Committee considers

the processes and controls involved in preparing the report. There is a robust governance framework to ensure the report is critically reviewed and signed off by key business and function teams. The Committee was satisfied that the process was effective and confirmed to the Board that, when taken as a whole, the Annual Report is fair, balanced and understandable.

Risk management and the internal control environment

Our risk management and internal control framework is described on page 46. We satisfied ourselves that improvements have been made in the approach to risk management including simplifying policies and guidance which has improved the clarity of risk and control ownership and through the focus on mitigating controls and risk appetite as described on page 46. Future improvements should focus on embedding more of the lessons learned from COVID-19 and in continuing to improve the quality of our risk assessment and management activities in relation to our restructuring programmes, financial planning and critical decision-making.

We also satisfied ourselves that the processes for identifying and managing risks are appropriate and that all principal risks and mitigating actions had been subject, during the year, to a detailed review by the Board or an appropriate Board Committee. Based on this and on our other activities, including consideration of the work of internal and external audit and attendance at the Committee by business and functional risk owners, we reported to the Board that a robust assessment of the principal risks facing the Group had been undertaken. Details of our principal risks are set out on pages 47 to 51. The Board allocated certain principal risks to the Committee and we considered these in detail throughout the year, as described below. From our discussions, we are satisfied that all of the principal risks that we oversee have received significant management attention during the year:

- Business Continuity: the Committee received updates on the status of the continuity risk management of each business, including the impact of COVID-19, particularly on our external suppliers and internal facilities.
- Cyber: at each meeting of our data security committee, emerging risks as a result of COVID-19 were considered together with lesson learnt from incidents and assessment of risk management effectiveness. Changes to the cyber security strategy were reviewed.
- Financial Shock: separated from market shock at the half-year, this was considered extensively during 2020 by the Committee and the Board due to COVID-19 and in our preparations for the rights issue. This included reviewing the Group's policies, procedures and controls for identifying, managing and mitigating financial shock in relation to, for example, financial scenario planning, financial forecasting, hedging and interest and discount rates.

Internal financial control

The Committee specifically reviews the Group's internal financial controls (see page 46). During 2020, we reviewed the results of self-attestation and testing performed by the internal control and internal audit teams to confirm the effective operation of key financial controls across the Group. We reviewed the ongoing impact of COVID-19 on our financial control environment and additional mitigating activities established as a result. We considered the external auditor's observations on the financial control environment. We reviewed the progress of the programme to strengthen financial reporting and compliance controls with particular focus on the use of spreadsheets, systems access and inventory management as well as the outcome of the increased supervisory review and oversight controls over balance sheet integrity and manual processes. We continued to review progress in and changes to the scope of the finance transformation programme with respect to financial control.

Effectiveness of risk management and internal control systems

We have conducted a review of the effectiveness of the Group's risk management and internal control systems, including those relating to the financial reporting process, and concluded that it is effective, whilst recognising the need for ongoing and continuous improvement. Where opportunities for improvement were identified, action plans have been put in place and progress is monitored by the Committee. We consider that our review of the risk management and internal control systems, in place throughout 2020 and up to the date of this report, satisfies the requirements of the Code, the DTR and the FRC's guidance on risk management.

Going concern and viability statements

Having regard to the net liabilities of £4,875m on the Group's 2020 balance sheet, we paid particular attention to these assessments. We reviewed the processes and assumptions underlying the statements set out on pages 52 to 55, considering in particular:

- the Group's forecast funding position over the next five years;
- the forecasts for material subsidiaries making up this position;
- an analysis of impacts of severe but plausible risk scenarios, ensuring that these included relevant principal risks and risks considered as part of the rights issue;
- the impact of multiple risks occurring simultaneously;
- additional mitigating actions that could be taken in extreme circumstances; and
- the current borrowing facilities in place and the availability of future facilities.

As a result, we are satisfied that the going concern and viability statements have been prepared on an appropriate basis.

Internal audit

The director of risk and internal audit regularly attends and reports to the Committee on risk and internal audit matters including:

- quarterly – a dashboard identifying key trends and headline findings from internal audit reports issued in the period and the status of related agreed actions; key themes from internal audit's work and details of any specific significant findings raised that warrant the Committee's attention, including those relating to audits conducted as part of the Group's response to the DPAs; and
- annually – compliance with expenses policies for the Directors and the Executive Team; and an internal audit work plan for the following year.

I meet the director of risk and internal audit before each meeting and on an ad hoc basis throughout the year, as do other members of the Committee, to discuss risk matters and the nature of internal audit findings in more depth. We continue to focus on the nature of issues raised by internal audit and the timescales to complete the related actions. The future work plan is risk-based, including risks to both short and longer-term objectives and balancing focus on principal risk areas and on business-as-usual transactional activity where controls are understood to be mature and established. Internal audit also provides assurance to our restructuring activities and incorporate the activities of our second line assurance functions in their approach. We monitor changes to their plan during the course

of the year and in view of the impact of COVID-19 on the Group, during the year we noted changes to the 2020 internal audit plan. We considered and reviewed the effectiveness of the Group's internal audit function, including resources, plans and performance as well as the function's interaction with management. Based on the reports and discussion, we are satisfied that the scope, extent and effectiveness of internal audit work are appropriate for the Group and that there is an appropriate plan in place to sustain this.

External audit

PwC were appointed as the Group's external auditor for the financial year commencing on 1 January 2018 following a formal tender process in 2016. The external audit contract will be put out to tender at least every ten years. Ian Chambers is the lead audit partner and has been in post since PwC were appointed; he will be required to rotate after five years. Other key audit partners will also be required to rotate every five years. Any future audit tenders will be carried out in line with the FRC's practice aid for audit committees.

Other than the services detailed below, PwC have no other connection with the Company or its Directors.

2020 audit

The Committee reviewed the quality of the external audit throughout the year and considered the performance of PwC, taking into account the Committee's own assessment and feedback, the results of a survey of senior finance personnel across the Group focusing on a range of factors we considered relevant to audit quality, feedback from the auditors on their performance against their own objectives and the firm-wide audit quality inspection report issued by the FRC in January 2020 regarding the Group's Financial Statements for the year ended 31 December 2018.

Based on these reviews, the Committee concluded that there had been appropriate focus and challenge by PwC on the primary areas of the audit and that they had applied robust challenge and scepticism throughout the audit. Consequently, the Committee has recommended to the Board that they be reappointed at the 2021 AGM.

In May 2020, PwC presented its audit plan, which identified its assessment of the key audit risks and the proposed scope of audit work. We agreed the approach and scope to be undertaken. Subsequently, an updated plan was agreed in November 2020, building on the work undertaken at the half-year 2020. Key risks and the audit approach to these risks are discussed in the Independent Auditor's Report (pages 190 to 203), which also highlights the other risks that PwC drew to our attention.

As part of the reporting of the half-year and full-year results, in August 2020 and March 2021, PwC reported to the Committee on its assessment of the Group's judgements and estimates in respect of these risks and the adequacy of the reporting. Where effective to do so, PwC also reported on its assessment of the Group's controls.

I meet with the lead partner prior to each Committee meeting and the whole Committee has a private meeting with PwC at least once a year.

During 2020, the Audit Quality Review Team (AQRT) of the FRC conducted a review of PwC's audit of the Group's Financial Statements for the year ended 31 December 2019. In December 2020, the AQRT provided their final report and I, as Chair of the Committee, have acknowledged the findings with the FRC and discussed them with the audit partner. The report concluded that there were no significant findings with only one matter requiring improvement. PwC have reported to the Audit Committee their response to the findings and how the suggested improvements have been incorporated into the current audit along with continuation of the areas identified as being of a high standard.

Non-audit services

In order to safeguard the auditor's independence and objectivity, and in accordance with the FRC's ethical standard, we do not engage PwC for any non-audit services except where it is work that they must, or are clearly best-suited to, perform. Accordingly, our policy for the engagement of the auditor to undertake non-audit services broadly limit these to audit-related services such as reporting to lenders and grant providers, where there is a requirement by law or regulation to perform the work. All other non-audit services are considered on a case-by-case basis in light of the requirements of the ethical standards and in compliance with our own policy.

Fees paid to PwC are set out in note 7 to the Consolidated Financial Statements on page 137. All proposed services must be pre-approved in accordance with the policy which is reviewed and approved annually. Above defined levels, my approval is also required before PwC is engaged. Quarterly, we also review the non-audit fees charged by PwC.

Non-audit related fees paid to the auditor during the year were £2.7m (2019: £1.1m), representing 26% (2019: 11%) of the audit fee. This included £1.0m (2019: £0.5m) relating to the review of the half-year results. PwC was also engaged as reporting accountant for the rights issue and bond workstreams, with total fees of £1.0m, representing 10% of the audit fee. Our annual review of the external auditor takes into account the nature and level of all services provided.

Based on our review of the services provided by PwC 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 PwC.

Compliance

During 2020, the Company complied with the relevant provisions of The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014, as disclosed within the external audit section.

Conclusion

This has been an extraordinary year and I would like to thank the management team, the finance team and the external auditors for their enthusiasm and resilience as we handled new issues compounded by the need for remote working.

Lewis Booth
Chair of the Audit Committee

REMUNERATION

Key areas of focus in 2020

- Responding to the challenges of COVID-19
- New remuneration policy
- Wider workforce remuneration

Areas of focus for 2021

- Continue to review and carefully monitor the incentive measures and targets to ensure that they remain aligned with performance and strategy, including ongoing consideration of sustainability measures
- Implement the new remuneration policy, subject to shareholder approval
- Gain further insights into the remuneration of the workforce to further inform decisions on senior management reward

I am pleased to present my report as Chair of the Remuneration Committee, outlining what we have accomplished in a very challenging year.

What has happened

As a result of the effects of COVID-19, we have had to take significant actions to manage the Group's financial position and we are well aware that the impact is being acutely felt by all of our stakeholders, including our employees, who are affected by restructuring and cost mitigation activity.

Against this backdrop, there have been no salary increases and the Executive Directors took a salary reduction and a salary deferral as well as deferring part of their 2019 bonus. No Group-level bonuses will be paid for 2020 and the existing LTIP awards are not expected to vest for the next three years.

Looking forward, there remains significant uncertainty over the severity, extent and duration of the pandemic and therefore the timing and shape of the recovery in our key markets, particularly in the civil aviation sector. As a Committee, we are acutely aware of the need to reward and motivate our people to deliver in a way that aligns with the interests of our shareholders.

The Committee met on eight occasions between April and December to work through what needed to be done. Initially, we considered whether we could reset the incentive targets under our current policy but concluded that the current remuneration policy does not work and will not support the necessary actions required to restructure and accelerate the Group's recovery to future growth. We gave some thought to whether restricted stock would be appropriate but concluded that it would not drive the performance that we need to deliver in the next few years. We also considered the intense workload and elevated risks faced by management and, whilst we recognise the impact of the pandemic on all of our stakeholders, we are increasingly concerned that we retain our key talent.

We concluded that the right course of action was to develop a new policy which is bespoke to Rolls-Royce and our unique circumstances.

What needs to happen

We need to incentivise our people to deliver our business strategy and restore our financial performance by:

- generating cash to strengthen the balance sheet and reduce net debt;
- improving operating margins to improve the quality of our underlying profit and cash;

- completing an ambitious restructuring plan in the Civil Aerospace business and the central functions;
- growing revenue in our Power Systems and Defence businesses; and
- engaging our people to deliver during an unprecedented period of disruption for the organisation.

Our remuneration policy must move us from where we are now to where we need to be. Accordingly, we have focused on:

- retaining our talent;
- emphasising short-term performance turning into longer-term growth;
- delivering reward in shares and requiring the long-term holding of those shares; and
- ensuring alignment between the Executive Directors, shareholders and the wider organisation.

We must balance the incentivisation of key short-term measures that are critical to our future success with longer-term value creation for our shareholders, whilst at the same time ensuring that our people are motivated and rewarded for delivering our recovery.

New remuneration policy

The policy comprises a new incentive plan designed to reward the key drivers for success, recognising the very different challenges for each of our businesses. It provides greater focus on shorter-term performance measures reflecting the urgency of our challenges and the importance of the actions during 2021 but includes longer-term, cumulative measures in 2022 and 2023. This is a hybrid scheme which replaces the current annual bonus and LTIP structure and removes the risk of windfall gains arising from grants issued up front in a traditional LTIP. Any awards from this plan will be deferred into shares after the end of the performance period at the share price at that time.

At the same time, we have reduced the maximum award which can be earned under the plan recognising the wider stakeholder environment and the shorter-term focus. This structure will give the Committee greater control to determine incentive outturns based on performance against strategy and we retain our usual discretion to ensure a fair result.

The shorter-term focus of the metrics is balanced by the delivery of incentive awards in shares, which will be required to be held for long periods, ensuring alignment with our shareholders. In addition, Executive Directors will take a portion of their salary in shares, deferred for two years, which further contributes to that alignment.

We have taken the opportunity to lower overall fixed reward, reducing Executive Directors' pension contributions to 12% with effect from January 2021, which fully aligns the Executive Directors' pension to the wider workforce.

We are focused on creating the right incentive structure for our business given our current circumstances. The new policy represents an intervention under extraordinary circumstances. As a Committee we will carefully monitor these arrangements in the context of the business circumstances and consider a more business-as-usual structure when and if appropriate.

Consultation with shareholders

We have consulted with our largest shareholders and the proxy agencies on the new policy. The meetings have been extremely helpful to enable us to explain the context for the bespoke approach and why it is appropriate for Rolls-Royce in these challenging circumstances. Our shareholders have given us valuable feedback to enable us to finalise the proposed policy and we have received a good level of support for both the overall approach and detailed policy.

Appointment of Chief Financial Officer

I am pleased that we have appointed Panos Kakoullis as our new Chief Financial Officer, who will join us in May 2021. We intend to apply the proposed new policy in setting Panos' reward package and further details are included in the report (see page 95).

2020 outturns

We had made good progress in 2019 on our transformation journey, reducing our cost base and improving cash generation to hit our cash flow target of £1bn. However, the global pandemic has been devastating for the aerospace industry in 2020, forcing us fundamentally to reset our business targets and focus on strengthening our balance sheet to support our financial recovery.

It became clear from an early stage in 2020 that our in-year financial performance (both profit and cash) would be severely impacted and that we would not achieve the financial targets to generate a bonus. With respect to non-financial metrics, we were pleased to see a continued strong response to our engagement survey with an improved overall score despite the difficult circumstances that our employees faced with salary reductions and deferrals, furlough and significant numbers of redundancies. It is testament to the loyalty and resilience of our management team and employees that we have seen improved employee engagement against this backdrop.

As a result of our financial performance in 2020, the Committee has confirmed that no bonus will be payable at Group level. This is consistent with the experience of all our stakeholders and is entirely appropriate for our circumstances.

Our long-term incentive plan targets for the 2018 plan will have a zero outturn. The severe effect of the pandemic on our financial performance in 2020 and beyond will also mean that the 2019 and 2020 LTIPs are no longer expected to vest.

The Committee feels that this is in line with the experience of our stakeholders and has chosen not to revisit these plans but rather to focus on a new remuneration policy that rewards delivery and execution of the actions that are needed in the next few years.

2020 salary review

The Committee has reviewed the salary levels of the Executive Directors and has concluded that there will be no increases in 2021 in line with the majority of the wider workforce. This will be the fourth year of zero increases for Executive Directors but is appropriate in the circumstances.

Wider workforce

The Committee has been kept informed of the broader reward actions taken across the workforce this year which have included furlough, reduced hours working, salary reductions and deferrals. Mindful of the difficult position that the Group faced and the experience of all stakeholders, the Executive Directors led the way, by agreeing to the deferral of 30% of their 2019 bonus, taking a 10% salary reduction plus a 10% salary deferral from April to December 2020. The Executive Directors also agreed to reduce pension allowances to 12% of salary from 1 January 2021. This reduction is sooner than previously anticipated under our policy and fully aligns the Executive Directors' pension contribution rate to the UK workforce rate.

The Committee has also been keen to ensure that as the new remuneration policy has developed, there is alignment to the wider workforce and that we are putting a plan in place that can cascade down the organisation rather than focusing only on the Executive Team. This has been front of mind in developing the metrics that will apply across the Group's bonus plans, so that the whole organisation is focused on delivering financial performance via the metrics that are applicable to each business.

Membership and operation of the Committee

In addition to myself, members of the Committee during 2020 were Lewis Booth, Beverly Goulet and Sir Kevin Smith. All Committee members are independent Non-Executive Directors. Our biographies are on pages 64 to 66 and our meeting attendance is on page 69. In addition to the members of the Committee, the Chairman, Chief Executive, Chief Financial Officer and any of the Non-Executive Directors may attend one or more meetings at the invitation of the Committee Chair. The Committee is supported by the Company Secretary, the Chief People Officer and the people director, performance and reward.

No Executive Director or Executive Team member was present during discussion of his or her own remuneration package and they were not involved in the final approval of the new remuneration policy design.

The Committee's responsibilities are outlined in its terms of reference, available at rolls-royce.com. We review these annually and refer them to the Board for approval. No changes were made in 2020.

Conclusion

Many hyperboles have been used to describe 2020 and I will not attempt to find more. Suffice to say that this has been an extremely difficult year for everyone, but I am confident that we have developed a remuneration policy which supports what we need to achieve over the next few years. As a Committee, we will be vigilant and mindful of our responsibilities. I appreciate the encouragement and support of our shareholders thus far and trust that they will continue to support us.

Irene Dorner

Chair of the Remuneration Committee

REMUNERATION COMMITTEE REPORT

Advisers

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 £110,200 (2019: £96,025). Fees are based on a time and materials basis. Deloitte also advised the Company on tax, corporate compliance, employee global mobility, assurance and corporate finance and Deloitte MCS Limited provided consulting services. They also provided personal tax advice to Sir Ian Davis and Lewis Booth. In addition, Stephen Daintith's son is employed by Deloitte.

The Committee requests that Deloitte attend meetings periodically during the year. The Committee is exclusively responsible for reviewing, selecting and appointing its advisers and is satisfied that the advice it has received has been objective and independent and that there is no conflict of interest associated with any advice provided. Deloitte is a founding member of the Remuneration Consultants Group and adheres to its code in relation to executive remuneration consulting. The lead engagement partner has no other connection with the Company or individual directors.

Shareholder voting

The remuneration policy and report were last approved by shareholders at our 2020 AGM. Details of voting are shown in the table below.

Principal responsibilities

- Determine the remuneration policy for the Executive Directors and set the remuneration for the Chairman, the Executive Directors, the Executive Team and the Company Secretary.
- Review workforce remuneration and related policies and the alignment of incentives and rewards with our culture.
- Determine the design, conditions and coverage of annual incentives and LTIPs for senior executives and approve total and individual payments under the plans.
- Determine targets for any performance-related pay plans.
- Determine the issue and terms of all-employee share plans.
- Oversee any major changes in remuneration.

	For		Against		Withheld ¹
	Number of votes	%	Number of votes	%	
Approval of the Directors' remuneration policy (7 May 2020)	1,380,264,437	96.73	46,667,350	3.27	7,597,751
Approval of the Directors' remuneration report (7 May 2020)	1,424,182,299	99.36	9,155,974	0.64	1,192,855

¹ Withheld votes are not counted towards the total percentage of votes cast.

Remuneration Committee focus during 2020

AREA OF FOCUS	MATTERS CONSIDERED	OUTCOME
Policy review and shareholder consultation	<p>The impact of COVID-19 forced us to consider our remuneration policy out of cycle to ensure it supports delivery and execution of our business strategy in the next few years and aligns with stakeholder interests.</p> <p>Consultation with shareholders on proposed policy changes.</p>	<p>The Committee reviewed the current remuneration policy and concluded that changes had to be made to focus on the recovery of financial performance through cash generation, to strengthen the balance sheet and reduce net debt, improve operating margins and the significant restructuring of the business. A unique solution, specific to our circumstances, was proposed and discussed with shareholders and their feedback was incorporated into the final policy design.</p> <p>The key proposed changes are as follows:</p> <ul style="list-style-type: none"> – a new incentive plan designed to reward the key drivers for success across our businesses, with focus on shorter-term metrics in 2021, with additional longer-term metrics in 2022 and 2023; – no LTIPs for the duration of the policy, minimising the risk of windfall gains; – a reduction in the maximum incentive level from 200% of target to 175%; – a focus on share-based reward with incentives delivered fully in shares and 30% of salary deferred into shares for the Chief Executive and 20% for other Executive Directors; – long deferral periods on incentive awards, increasing the average duration by one year versus existing incentives; and – an immediate reduction in pension contributions to 12% of salary to align with the wider workforce. <p>In developing the policy, the Committee has also created alignment with the remuneration of the wider workforce through a cascade of key elements of the policy down through the organisation.</p>

REMUNERATION COMMITTEE REPORT

AREA OF FOCUS	MATTERS CONSIDERED	OUTCOME
Base salaries	Review of base salaries in accordance with the remuneration policy and the broader employee and external context.	The Committee reviewed the salaries of the Executive Directors in the context of the severe challenges facing the organisation and implemented a 10% reduction in salary from April to December for 2020 and a 10% salary deferral from April (which was repaid at the end of 2020). They also concluded that no increases would be made in 2021. Under the proposed policy, 30% of the CEO's salary and 20% of the CFO's salary will be delivered in shares with two-year deferral periods.
Annual bonus	2020 annual incentive – review of performance against the 2020 bonus targets.	Warren East and Stephen Daintith did not receive a bonus for 2020 as the performance targets were not met as a result of the significant impact of COVID-19.
Rolls-Royce incentive plan	2021 incentives – review of appropriate metrics and targets for the new incentive plan to reflect the key deliverables to restore financial performance in 2021 and beyond.	<p>The Committee agreed that for 2021 a new incentive plan would be introduced to better reflect the current circumstances. This will replace the existing annual bonus and LTIP with a blend of short and long-term metrics. The following metrics would apply for 2021:</p> <ul style="list-style-type: none"> – Profit – 37.5% – Cash – 37.5% – Cost base reduction – 15% – People – 10% <p>The plan will focus on short-term metrics in 2021, in line with the Group's critical near-term priority to restore financial stability. For 2022 and 2023, a blend of short and long-term metrics will apply.</p> <p>Awards will be based 80% on Group performance and 20% on individual performance and will be delivered in shares.</p> <p>The target levels will be 220% of salary for the Chief Executive (maximum 385%) and 190% of salary for other Executive Directors (maximum 333%).</p> <p>The Committee also agreed the long-term metrics and weightings for the 2022 and 2023 incentive plans as follows (the short-term targets for those years will be set in early 2022 and 2023 respectively):</p> <p>2022 Cumulative Cash – 20% Net Debt – 20%</p> <p>2023 Cumulative Cash – 20% Relative TSR¹ – 25% Sustainability – 5%</p> <p>Targets for each metric were also agreed.</p>
Long-term incentive plan	2018 LTIP – review of achievement of performance measures.	<p>¹ measured equally versus the FTSE 100 constituents and S&P global industrials index constituents.</p> <p>The 2018 LTIP will not vest in March 2021 due to performance conditions not being met as a result of the significant impact of COVID-19.</p> <p>There will be no LTIP grants for the duration of the new policy. The only incentive plan in place will be the Rolls-Royce incentive plan.</p>

REMUNERATION POLICY FROM 2021

Introduction

The policy will take effect from 13 May 2021, subject to shareholder approval at the AGM. The letter from the Chair of the Remuneration Committee sets out the decision-making process for recommending a new policy (see page 81).

Key policy themes

At the 2020 AGM, shareholders approved a new remuneration policy, which was broadly similar to the one that was in place previously, on the basis that at the time the Committee felt that it continued to support the business strategy; however, the devastating impact of COVID-19 on the Aerospace sector has forced the Committee to review the policy once again to ensure that it is right for the current circumstances and supports the necessary restructure and the recovery required to secure future growth over the next three years. They have concluded that a bespoke solution is needed that is tailored to the specific challenges facing Rolls-Royce and which will:

- **Retain talent** – Ensure that we have the right talent in our organisation to deliver the financial recovery and a return to growth. Shareholders have shared this concern during the consultation process. The changes we are proposing to our remuneration policy are designed to engage and motivate our talent and reward the behaviours that we need to succeed in the current circumstances. We also need to be able to recruit new talent into the organisation over the next few years to secure our future. Our policy needs to attract and motivate key talent to deliver and execute our strategy.
- **Place emphasis on short-term performance turning into longer-term growth** – This reflects the urgency of our challenges and the importance of the actions during 2021 to restore financial stability. We also recognise that we must balance the incentivisation of key short-term measures that are critical to our future success with longer-term value creation for our shareholders.
- **Emphasise shares and long-term holding of those shares** – As part of the balance of incentivising short-term performance with longer-term shareholder interests we are proposing that 100% of any incentive payment should be delivered in shares with meaningful deferral requirements. In addition, a proportion of fixed pay will be delivered in shares. This both protects cash and increases executive alignment with shareholders.
- **Ensure alignment between Executive Directors and the wider organisation** – It is important that our policy cascades throughout the organisation and all employees are rewarded for delivery and execution of our policy.

The Committee sees this as a temporary intervention and intends to consider a more business-as-usual policy in due course.

Changes to policy design

We have developed a policy which is specific to the challenges facing Rolls-Royce which has been carefully designed to incentivise our people to restore our financial performance through:

- cash generation to strengthen the balance sheet and reduce net debt;

- improved operating margins to improve the quality of our underlying profit and cash;
- an ambitious restructuring plan in the Civil Aerospace business and the central functions;
- revenue growth in our Power Systems and Defence businesses; and
- engaging our people to deliver during an unprecedented period of disruption for the organisation.

In creating this solution we have aimed to ensure that the focus on short-term performance is balanced with long-term value creation and whilst the overall target reward package is maintained, there is a significant reduction in the maximum, together with heavy emphasis on delivery in shares and long-term deferral of those shares.

No Executive Director or Executive Team member was present during discussion of his or her own remuneration package and they were not involved in the final approval of the new remuneration policy design.

A new incentive plan

This has been designed to reward the key drivers for success across our businesses, supporting the financial recovery required in 2021 and beyond. Initially the focus will be on short-term metrics in 2021; cash, profit, cost base reduction and people. For 2022 and 2023 longer-term metrics will be introduced including net debt reduction, cumulative profit and cash, TSR and a sustainability metric. The short-term metrics will be set annually, whereas the long-term metrics have been set by the Committee at the beginning of 2021. The structure of the incentive plan is designed to reflect the urgency of our challenges and the importance of delivery and execution in 2021. There will be no cash awards from this plan – any awards will be delivered in shares.

	2021	2022	2023
Financial			
Cash	37.5%	20.0%	20.0%
Profit	37.5%	20.0%	20.0%
Costbase reduction	15.0%	10.0%	
Total financial	90.0%	50.0%	40.0%
Non-financial			
People	10.0%	10.0%	10.0%
Total non-financial	10.0%	10.0%	10.0%
Long term¹			
Cumulative cash (2 year)	20.0%		
Net debt	20.0%		
Cumulative cash (3 year)		20.0%	
Relative TSR		25.0%	
CO ₂ sustainability		5.0%	
Total long term	40.0%	50.0%	
Total	100.0%	100.0%	100.0%

¹ Long-term targets set in 2021.

This plan will be the only incentive plan in operation for the period of the policy; it will replace the current annual incentive and long-term incentive plan. This removes the risk of windfalls arising from grants issued at current share price and places greater control for the Remuneration Committee to determine incentive outturns based on performance against strategy.

The target award level for the CEO will be 220% of salary, and 190% of salary for other Executive Directors.

A reduction in maximum potential awards

This recognises the stakeholder environment and shorter-term performance periods upon which a significant proportion of the incentives over the three-year period would be based. The maximum is reduced from 200% of target to 175%. For the Chief Executive, this is from 430% to 385% and for other Executive Directors, from 375% to 333%.

Delivery of incentives and pay in shares

All awards from the incentive will be deferred into shares at the end of a performance period and will be settled as follows:

- 40% after three years
- 60% after four years

When compared with the current combination of cash bonus, deferred bonus shares and LTIP (including holding periods) the actual duration of shareholdings is materially increased. In addition, 30% of salary will be deferred into shares for the Chief Executive and 20% for other Executive Directors, which will be required to be deferred for two years. This creates alignment with the long-term interests of our shareholders and balances the focus on shorter-term metrics, helping to ensure the longer-term balance in the reward package.

Pension reduction

In the current policy we committed to reduce pension contributions for existing Executive Directors from a maximum of 25% of salary to 17% by 2022 to align with the wider workforce rate for existing UK employees. 17% was a weighted average wider workforce rate at that time, which has now reduced to 12% of salary following the closure of the UK Defined Benefit pension plan to future accrual. As part of the new policy we have reduced pension contributions to 12% of salary with effect from 1 January 2021.

Consideration of shareholder feedback

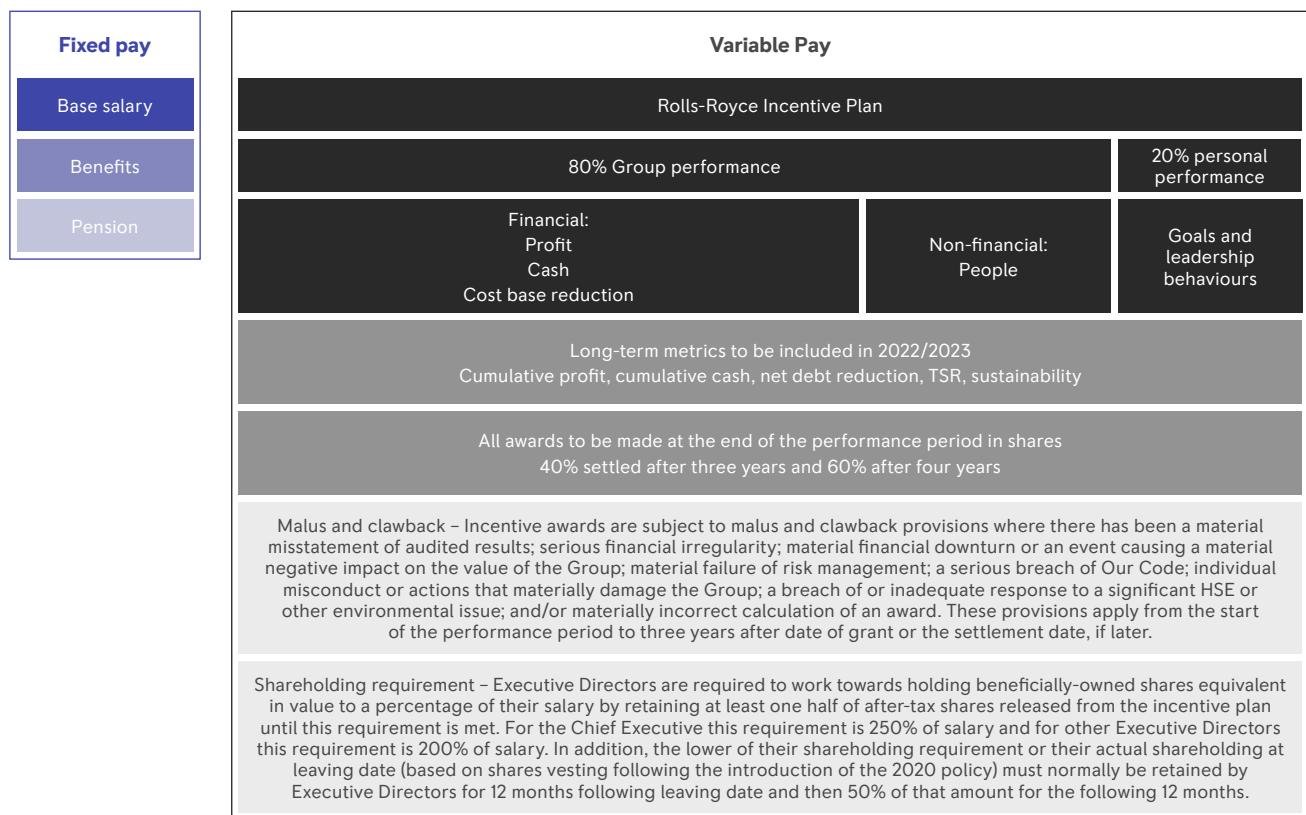
During the policy review we have engaged in detailed consultation with our largest shareholders and the proxy agencies to provide context for the proposed new policy and gain feedback on how it could be improved. We have been pleased that the majority of our shareholders understand the context for the new policy and support the approach of developing a bespoke solution that is unique to our circumstances. The overall feedback from this consultation was:

- an understanding of the need to place more focus on the short-term performance metrics to deliver financial stability;
- support for us continuing to apply performance based incentives, rather than using restricted stock;
- a need to align the incentive targets with the promises made in our equity raise;
- support for alignment of shareholder interests through a significant proportion of the package being delivered in shares;
- recognition of the accelerated pension reduction to 12% of salary and the reduction in maximum incentive award to 175% of target;
- the importance of focusing on talent retention and attraction;
- the importance of aligning the wider workforce with the Executive Directors' remuneration;
- the approach is simple and well balanced;
- the trust placed in the Remuneration Committee's track record in applying discretion – as this is expected to be key to ensuring appropriate outcomes for the next three years. Setting stretching but achievable targets will be key as will the disclosure of those targets; and
- support for inclusion of a CO₂ based sustainability metric as a long-term measure.

These views have been reflected in the final policy design for 2021.

REMUNERATION COMMITTEE REPORT

Summary of our revised remuneration policy



Summary of new incentive compared to previous policy

		Year 1	Year 2	Year 3	Year 4	Year 5
Previous policy						
Chief Executive	90% On Target/ 180% Maximum	STIP	60% paid as cash			
Chief Financial Officer	75% On Target/ 150% Maximum		40% deferred for 2 years			
New policy (2021 award)						
Chief Executive	125% On Target/ 250% Maximum	LTIP (3 year performance period)		100% deferred for 2 years		
Chief Financial Officer	112.5% On Target/ 225% Maximum					
Chief Executive	220% On Target/ 385% Maximum	Rolls-Royce incentive plan	40% deferred for 3 years	60% deferred for 4 years		
Chief Financial Officer	190% On Target/ 333% Maximum					

REMUNERATION COMMITTEE REPORT

Remuneration policy table

The table below sets out each element of Executive Directors' remuneration.

Pay element – fixed pay

Base salary	
Purpose and link to strategy	The Company provides competitive salaries suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Salaries are reviewed, but not necessarily increased, annually. Decisions on salary are informed but not led by reference to companies of a similar size, complexity and international reach.
	A proportion of salary may be deferred into shares for up to two years.
Maximum opportunity	Any salary increases will be assessed annually and will not normally exceed average increases for employees in other appropriate parts of the Group. The Committee may exercise discretion to make larger increases in circumstances where it is necessary to address particular issues or risks, including growth in the role for new appointments.
Benefits	
Purpose and link to strategy	The Company provides competitive benefits suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Benefits may include car or car allowance and related costs, financial planning assistance, private medical insurance, life assurance and other appropriate benefits at the discretion of the Committee.
	Relocation support or support for accommodation and travel may be offered to executives where necessary. Executive Directors may participate in all-employee share plans including ShareSave and the Share Incentive Plan.
Maximum opportunity	Benefits excluding all employee share plans, and any accommodation, relocation and associated tax costs will not exceed £100,000 per annum.
Pension	
Purpose and link to strategy	The Company provides a competitive retirement savings plan suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.
Operation	Executive Directors are offered membership of a defined contribution plan. A cash allowance may be payable in lieu of pension contributions.
Maximum opportunity	The maximum contribution is 12% of base salary only.

Pay element – variable pay

Rolls-Royce incentive plan	
Purpose and link to strategy	To incentivise the execution of the business strategy, delivery of financial targets, and the achievement of personal objectives.
Operation	Incentives are determined based on Group financial performance and the individual performance of the Executive Directors. Group measures may combine both short and long-term measures. The Committee may also apply non-financial metrics that support the underlying strategic priorities for the forthcoming year and/or adjust the pay-out level to ensure the outturns reflect performance. Maximum incentive levels will reduce from 200% to 175% of target. This reduction in maximum opportunity means that 29% of the maximum opportunity is payable if base performance is achieved and 57% of maximum for target performance.
The financial and non-financial metrics are generally set with reference to the prior year and to the budgets and business plans for the coming year, ensuring the targets are appropriately stretching. Metrics may be one-year or a combination of one-year and multi-year cumulative metrics. All the incentive is compulsorily deferred into shares: 40% for three years and 60% for four years, and released subject to continued employment. Deferred shares may attract an issue of C Shares or equivalent during the deferral period.	

REMUNERATION COMMITTEE REPORT

Pay element – variable pay

Rolls-Royce incentive plan (continued)

Operation (continued)	<p>Awards are subject to malus and clawback provisions where there has been a material misstatement of audited results; serious financial irregularity; material financial downturn or an event causing a material negative impact on the value of the Group; material failure of risk management; a serious breach of Our Code; individual misconduct or actions that materially damage the Group; a breach of or inadequate response to a significant HSE or other environmental issue; and/or a materially incorrect calculation of an award. These provisions apply from the start of the performance period to three years from the date of grant or the settlement date, if later. For awards granted prior to the adoption of this policy, legacy malus and clawback provisions may apply.</p> <p>The Committee has discretion to adjust the formulaic outcome (including down to zero) to ensure alignment of pay with performance and fairness for shareholders and participants.</p>
Maximum opportunity	The normal annual maximum for the Chief Executive is 385% of salary and 333% for other Executive Directors.
Performance measures	<p>The incentive is weighted 80% on Group metrics, and 20% on individual performance. Within the Group metrics:</p> <ul style="list-style-type: none"> – at least 85% is based on Group financial targets (for example profit and free cash flow); – up to 15% is based on non-financial metrics such as employee engagement and sustainability – individual objectives are set and agreed with the Remuneration Committee at the start of each year, to reflect the prevailing business context; and – the Committee may, in the context of the underlying business strategy, use different performance measures.

The table below sets out the main elements of Non-Executive Directors' remuneration.

Pay element

Fees	
Purpose and link to strategy	To reward individuals for fulfilling their role and attract individuals of the skills and calibre required.
Operation	<p>The Committee makes recommendations to the Board on the Chairman's remuneration. The Chairman and the Executive Directors determine the remuneration of the Non-Executive Directors. Levels take into account fees paid by other companies of a similar size and complexity.</p> <p>The Chairman is paid a single fee. Other Non-Executive Directors are paid a base fee covering Board and Board Committee membership, with Chairs of Committees, the Senior Independent Director and the Employee Champion receiving an additional fee.</p>
Maximum opportunity	
Benefits	The maximum total remuneration payable to Non-Executive Directors, including the Chairman, is £1,600,000 per annum.
Purpose and link to strategy	To devote maximum time and attention to the requirements of the role.
Operation	Travel, hotel and subsistence incurred in attending meetings are reimbursed by the Company. The Group may pay tax on such benefits. It may provide support with tax matters for Non-Executive Directors based outside the UK. The Chairman has occasional use of chauffeur services.
Maximum opportunity	Maximum value of £5,000 per annum towards tax advice and filing, and £15,000 per annum for chauffeur services.

Remuneration policy – worked examples for 2021

Chief Executive £000

Minimum	100%	£1,073
On-target	34%	66%
Maximum	23%	77%

Chief Financial Officer £000

Minimum	100%	£784
On-target	38%	62%
Maximum	26%	74%

- Fixed remuneration (including salary, benefits and pension)
- Rolls-Royce incentive plan

Minimum – fixed remuneration (salary, pension, benefits), no incentive award.

On-target – fixed remuneration, 57% of maximum incentive award.

Maximum – fixed remuneration, 100% of maximum incentive award.

There is no share price impact as incentive awards are granted following the end of the performance period.

Performance measures and targets

The Committee will set Group financial targets for incentive awards with reference to the prior year and to forward-looking business forecasts, ensuring the targets are appropriately stretching. Metrics may include both annual and longer-term measures.

The Committee may, in the context of the underlying business strategy, use different performance measures for incentives and/or vary the weightings of the measures, including increasing the proportion based on Group measures.

The measurement of performance against performance targets is at the Committee's discretion, which may include appropriate adjustments to financial or non-financial elements and/or consideration of overall performance in the round. Adjustments may be either upwards or downwards.

Long-term performance conditions may also 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.

Policy on new appointments

The Committee will appoint new Executive Directors with a package that is in line with the remuneration policy. Base salary may be set at a higher or lower level than the previous incumbent. The maximum incentive opportunity on appointment is 385% for the Chief Executive and 333% for other Executive Directors.

Remuneration forfeited on resignation from a previous employer may be compensated. This will be considered on a case-by-case basis and may comprise cash or shares. In general:

- 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, where possible, be subject to performance (either Rolls-Royce performance conditions or actual/forecast performance outturns from the previous company); and
- the timing of any compensation will, where practicable, match the vesting schedule of the remuneration forfeited.

Legacy terms for internal appointments may be honoured, including any outstanding incentive awards. If an Executive Director is appointed following a merger or an acquisition of a company by Rolls-Royce, legacy terms and conditions may be honoured.

Wider workforce considerations

When setting remuneration for Executive Directors and the senior management team, the Committee carefully considers wider remuneration across the Group, including salary increases, bonus awards, share plan participation and pay ratios between Executive Directors and other employees.

This has been a particular area of focus for the Committee in designing a new policy that is capable of cascading down the organisation.

There have been a number of additional areas where alignment has been created between Executive Directors and the workforce in 2020 including salary reductions and deferrals, and alignment of pension contributions at 12% of salary.

At more senior levels, remuneration is increasingly long-term and larger proportions are dependent on Group and business performance, as well as individual performance and an increasingly larger proportion is delivered in the form of shares. In terms of the management population generally, the direction of travel is to re-balance the total reward package from fixed elements to variable performance-related elements to support cultural transformation. The Committee periodically reviews benchmarking data to ensure that they are aligned with market practice within the appropriate comparator groups, as one source of data.

We are committed to sharing business success across the organisation, with employees participating in a short-term incentive plan. There is strong alignment of business metrics between the Executive Directors bonus plan and those in which the majority of the workforce participate. In addition, the Group offers an all-employee share save plan to eligible employees globally every two years which aligns employee interests with those of our shareholders. This continues to be a popular benefit with over 40% of employees joining the most recent plan.

Input on the new remuneration policy was sought from the Company's Board apprentice cohort. Application of the policy will be influenced by the remuneration arrangements for all employees. Irene Dorner has designated responsibility for engaging with employees and bringing their voice into the boardroom, in addition to being the Chair of the Remuneration Committee, which further strengthens the link between employees and executive remuneration. See stakeholder engagement, page 72.

Share plans

The Committee retains a number of discretions consistent with the relevant share plan rules. In the event of any variation in the share capital of the Company, a demerger, special dividend, distribution or any other transaction which will materially affect the value of shares, the Committee may make an adjustment to the number or class of shares subject to award.

The treatment of leavers in our ShareSave and Share Incentive Plan is covered by the respective plan rules. Change of control provisions in respect of employee share plans are set out on page 210.

Termination

The Company is required to give Executive Directors 12 months' notice under their service contracts. Payment in lieu of notice will not exceed the value of 12 months' salary, benefits and pension contributions. Both mitigation and the timing 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. There is no automatic entitlement to an incentive. Taking into account the circumstances, the Committee has discretion to award an incentive applying the relevant performance conditions and with appropriate time pro-rating.

Deferred shares from the incentive plan will generally be retained in cases such as retirement, death, injury, ill-health, redundancy or any other reason at the discretion of the Committee and may include appropriate time pro-rating. Awards will typically vest at the normal time unless the Committee determines otherwise.

For the LTIP grants issued under the previous policy, 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-rated 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 outturn. If an individual leaves after the LTIP shares have vested but during the holding period, shares will not be forfeited but the holding period will remain in force. The Committee also has the discretion to mitigate or clawback awards where an Executive Director retires and then becomes employed or engaged by another business in a non-voluntary capacity within 12 months.

Post-employment

Post-employment, an Executive Director will normally be required to retain the lower of their shareholding requirement or their actual shareholding at leaving date (based on shares vesting following the introduction of the new policy) for one year after leaving, and 50% of this level for a second year. The Committee can waive or modify this requirement (for example in compassionate circumstances).

Service contracts

The service contract for Warren East includes 12 months' notice of termination from the Company and six months' notice from the Executive Director. The service contracts for Stephen Daintith and Panos Kakoullis include 12 months' notice from the Company and 12

months' notice from the Executive Director. All contracts include the entitlement to paid holidays, sick pay, and other standard employment terms including reimbursement of reasonable business expenses.

The Chairman and Non-Executive Directors have letters of appointment. 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. Service contracts and letters of appointment can be viewed at the Company's registered office.

Legacy commitments

Any remuneration payments and/or payments for loss of office made under legacy arrangements prior to the approval of the Company's remuneration policy may be paid out subject to the terms of the remuneration policy in place at the time they were agreed. For these purposes, 'payments' include the Company satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are agreed at the time the award is granted. LTIPs granted under previous policies remain in place, consistent with the terms of that policy.

Minor amendments

The Committee may make minor amendments to the policy (for regulatory, exchange control, tax or administrative purposes or to take account of a change in legislation) without obtaining shareholder approval.

Provision 40, section 41 disclosures

When developing the proposed remuneration policy and considering its implementation for 2021, the Committee was mindful of the Code and considers that the executive remuneration framework appropriately addresses the following factors:

Clarity	We provide open and transparent disclosures regarding our executive remuneration arrangements. We have explained the changes to our proposed remuneration policy in a way that highlights their alignment to both our vision and strategy as well as the provisions of the Code.
Simplicity	Remuneration arrangements for our Executives and our wider workforce are simple in nature and well understood by both participants and shareholders.
Predictability	Our remuneration policy contains details of maximum opportunity levels for each component of pay, with actual incentive outcomes varying depending on the level of performance achieved against specific measures.
Proportionality, risk, and alignment to culture	The metrics used to measure performance for incentive awards drive behaviours that are closely aligned to our vision and strategy. In particular our variable pay arrangements continue to focus on delivering an unprecedented level of transformation.
	The Committee considers that our variable pay structure does not encourage inappropriate risk-taking.
	The incentives are subject to the achievement of stretching performance targets, and the Committee's holistic assessment of performance that can result in the application of discretion.
	The use of holding periods, the payment of fixed salary in shares with holding periods, and our shareholding requirements (including after leaving employment with Rolls-Royce) provide a clear link to the ongoing performance of the business and therefore alignment with shareholders.
	Malus and clawback provisions also apply to the incentive plan.

REMUNERATION REPORT FOR 2020

Executive Directors' remuneration

The following pages show how we have applied our remuneration policy during 2020 and disclose all elements of remuneration received by our Executive Directors. Details of remuneration received by our Non-Executive Directors during 2020 can be found on pages 99 and 100.

Executive Directors' single figure of remuneration (audited)

	Salary (a) ¹ £000		Benefits (b) £000		Bonus (c) £000		Long-term incentives (d) ^{2,3} £000		Pension (e) £000		Total remuneration £000		Total fixed remuneration £000		Total variable remuneration £000	
	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019
Executive Directors																
Warren East	873	944	17	17	–	883	–	448	220	236	1,110	2,528	1,110	1,197	–	1,331
Stephen Daintith	629	680	22	20	–	530	–	297	144	150	795	1,677	795	850	–	827

¹ Neither Warren East nor Stephen Daintith received a salary increase in 2020. The last increase made to Warren East was in September 2017. A 10% reduction in salary was applied from April to December 2020. In addition, a further 10% of salary was deferred. The deferred amount was repaid in December 2020.

² The 2020 long-term incentives value is based on the 2018 LTIP award due to its three-year performance period ending on 31 December 2020. The 2018 LTIP award will lapse on 8 March 2021 as the performance conditions were not met.

³ The 2019 long-term incentives value is based on the 2017 LTIP award due to its three-year performance period ending on 31 December 2019. The 2017 LTIP award matured on 5 May 2020 at 53% of maximum, determined according to the achievement against the performance measures during the performance period. The 2019 long-term incentives value has been updated from the 2019 Annual Report. This value is now based on the share price on 5 May 2020 of 102.95p and has been adjusted for the rights issue.

a) Salary

The Company provides suitable competitive salaries to attract and retain individuals of the right calibre to develop and execute the business strategy. Given the significant impact of COVID-19 on the Group in 2020, Warren East and Stephen Daintith both had a temporary reduction in their salary from April to the end of 2020 and an additional 10% salary deferral (which was repaid in December 2020). The Committee reviewed the salary of Warren East as part of the remuneration policy review and agreed there would be no increases for 2021 (which is the fourth consecutive year of no pay adjustment). In addition as part of the policy review, 30% of his 2021 salary is proposed to be deferred into shares for two years.

Executive Director	Base salary as at 1 March 2021	Base salary as at 1 March 2020
Warren East	£943,500	£943,500
Stephen Daintith	£680,000	£680,000

b) Executive Directors' benefits (audited)

Benefits are provided to ensure that remuneration packages remain sufficiently competitive to attract and retain individuals of the right calibre to develop and execute the business strategy and to enable them to devote themselves fully to their roles. The taxable value of all benefits paid to Executive Directors during 2020 is shown below.

Executive Directors	Car or car allowance inc. fuel allowance £000		Medical insurance £000		Travel and subsistence £000		Total £000	
	2020	2019	2020	2019	2020	2019	2020	2019
Warren East	15	15	1	1	0	1	16	17
Stephen Daintith	17	17	2	2	3	1	22	20

c) Annual bonus outturn (audited)

The Company's annual bonus scheme is designed to incentivise the execution of the business strategy, delivery of financial targets and the achievement of personal objectives. Executive Directors receive any annual bonus awarded in March following the performance period. 60% of the bonus is paid in cash with the remaining 40% awarded in deferred shares. Deferred shares are held in trust for two years before being released, subject to the recipient still being employed by the Group and include the right to receive an amount equal in value to the C Shares issued during the deferral period. The

annual maximum for the Chief Executive is 180% of salary and 150% for the other Executive Director(s):

- 80% of the award is based on Group performance
- 20% of the award is based on individual performance

The Committee reviewed the 2020 outturn against the performance measures.

REMUNERATION COMMITTEE REPORT

Bonus outturn table

	Profit	Cash	Customer ¹	Employee Engagement	Total
Weighting	25.0%	50.0%	12.5%	12.5%	100.0%
Base (25%)	£890m	£970m	Performance measured as the average of business scorecards	3.58	
Target (50%)	£990m	£1,120m		3.66	
Maximum (100%)	£1,190m	£1,420m		3.74	
2020 Performance ²	(£1,946m)	(£4,171m)	76.8%	3.68	
% of maximum	0.0%	0.0%	38.4%	62.5%	0.0%

Overall outturn is 0% as the Group base level of profit has to be met to generate any bonus.

¹ Customer metric is measured on the average of the business scorecards (see below).

² Adjusted to exclude ITP Aero, non-core businesses, FX and exceptional items.

Achievement of the base level of Group profit is the trigger for any bonus awards for Executive Directors and as it has not been met for 2020 due to the impact of the COVID-19 pandemic, no bonuses are payable to Warren East or Stephen Daintith and the Committee did not apply any discretion.

Definitions used for performance measures:

Profit – adjusted operating profit before tax for 2020.

Cash – free cash flow which is cash flow before acquisitions and disposals, shareholder payments and foreign exchange.

Customer metric – Group performance is assessed using an index score based on the average outcome of bespoke customer metrics for each of Civil Aerospace, Power Systems and Defence. This approach means that each business focuses on the most meaningful customer metrics (see page 17). The customer metrics for each business are below:

Civil Aerospace – OE delivery to purchase order, TotalCare engine availability, CorporateCare engine availability, Trent 1000 aircraft on ground (AOG).

Power Systems – OE delivery to purchase order, spares delivery to purchase order, claims per unit, time to solve.

Defence – OE delivery to purchase order, spares delivery to purchase order, engine availability, submarines composite delivery. The specific business targets are commercially sensitive.

Employee engagement – measured through our annual Gallup engagement survey. 72% of employees completed the survey and we achieved a Group score of 3.68, which showed a strong year-on-year improvement from 3.53.

Individual performance

Subject to achievement of a minimum profit threshold, the Executive Directors have 20% of their bonus based on achievement of their personal objectives. Personal performance objectives are set at the beginning of the year and are aligned with the Group's internal strategic priorities.

For Executive Directors, these have included:

- Deliver Group revenue, profit and cash in line with budget with specific focus on at least £1bn of free cash flow
- Strengthen the balance sheet with a view to regaining a Grade A credit rating
- Deliver Group restructuring measured by headcount reductions and run-rate cost savings of at least £400m by the end of 2020
- Accelerate progress on diversity and HSE against agreed plans and objectives
- Rebuild trust and confidence with Civil Aerospace customers

The Committee recognised that the impact of COVID-19 had rendered the majority of personal objectives set at the beginning of 2020 obsolete. In any case, as the minimum Group profit threshold had not been met, no personal element of bonus was payable.

The Committee noted the significant efforts made by the management team in addressing the severe impact of the COVID-19 pandemic, specifically initiating the largest restructure in our recent history, consolidating our global manufacturing footprint, delivering significant cost reduction measures and securing additional liquidity.

The Committee noted that in respect of HSE, despite the challenges faced in 2020, there was a continued focus on the healthy, safety and wellbeing of employees with a range of support measures being put in place for employees. There was a significant reduction in reportable injuries and the wellbeing target for all sites becoming 'LiveWell' accredited by 2020 was exceeded.

On diversity & inclusion, the 2020 target of women accounting for at least 17% of the global workforce was delivered by the end of 2020. In addition, there was a marked improvement in the attraction of diverse talent; for ELG hires in 2020, 50% were female and women now represent 30% of the Executive Team, Company Secretary and their direct reports.

REMUNERATION COMMITTEE REPORT

2020 annual bonus outturn

	Group performance (% of maximum)	Individual performance (% of maximum)	Total bonus (% of maximum)	Total bonus (% of salary)
Warren East	–	–	–	–
Stephen Daintith	–	–	–	–

2019 deferred bonus shares

Grants of deferred shares from the 2019 annual incentive plan were made on 16th March 2020 as follows:

	Face value of shares on grant
Warren East	£353,246
Stephen Daintith	£212,163

There are no further performance conditions attaching to these shares. They are due to vest on 16 March 2022 subject to the rules of the plan.

d) Long-term incentives (audited)

Conditional share awards are made to Executive Directors under the LTIP to reward the execution and development of the business strategy over a multi-year period. The conditional shares are then subject to a further two-year holding period.

2018 LTIP awards

The following sets out details in respect of the March 2018 LTIP award for which the final year of performance was the 2020 financial year. The performance conditions were assessed to the end of 2020 and the shares are then subject to a two-year holding period.

	Weighting	Threshold (20% vesting)	Mid (50% vesting)	Maximum (100% vesting)	Performance achieved	Vesting as a % of maximum
CPS ¹	60%	78p	123p	162p	(94)p	0%
EPS ²	20%	67p	80p	94p	(47)p	0%
Relative TSR v FTSE 100 constituents	10%	Median		Upper quartile	Below median	0%
Relative TSR v constituents of the S&P Global Industrials index	10%	Median		Upper quartile	Below median	0%
						Total vesting of 0%

¹ CPS ranges were adjusted to reflect M&A activity in line with the plan definition. The original targets were minimum 95p, mid 126p, maximum 158p.

² EPS ranges were adjusted to reflect M&A activity in line with the plan definition. The original targets were 73p, 86p, 103p.

e) Pension entitlements (audited)

Executive Directors are offered membership of a defined contribution plan. A cash allowance may be payable in lieu of pension contributions. For incumbent directors, the maximum employer contribution to a defined contribution plan (or to be taken as a cash allowance) for 2020 was 23% of salary for the Chief Executive and 21% of salary for the Chief Financial Officer.

From 1 January 2021, all Executive Directors will be offered an employer contribution of 12% of salary into the defined contribution pension plan (or cash allowance of equivalent value). This aligns to the average rate for the UK workforce. This reflects the reduction in the wider workforce UK rate to 12%, with the closure of the legacy defined benefit plan.

LTIP awards made in March 2020

The performance targets for awards made in March 2020 are shown below. Performance will be measured over three years to 31 December 2022.

	Threshold (20% vesting)	Mid (50% vesting)	Maximum (100% vesting)
CPS (60%)	162p	203p	244p
EPS (20%)	85p	106p	127p
Relative TSR (20%)	Median	Between median and upper quartile	Upper quartile

	Numbers of shares ¹	% of salary	Face value of award ² £000	Performance period end date
Warren East	481,771	250	2,359	31 December 2022
Stephen Daintith	312,500	225	1,530	31 December 2022

¹ Number of shares adjusted following the rights issue.

² Calculated as 250% of salary for Warren East and 225% of salary for Stephen Daintith, divided by share price at date of grant of 489.6p per share.

As disclosed at the time of the award, under the LTIP rules, the Committee has full discretion to ensure that the final outturns reflect all relevant factors, including consideration of any windfall gains. Currently, the LTIP awards are not expected to vest.

REMUNERATION COMMITTEE REPORT

Other (audited)*Payments to past directors*

An agreement was put in place between the Company and Colin Smith in 2017, for Colin to represent the Company in an ambassadorial capacity. The agreement was for up to 21.5 days for the latter part of 2017, 35 days for 2018 and 2019 and up to 20 days for 2020. This agreement has been extended for 2021 for up to 20 days. Total payments of £193,380 have been made under this agreement, of which £34,020 was paid in 2020.

Chief Financial Officer succession

As announced in August 2020, Stephen Daintith has resigned from the Company. He will leave Rolls-Royce on 19 March 2021. A statement in accordance with s430(2B) Companies Act 2006 will be available at rolls-royce.com from his leaving date, 19 March 2021. Stephen will not receive any payment for loss of office. Panos Kakoullis will join the Company as Chief Financial Officer on 3 May 2021. His remuneration arrangements are set out below. His incentive opportunity for 2021 will be time pro-rated. No buy-out arrangements were needed to facilitate his recruitment.

Implementation of remuneration policy in 2021

(Subject to approval by shareholders at the 2021 AGM)

Base salary	There will be no change to base salary for 2021; base salaries remain as: Warren East – £943,500; Stephen Daintith – £680,000; Panos Kakoullis – £680,000. 30% of Warren East's salary and 20% for Panos Kakoullis will be deferred into shares for two years.				
Benefits	There will be no change to our approach to benefits in 2021, which includes car allowance, financial planning assistance, insurances and other benefits.				
Pensions	The pension cash allowance for Warren East and Stephen Daintith was reduced to 12% of salary from 1 January 2021 in line with the rate applied to the wider UK workforce from the same date. Panos Kakoullis will receive a pension allowance of 12% of base salary.				
Rolls-Royce incentive plan	For 2021, the Rolls-Royce incentive plan will be implemented in place of the existing bonus and LTIPs. Awards will be made based on 80% Group performance and 20% individual performance.				
For 2021, the Group measures and weightings: profit before tax (37.5%); free cash flow (37.5%); cost base reduction (15%); and employee engagement (10%). Where targets are set with a one-year performance period, these are considered to be commercially sensitive and will be disclosed following the end of the performance period. The 2022 and 2023 awards will include longer term multi-year performance metrics as illustrated on page 87. Performance against targets and the details and context for the assessment of performance will be disclosed at the end of the relevant performance period. The Committee can disclose the following:					
2022	Weighting	Target	2023	Weighting	Target
Cumulative cash (2 year target)	20%	(£1,215m)	Relative TSR (50% versus the FTSE 100 constituents and 50% versus the S&P global industrials index constituents)	25%	Median triggers threshold vesting and upper quartile maximum
Net Debt	20%	(£1,409m)			

The Committee may make appropriate adjustments and use judgement in assessing performance outcomes. It retains its overriding ability to use discretion to adjust any formulaic outcome to ensure that the final outcome is fair and justified in the context of the overall performance of the business.

Target opportunities:	Maximum opportunities are 175% of target:	Any awards will be deferred fully into shares which will be settled as follows:
– Chief Executive – 220% of salary	– Chief Executive – 385% of salary	– 40% after three years
– Chief Financial Officer – 190% of salary (126% of salary pro-rated for time)	– Chief Financial Officer – 333% of salary (222% of salary pro-rated for time)	– 60% after four years

Other information**Executive Directors' share interests (audited)**

The Directors and their connected persons hold the following interests in the ordinary shares of the Company:

	Ordinary shares	Conditional shares not subject to performance conditions (deferred share bonus)	Conditional shares subject to performance conditions (LTIP)	Options over shares subject to savings contract (Sharesave)
31 December 2020	11 March 2021	31 December 2020	31 December 2020	31 December 2020
Warren East	932,771	932,771	342,446	3,411,539
Stephen Daintith	613,876	613,876	205,675	2,218,540

REMUNERATION COMMITTEE REPORT

Executive Directors' interests in vested and unvested share awards (audited)

Warren East	31 December 2019	Granted during the year	Rights issue adjustment	Vested awards	Lapsed awards ¹	31 December 2020	Market price at date of award (p)	Date of grant	Vesting date/ lapse date ²	Market price at vesting (p)
LTIP 2017	281,954	–	285,990	–	132,518	435,426	820.17	05/05/17	05/05/22	–
LTIP 2018	275,083	–	526,453	–	–	801,536	857.47	08/03/18	08/03/23	–
LTIP 2019	264,532	–	506,261	–	–	770,793	891.67	15/03/19	15/03/24	–
LTIP 2020	–	481,771	922,013	–	–	1,403,784	489.60	16/03/20	16/03/25	–
Total	821,569	481,771	2,240,717	–	132,518	3,411,539				

Deferred share bonus (2017)	54,321	–	–	54,321	–	–	857.47	08/03/18	09/03/20	556.62
Deferred share bonus (2018)	45,376	–	86,840	–	–	132,216	891.67	15/03/19	15/03/21	–
Deferred share bonus (2019)	–	72,150	138,080	–	–	210,230	489.60	16/03/20	16/03/22	–
Total	99,697	72,150	224,920	54,321	–	342,446				
ShareSave (options) ³	1,264	–	2,419	–	–	3,683	211.68	12/10/15	01/02/21	–

Stephen Daintith	31 December 2019	Granted during the year	Rights issue adjustment	Vested awards	Lapsed awards ¹	31 December 2020	Market price at date of award (p)	Date of grant	Vesting date/ lapse date ²	Market price at vesting (p)
LTIP 2017	186,547	–	189,217	–	87,677	288,087	820.17	05/05/17	05/05/22	–
LTIP 2018	178,432	–	341,483	–	–	519,915	857.47	08/03/18	08/03/23	–
LTIP 2019	171,589	–	328,387	–	–	499,976	891.67	15/03/19	15/03/24	–
LTIP 2020	–	312,500	598,062	–	–	910,562	489.60	16/03/20	16/03/25	–
Total	536,568	312,500	1,457,149	–	87,677	2,218,540				
Deferred share bonus (2017)	26,708	–	–	26,708	–	–	857.47	08/03/18	09/03/20	556.62
Deferred share bonus (2018)	27,253	–	52,156	–	–	79,409	891.67	15/03/19	15/03/21	–
Deferred share bonus (2019)	–	43,334	82,932	–	–	126,266	489.60	16/03/20	16/03/22	–
Total	53,961	43,334	135,088	26,708	–	205,675				
ShareSave (options) ³	925	–	1,770	–	–	2,695	260.28	13/10/17	01/02/21	–
ShareSave (options) ³	292	–	558	–	–	850	232.17	16/10/19	01/02/23	–

¹ LTIP awards are subject to performance adjustment after three years (the performance period).

² LTIP awards are subject to a two-year holding period following the performance period.

³ The ShareSave exercise price shown has been adjusted as a result of the rights issue in 2020.

Shareholding requirement (audited)

Executive Directors are required to work towards holding beneficially-owned shares equivalent in value to a percentage of their salary by retaining at least one half of after-tax shares released from the incentive plans until this requirement is met. For the Chief Executive this requirement is 250% of salary and for other Executive Directors this requirement is 200% of salary. The current shareholdings, as a percentage of salary, for Warren East and Stephen Daintith are 170% and 153% respectively.*

In addition Executive Directors are required to retain the lower of their shareholding requirement and their actual shareholding (based on shares vesting following the approval of the remuneration policy at the 2020 AGM) at the date of leaving for one year after leaving and 50% of this level for a second year. During 2021, the Committee will be formalising the structures in place to allow it to monitor and enforce post-employment shareholding requirements.

* The percentage of the requirement was calculated by reference to the average share price, over the three months to 31 December 2020 and salary as at the date of the last grant on 9 March 2020. LTIP awards subject to the two-year holding period following the performance period are included in this calculation. LTIP awards that have not been subject to the performance adjustment and ShareSave options are not included in this calculation.

REMUNERATION COMMITTEE REPORT

Pay across the organisation

This section of the report enables our remuneration arrangements to be seen in context by providing:

- a comparison of the year-on-year percentage change in our Director's remuneration with the change in average remuneration across the UK;
- a year-on-year comparison of the total amount spent on employment costs across the Group and shareholder payments;
- a ten-year history of our Chief Executive's remuneration;
- our TSR performance over the same period; and
- an indication of the ratio between our Chief Executive's remuneration and the remuneration of employees.

Percentage change in Directors' remuneration

The following table compares the percentage change in each of the Director's salary/fees, bonus and benefits (excluding LTIP) to the average percentage change in salary, bonus and benefits for all UK employees from 2019 to 2020.

Change in remuneration

	Salary	Benefits	Annual bonus
Warren East	(7.5)%	(8.03)%	(100)%
Stephen Daintith	(7.5)%	11.01%	(100)%
Sir Ian Davis	(7.5)%	(84.55)%	n/a
Lewis Booth	(7.5)%	(73.58)%	n/a
Sir Frank Chapman	(7.5)%	(61.73)%	n/a
George Culmer (appointed 2 January 2020)	n/a	n/a	n/a
Irene Dorner ¹	14.26%	(92.41)%	n/a
Beverly Goulet	(7.5)%	(72.27)%	n/a
Lee Hsien Yang	(7.5)%	(82.56)%	n/a
Nick Luff	(7.5)%	–	n/a
Sir Kevin Smith	(7.5)%	(79.32)%	n/a
Jasmin Staiblin	(7.5)%	(72.72)%	n/a
Dame Angela Strank (appointed 1 May 2020)	n/a	n/a	n/a
UK employees average ²	1.96%	2.23%	(89.94)%

¹ Irene Dorner became Remuneration Committee Chair on 1 January 2020.

² UK employees were chosen as a comparator group in order to avoid the impact of exchange rate movements over the year. UK employees including apprentices, graduates and interns, make up 43% of the total employee population and are employed by Rolls-Royce plc or its relevant subsidiaries. Rolls-Royce Holdings plc has no employees.

Chief Executive pay ratio

The Committee is mindful of the relationship between the remuneration of the Chief Executive and the wider employee population. This is the third year that we have published our CEO pay ratio and we have continued to use method A, as we believe that this is the most accurate and robust methodology. We have used the full time equivalent total remuneration of all UK employees at 31 December 2020.

Year	Method	25th percentile	Median	75th percentile
2020	Option A	26:1	22:1	19:1
2019	Option A	66:1	56:1	48:1
2018	Option A	92:1	77:1	66:1

For 2020, the salary and total remuneration for the three employees identified at the 25th, median and 75th percentiles are as follows:

Year	25th percentile	Median	75th percentile
Salary	£37.0k	£44.4k	£54.0k
Total Remuneration	£42.7k	£50.1k	£59.4k

The pay ratio has reduced again this year as a result of the 2020 bonus not meeting the threshold for payment and the 2018 LTIP plan not vesting.

The Chief Executive has a larger proportion of his total pay based on variable elements linked to performance than other UK employees. As outlined on page 90, the Committee has considered the wider workforce context in terms of alignment of total reward or the Executive Directors, with the pension changes being one such example from 2020.

REMUNERATION COMMITTEE REPORT

The majority of employees participate in a bonus plan, with a good degree of alignment of financial measures with the Executives Directors' bonus plan. We also encourage all eligible employees to join our ShareSave plan. For our most recent launch in 2019 approximately 40% of our global population joined the plan, sharing in approximately 14 million shares and stock appreciation rights.

The Remuneration Committee believes that the median pay ratio for 2020 is consistent with the pay and progression policies for the Group's UK employees as a whole.

Relative importance of spend on pay

The following chart sets out the percentage change in payments to shareholders and overall expenditure on pay across the Group.



* Value of C Shares redeemed during the year.

Chief Executive pay

Year	Chief Executive ¹	Single figure of total remuneration £000	Annual bonus as a % of maximum	LTIP as a % of maximum
2020	Warren East	1,110	–	–
2019	Warren East	2,528	52	53
2018	Warren East	4,075	60	100
2017	Warren East	2,331	68	–
2016	Warren East	2,089	55	–
2015	Warren East	543	–	–
2015	John Rishton	754	–	–
2014	John Rishton	2,596	–	45
2013	John Rishton ²	6,228	55	100
2012	John Rishton ²	4,577	85	–
2011	John Rishton	3,677	63	–
2011	Sir John Rose ³	3,832	–	75

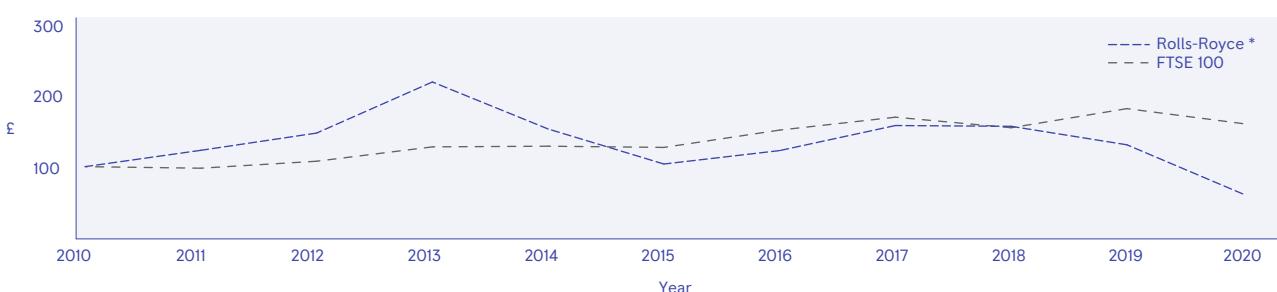
¹ On 31 March 2011, Sir John Rose retired and John Rishton was appointed. John Rishton retired on 2 July 2015 and Warren East was appointed as Chief Executive on 3 July 2015.

² 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 had 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 exceeded that of his predecessor.

³ The remuneration for Sir John Rose does not include any pension accrual or contribution as he received his pension from 1 February 2008.

TSR performance

The Company's TSR performance over the previous ten 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 ten years, relative to the FTSE 100 index.



* Prior years have been adjusted for the rights issue.

Gender pay reporting

The Company is committed to creating a diverse and inclusive place to work where our people can be themselves and be at their best. More information about this can be found on pages 40 to 44. We published our UK gender pay gap in March 2021, which showed:

REMUNERATION COMMITTEE REPORT

Median gender pay gap across all Rolls-Royce employees in the UK**Mean gender pay gap across all Rolls-Royce employees in the UK**

Overall women represented 15.7% of our workforce at 5 April 2020. However, we continue to make progress in recruiting more women into senior positions and 25% of our women are now in management positions (compared to 17% of men). See pages 40 to 44 for further information on what we are doing to address diversity across the organisation.

Contractual arrangements

Each Executive Director has a service agreement that sets out the contract between that Executive Director and the Company.

Executive Directors' service contracts

	Date of contract	Notice period from Company	Notice period from individual
Warren East	21 April 2015	12 months	6 months
Stephen Daintith	21 September 2016	12 months	12 months

Payments received for serving on external boards

Executive Directors retain payments received from serving on the boards of external companies, the details of which are given below:

	Directorships held	Payments received and retained £000
Warren East	ASML Holding NV	52
Stephen Daintith	3i Group plc	81

Non-Executive Directors' remuneration**Single figure of remuneration (audited)**

	Fees ¹ (£000)		Benefits (£000)		Total remuneration (£000)	
	2020	2019	2020	2019	2020	2019
Chairman and Non-Executive Directors						
Sir Ian Davis	393	425	–	3	393	428
Lewis Booth	88	95	11	40	99	135
Ruth Cairnie (stepped down 31 December 2019)	n/a	90	n/a	3	n/a	93
Sir Frank Chapman	83	90	1	3	84	93
George Culmer (appointed 2 January 2020)	65	–	1	–	66	–
Irene Dorner ²	97	85	–	1	97	86
Beverly Goulet	65	70	3	11	68	81
Lee Hsien Yang	65	70	7	40	72	110
Nick Luff	65	70	–	–	65	70
Brad Singer (stepped down 9 December 2019)	n/a	66	n/a	21	n/a	87
Sir Kevin Smith	97	105	–	2	97	107
Jasmin Staiblin	65	70	4	14	69	84
Dame Angela Strank (appointed 1 May 2020)	42	–	–	–	42	–
Total	1,125	1,236	27	138	1,152	1,374

¹ In line with the senior management team, a 10% reduction in fees was applied from April to December 2020. In addition, a further 10% of fees was deferred. The deferred amount was repaid in December 2020.

² Irene Dorner became Remuneration Committee Chair on 1 January 2020.

Non-Executive Directors' fees

The Chairman's fee is reviewed by the Board as a whole on the recommendation of the Committee. The review of the other Non-Executive Directors' base fees is reserved to the Executive Directors, who consider recommendations from the Chairman. No individual may be involved in setting his or her own fee. The Chairman and the 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 (who reside in a permitted dealing territory) 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. Sir Ian Davis and Lee Hsien Yang use this facility.

REMUNERATION COMMITTEE REPORT

Non-Executive Directors' fees

(Fees are unchanged for 2021)

	2020 £000	2019 £000
Chairman	425	425
Other Non-Executive Directors base fee	70	70
Chairman of the Audit Committee	25	25
Chairman of the Remuneration Committee	20	20
Chairman of the Safety, Ethics & Sustainability Committee	20	20
Chairman of the Science & Technology Committee	20	20
Senior Independent Director	15	15
Employee Champion	15	15

Non-Executive Directors' benefits (audited)

The benefits for Non-Executive Directors relate predominantly to travel, hotel and subsistence incurred in attending meetings. For Non-Executive Directors based outside the UK, the Company may also pay towards tax advice and the cost of making tax filings.

Non-Executive Directors' share interests (audited)

The Non-Executive Directors and their connected persons hold the following interests in the ordinary shares of the Company:

Chairman and Non-Executive Directors	31 December 2020	11 March 2021
Sir Ian Davis	378,550	384,279
Paul Adams ¹ (appointed 11 March 2021)	n/a	10,000
Lewis Booth	303,333	303,333
Sir Frank Chapman	144,326	144,326
George Culmer (appointed 2 January 2020)	37,960	37,960
Irene Dorner	54,578	54,578
Beverly Goulet	40,560	40,560
Lee Hsien Yang	52,482	55,326
Nick Luff	43,333	43,333
Sir Kevin Smith	116,540	116,540
Jasmin Staiblin	-	-
Dame Angela Strank (appointed 1 May 2020)	-	-

¹ Share interests held as American Depository Receipts.

Non-Executive Directors' letters of appointment

Our Non-Executive Directors serve three, three-year terms (nine years in total). In light of the COVID-19 pandemic, we announced extensions to the terms for both Lewis Booth and Sir Frank Chapman until the 2021 AGM at the latest.

Chairman and Non-Executive Directors	Original appointment date	Current letter of appointment end date
Sir Ian Davis	1 March 2013	28 February 2022
Paul Adams (appointed 11 March 2021)	11 March 2021	10 March 2024
Lewis Booth ¹	25 May 2011	24 May 2020
Sir Frank Chapman ¹	10 November 2011	13 May 2021
George Culmer	2 January 2020	1 January 2023
Irene Dorner	27 July 2015	26 July 2021
Beverly Goulet	3 July 2017	2 July 2023
Lee Hsien Yang	1 January 2014	31 December 2022
Nick Luff	3 May 2018	2 May 2021
Sir Kevin Smith	1 November 2015	31 October 2021
Jasmin Staiblin ¹	21 May 2012	20 May 2021
Dame Angela Strank	1 May 2020	30 April 2023

¹ Lewis Booth, Sir Frank Chapman and Jasmin Staiblin will not be standing for re-election at the 2021 AGM.

Statutory requirements

The Committee's composition, responsibilities and operation comply with the principles of good governance, as set out in the Code, the Listing Rules (of the Financial Conduct Authority) and the Companies Act 2006. The Directors' remuneration report has been prepared on the basis prescribed in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

SAFETY, ETHICS & SUSTAINABILITY

Key areas of focus in 2020

- Effects of COVID-19 on both people and product safety and oversight of the mitigations
- Maintaining product safety governance through organisational change and transfer to the new RRMS
- Improvement in HSE performance against targets
- Delivery of the Group's sustainability strategy
- Progress of the Group's ethics and compliance programme

Key areas of focus for 2021

- In-depth review of climate change principal risk
- Development of an operational environment strategy and next generation targets, aligning with our sustainability strategy
- Review of the product safety and compliance principal risks relative to our risk appetite

Activities and overview of 2020

Product safety

- we reviewed product safety and safety governance frameworks through organisational and systematic change;
- as a result of COVID-19, we considered the management of fleet safety while aircraft have been grounded and monitored safety following return to flight;
- we reviewed large engine safety management status reports;
- we provided oversight of the integration of Rolls-Royce Electrical activities into the Group's product safety governance system;
- we considered detailed reviews of in-service product safety issues;
- we analysed product safety policies, processes, performance metrics and training and scrutinised improvements; and
- the Committee and other Board members attended a series of deep dives into the operation of the safety management system.

HSE

- HSE performance and balanced scorecard, total reportable injury (TRI) rate and business reports were regularly considered;
- we monitored HSE programmes including safety cases, electrical safety, contractor management and employee wellbeing;
- we considered COVID-19 HSE impacts and mitigations and reviewed the HSE Group risk profile; and
- the Committee analysed shared learning from major and high-potential incidents, and tracked progress against HSE and environmental targets.

Ethics and compliance

- we discussed regulatory and prosecutorial matters;
- the Committee monitored and reported to the Board on concerns raised through the Ethics Line and reviewed detailed reports of significant issues;
- we reviewed the anti-bullying and harassment programme; and
- we monitored progress of the Group's ethics and compliance programme.

Sustainability

- we completed a strategic review of our sustainability approach, which is reported in the sustainability report (see pages 34 to 45);
- the Committee monitored progress against the sustainability strategy and its acceleration through COVID-19; and

- we reviewed sustainability reporting and communication expectations and supported sustainability engagement during 2020. We considered improvement plans for 2021.

Principal risks

- we undertook a review of the Product Safety, People Safety and Compliance principal risks and supported the development of more accurate risk indicators while scrutinising improvement plans; and
- we undertook a review of the People Safety Group risk appetite.

Role of the Committee

The Committee monitors the operation of the Group's product safety governance frameworks, scrutinising the development and implementation of changes. We review the Group's HSE performance, support improvement programmes, monitor incidents and investigate remedial actions. The Committee monitors the Group's compliance with legislative, regulatory and ethical standards while supporting management to embed ethics and compliance culture and behaviours. We endorse the Group's sustainability strategy, track progress towards sustainability targets and review the environmental impacts of products and operations. We continuously review the Product Safety, People Safety, Compliance and Climate Change principal risks.

The Committee's responsibilities are outlined in its terms of reference, available at rolls-royce.com. We review these annually and refer them to the Board for approval. No changes were made in 2020.

Membership of the Committee

In addition to myself, members of the Committee during 2020 were George Culmer, Irene Dorner, Lee Hsien Yang, Nick Luff and Dame Angela Strank. Dame Angela joined the Committee in May and Nick stepped down in July. All Committee members are Independent Non-Executive Directors. Our biographies are on pages 64 to 66 and our meeting attendance is on page 69. In addition to the members of the Committee, the Chairman, Chief Executive, General Counsel, Chief People Officer and Chief Technology Officer attend most meetings. The Committee is supported by the Chief Governance Officer.

Sir Frank Chapman

Chair of the Safety, Ethics & Sustainability Committee

SCIENCE & TECHNOLOGY

Key areas of focus in 2020

- Oversight of the Group's technology programme and approach to low carbon power
- Review of key programmes and business cases including SMRs, UltraFan and hybrid-electric regional aviation
- Review of digital, electrical and hybrid-electrical and hydrogen fuel-based technologies
- Continued review of efficiency and effectiveness of technology development

Key areas of focus for 2021

- Continued oversight of the Group's technology programme, providing support to technologies emerging from the net zero strategy in particular
- Continuous review of key programmes and business cases, including SMRs, UltraFan and Rolls-Royce Electrical
- Continued focus on the development of the Group's engineering capability in line with our future technology needs
- Resumption of site visits following a temporary suspension as a result of COVID-19

Activities and overview of 2020

Technology strategy

- we reviewed the strategic direction of the Group's research technology and development activities, with consideration to their environmental impact amongst other matters, and to ensure investment is appropriately allocated;
- the key technology programmes were kept under review throughout the year;
- we assisted the Board in its oversight of major R&D investment and provided assurance on its competitiveness and the adequacy of technology investment, with thorough consideration to the environmental impact of both new products and technology; and
- we maintained a focus on low carbon technologies. These underpin the Group's sustainability strategy and leverage the Company's advanced manufacturing capabilities as well as its nuclear power design expertise, to develop a near-zero carbon source of power generation by early 2030s, at a competitive cost of electricity.

Cross-sector technology

We continued to provide oversight of the effectiveness of key engineering and technology processes and operations, including the delivery of major product development and technology programmes.

Technology capabilities and skills

We discussed the processes for ensuring there was effective resourcing and development of required technological capability and skills.

Technology trends and risks

We provided assurance on the identification and management of key technological risks and reviewed and considered other topics or risks appropriate to the overall remit of the Committee as delegated by the Board.

Principal risk

We continued to monitor disruptive technologies as part of the Competitive Environment principal risk.

I would like to pay tribute to the work of our technology community and the flexibility, resilience and commitment of our people during these extremely challenging times. I thank them on behalf of the Board for their significant contribution which has enabled us to meet major technology milestones in the year that will be critical to the future of our Company.

Role of the Committee

In 2020, the Committee continues to provide dedicated focus to the research and technology part of the Group's R&D investment. This enables the Group to conceive, design and deliver world-class technology that meets our customers' current and future needs. We provide directional input and oversight of the Group's scientific and technological strategy, processes and related investments. In doing this, we place importance on ensuring active dialogue with engineering and technology leaders and experts, inviting relevant employees to Committee meetings, meeting with employees during site visits and developing future leaders through the Board apprentice programme.

The Committee's responsibilities are outlined in its terms of reference, available at rolls-royce.com. We review these annually and refer them to the Board for approval. No changes were made in 2020.

Membership of the Committee

In addition to myself, the members of the Committee during 2020 were Sir Frank Chapman, Jasmin Staiblin and Dame Angela Strank, all Non-Executive Directors are independent. Our biographies are on pages 64 to 66 and our meeting attendance is on page 69. In addition to the members of the Committee, the Chairman, Chief Executive, Chief Financial Officer and any of the Non-Executive Directors may attend one or more meetings at the Committee chair's invitation. The Committee is supported by the Corporate Governance Director and the Chief Technology Officer.

Sir Kevin Smith

Chair of the Science & Technology Committee

RESPONSIBILITY STATEMENTS

Statement of Directors' responsibilities in respect of the Financial Statements

The Directors are responsible for preparing the Annual Report and the Financial Statements in accordance with applicable law and regulation.

Company law requires the Directors to prepare financial statements for each financial year. Under that law, the Directors have prepared the Group Financial Statements in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006. Additionally, the Financial Conduct Authority's Disclosure Guidance and Transparency Rules require the directors to prepare the group financial statements in accordance with international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union and the parent company Financial Statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards, comprising FRS 101 Reduced Disclosure Framework, 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 the profit or loss of the Group and parent company for that period.

In preparing the Financial Statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- state whether, for the group and company, international accounting standards in conformity with the requirements of the Companies Act 2006 and, for the group, international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union, have been followed for the Group Financial Statements and United Kingdom Accounting Standards comprising FRS 101, have been followed for the Company Financial Statements, subject to any material departures disclosed and explained in the Financial Statements;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the Financial Statements on the going concern basis unless it is inappropriate to presume that the Group and parent company will continue in business.

The Directors are also responsible for safeguarding the assets of the Group and parent company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group and parent company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and parent company. This enables them to ensure that the Financial Statements and the Directors' Remuneration Report comply with the Companies Act 2006 and, as regards the Group's Consolidated Financial Statements, Article 4 of the IAS Regulation.

The Directors are responsible for the maintenance and integrity of the parent company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Directors' confirmations

The Directors consider that the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group and parent company's position and performance, business model and strategy.

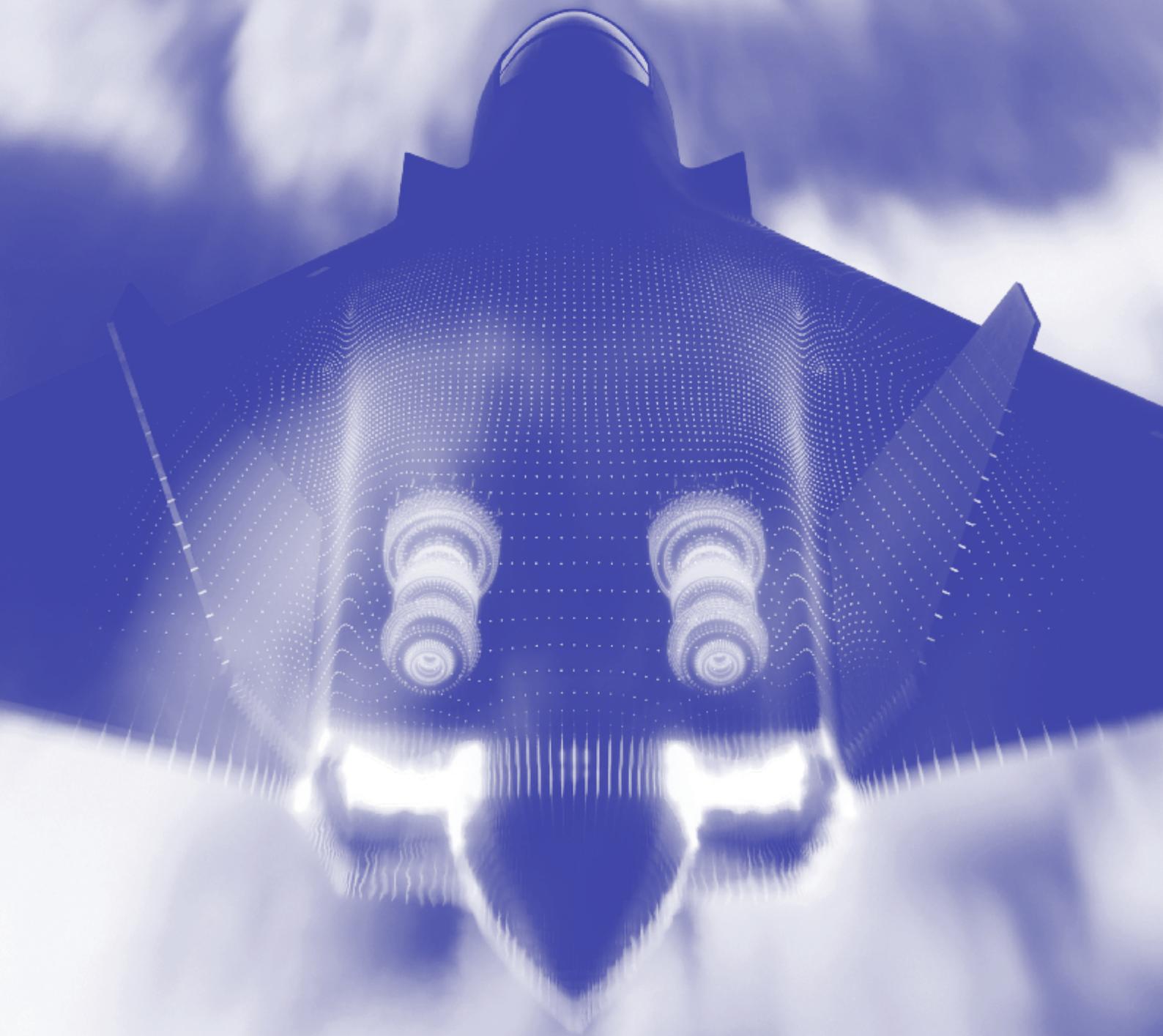
Each of the Directors, whose names and functions are listed in the Directors' Report, confirm that to the best of his or her knowledge:

- the Group Financial Statements, which have been prepared in accordance with international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the European Union, give a true and fair view of the assets, liabilities, financial position and loss of the Group;
- the parent company Financial Statements, which have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards, comprising FRS 101 Reduced Disclosure Framework, and applicable law), give a true and fair view of the assets, liabilities, financial position and result of the Company;
- the Strategic Report includes a fair review of the development and performance of the business and the position of the Group and parent company, together with a description of the principal risks and uncertainties that it faces; and
- there is no relevant audit information of which the Company's auditor is unaware. The Director has taken all steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

By order of the Board

Pamela Coles
Company Secretary
11 March 2021

FINANCIAL STATEMENTS



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CONSOLIDATED FINANCIAL STATEMENTS

Consolidated income statement

For the year ended 31 December 2020

	Notes	2020 £m	2019 £m
Revenue	2	11,824	16,587
Cost of sales ^{1,2}		(12,034)	(15,645)
Gross (loss)/profit		(210)	942
Commercial and administrative costs ¹		(808)	(1,128)
Research and development costs ¹	3	(1,254)	(770)
Share of results of joint ventures and associates	13	191	104
Operating loss		(2,081)	(852)
(Loss)/gain arising on acquisition and disposal of businesses ³	28	(14)	139
Loss before financing and taxation	2	(2,095)	(713)
Financing income	4	67	252
Financing costs ⁴	4	(882)	(430)
Net financing costs		(815)	(178)
Loss before taxation ⁵		(2,910)	(891)
Taxation	5	(259)	(420)
Loss for the year		(3,169)	(1,311)
Attributable to:			
Ordinary shareholders		(3,170)	(1,315)
Non-controlling interests		1	4
Loss for the year		(3,169)	(1,311)
Other comprehensive expense		(265)	(1,013)
Total comprehensive expense for the year		(3,434)	(2,324)
Loss per ordinary share attributable to ordinary shareholders:			
Basic ⁶	6	(52.95)p	(23.70)p
Diluted ⁶	6	(52.95)p	(23.70)p
Underlying earnings per ordinary share are shown in note 6			
Payments to ordinary shareholders in respect of the year:	21		
Pence per share ⁶		–	1.6p
Total		–	87
Underlying (loss)/profit before taxation ⁵	2	(3,958)	583

¹ Included within cost of sales, commercial and administrative costs and research and development costs are: exceptional items relating to impairments and write-offs arising as a result of the financial and operational impact of COVID-19 plus other market-driven events; impairments and provisions related to the fundamental restructuring activity announced on 20 May 2020 to reshape and resize the Group have also been recorded; and reflecting the impact of COVID-19 and the work the Group has performed to reduce fleet AOG levels and improve the availability of spare engines, the Trent 1000 provision has been reduced. In the prior year, exceptional charges related to the Trent 1000 and Trent 900 Civil Aerospace programmes and restructuring costs were included within cost of sales and commercial and administrative costs. Further details can be found in notes 2, 12 and 22.

² Cost of sales includes a charge for expected credit losses of £119m (2019: £54m) – see note 15.

³ North America Civil Nuclear business was disposed of on 31 January 2020, Knowledge Management System business was disposed of on 3 February 2020, Trigno Energy Srl was disposed of on 7 May 2020 and Exostar LLC was disposed of on 6 July 2020. Qinous GmbH was acquired on 15 January 2020, Kinolt Group S.A. was acquired on 1 July 2020 and Servowatch Systems Limited was acquired on 7 December 2020. Sales proceeds on a prior period disposal have been adjusted during the year. Commercial Marine was disposed of on 1 April 2019 and Rolls-Royce Power Development Limited was disposed of on 15 April 2019. Further details can be found in note 28.

⁴ Included within financing costs are fair value changes on derivative contracts. Further details can be found in notes 2, 4 and 21.

⁵ (Loss)/profit before taxation disclosed on a statutory and underlying basis. Further details can be found in note 2.

⁶ The comparative figures for earnings per share and payments to shareholders per share have been adjusted to reflect the bonus element of the rights issue – see note 6. As a result of the COVID-19 pandemic, the Directors cancelled the proposed final payment to shareholders of 2.4p (adjusted) per share.

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated statement of comprehensive income

For the year ended 31 December 2020

	Notes	2020 £m	2019 £m
Loss for the year		(3,169)	(1,311)
Other comprehensive expense (OCI)			
Actuarial movements on post-retirement schemes ¹	23	(590)	(934)
Share of OCI of joint ventures and associates	13	(1)	(1)
Related tax movements	5	195	324
Items that will not be reclassified to profit or loss		(396)	(611)
Foreign exchange translation differences on foreign operations		121	(313)
Reclassified to income statement on disposal of businesses	28	6	(98)
Movement on fair values (debited)/credited to cash flow hedge reserve		(16)	12
Reclassified to income statement from cash flow hedge reserve		26	10
Share of OCI of joint ventures and associates	13	(4)	(7)
Related tax movements	5	(2)	(6)
Items that may be reclassified to profit or loss		131	(402)
Total other comprehensive expense		(265)	(1,013)
Total comprehensive expense for the year		(3,434)	(2,324)
Attributable to:			
Ordinary shareholders		(3,435)	(2,328)
Non-controlling interests		1	4
Total comprehensive expense for the year		(3,434)	(2,324)

¹ Included in actuarial movements in post-retirement schemes is an experience loss of £188m which includes the impact of updated membership data and members leaving on voluntary severance. Included in the prior period is an asset re-measurement net loss estimated at £600m following the agreement to transfer the future pension obligation of circa 33,000 pensioners in the UK scheme to Legal & General Assurance Society Limited. See note 23 for further information.

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated balance sheet

At 31 December 2020

	Notes	31 December 2020 £m	31 December 2019 £m
ASSETS			
Intangible assets	9	5,145	5,442
Property, plant and equipment	10	4,515	4,803
Right-of-use assets	11	1,405	2,009
Investments – joint ventures and associates	13	394	402
Investments – other	13	19	14
Other financial assets	21	687	467
Deferred tax assets	5	1,826	1,887
Post-retirement scheme surpluses	23	907	1,170
Non-current assets		14,898	16,194
Inventories	14	3,690	4,320
Trade receivables and other assets	15	5,455	5,065
Contract assets	16	1,510	2,095
Taxation recoverable		117	39
Other financial assets	21	107	86
Short-term investments	21	–	6
Cash and cash equivalents	17	3,452	4,443
Current assets		14,331	16,054
Assets held for sale	28	288	18
TOTAL ASSETS		29,517	32,266
LIABILITIES			
Borrowings and lease liabilities	18	(1,272)	(775)
Other financial liabilities	21	(608)	(493)
Trade payables and other liabilities	20	(6,653)	(8,450)
Contract liabilities	16	(4,187)	(4,228)
Current tax liabilities		(154)	(172)
Provisions for liabilities and charges	22	(826)	(858)
Current liabilities		(13,700)	(14,976)
Borrowings and lease liabilities	18	(6,058)	(4,910)
Other financial liabilities	21	(3,046)	(3,094)
Trade payables and other liabilities	20	(1,922)	(2,071)
Contract liabilities	16	(6,245)	(6,612)
Deferred tax liabilities	5	(494)	(618)
Provisions for liabilities and charges	22	(1,119)	(1,946)
Post-retirement scheme deficits	23	(1,580)	(1,378)
Non-current liabilities		(20,464)	(20,629)
Liabilities associated with assets held for sale	28	(228)	(15)
TOTAL LIABILITIES		(34,392)	(35,620)
NET LIABILITIES		(4,875)	(3,354)
EQUITY			
Called-up share capital	24	1,674	386
Share premium		1,012	319
Capital redemption reserve		162	159
Cash flow hedging reserve		(94)	(96)
Merger reserve		650	650
Translation reserve		524	397
Accumulated losses		(8,825)	(5,191)
Equity attributable to ordinary shareholders		(4,897)	(3,376)
Non-controlling interests		22	22
TOTAL EQUITY		(4,875)	(3,354)

The Financial Statements on pages 106 to 176 were approved by the Board on 11 March 2021 and signed on its behalf by:

Warren East Stephen Daintith
Chief Executive Chief Financial Officer

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated cash flow statement

For the year ended 31 December 2020

	Notes	31 December 2020 £m	31 December 2019 £m
Reconciliation of cash flows from operating activities			
Operating loss ¹		(2,081)	(852)
Loss/(profit) on disposal of property, plant and equipment		37	(13)
Share of results of joint ventures and associates	13	(191)	(104)
Dividends received from joint ventures and associates	13	60	92
Amortisation and impairment of intangible assets	9	902	372
Depreciation and impairment of property, plant and equipment	10	821	532
Depreciation and impairment of right-of-use assets	11	732	411
Adjustment of amounts payable under residual value guarantees within lease liabilities ²		(102)	–
Impairment of and other movements on investments	13	24	1
(Decrease)/increase in provisions		(801)	1,108
Decrease/(increase) in inventories		588	(43)
Movement in trade receivables/payables and other assets/liabilities		(2,655)	73
Movement in contract assets/liabilities		259	1,737
Financial penalties paid ³		(135)	(102)
Cash flows on other financial assets and liabilities held for operating purposes		(126)	(757)
Interest received		13	31
Net defined benefit post-retirement (credit)/cost recognised in loss before financing	23	(68)	222
Cash funding of defined benefit post-retirement schemes	23	(80)	(266)
Share-based payments	25	25	30
Net cash (outflow)/inflow from operating activities before taxation		(2,778)	2,472
Taxation paid		(231)	(175)
Net cash (outflow)/inflow from operating activities		(3,009)	2,297
Cash flows from investing activities			
Net movement in unlisted investments	13	(5)	3
Additions of intangible assets	9	(365)	(640)
Disposals of intangible assets	9	18	13
Purchases of property, plant and equipment		(585)	(747)
Disposals of property, plant and equipment		23	50
Acquisition of businesses	28	(106)	(43)
Disposal of businesses ⁴	28	23	453
Movement in investments in joint ventures and associates and other movements on investments	13	(19)	(7)
Decrease in short-term investments		6	–
Net cash outflow from investing activities		(1,010)	(918)
Cash flows from financing activities			
Repayment of loans ⁵		(2,884)	(1,136)
Proceeds from increase in loans ⁵		4,774	22
Capital element of lease payments		(284)	(271)
Net cash flow from increase/(decrease) in borrowings and leases		1,606	(1,385)
Interest paid		(88)	(104)
Interest element of lease payments		(74)	(88)
Fees paid on undrawn facilities		(97)	–
Cash flows on settlement of excess derivative contracts ⁶	4	(202)	–
Issue of ordinary shares – rights issue (net of expenses and rights taken by share trust) ⁷		1,972	–
Issue of ordinary shares – other (net of expenses)		–	24
Purchase of ordinary shares		(1)	(15)
Dividends to NCI		(1)	(4)
Redemption of C Shares		(91)	(220)
Net cash inflow/(outflow) from financing activities		3,024	(1,792)
Change in cash and cash equivalents		(995)	(413)
Cash and cash equivalents at 1 January		4,435	4,952
Exchange gains/(losses) on cash and cash equivalents		56	(104)
Cash and cash equivalents at 31 December⁸		3,496	4,435

Consolidated cash flow statement

For the year ended 31 December 2020

- ¹ During the year, the Group has received £47m from the British Government as part of the UK furlough scheme. This has been recognised within operating loss.
- ² Where the cost of meeting residual value guarantees is less than that previously estimated, as costs have been mitigated or liabilities waived by the lessor, the lease liability has been remeasured. Where the value of this remeasurement exceeds the value of the right-of-use asset, the reduction in the lease liability is credited to cost of sales.
- ³ Relates to penalties paid on agreements with investigating bodies.
- ⁴ Includes £55m adjustment of cash consideration on prior period disposal paid during the year. Further detail is provided in note 28.
- ⁵ Repayment of loans includes repayment of the £2.5bn revolving credit facility. Proceeds from increase in loans includes the drawdown of £2.5bn revolving credit facility, proceeds of £2.0bn from new unsecured loan notes and £0.3bn cash received from the Covid Corporate Financing Facility (CCFF). Further detail is provided in note 18.
- ⁶ The impact of COVID-19 on the aerospace industry resulted in a deterioration in net US Dollar receipts across the Group leading to a net US Dollar outflow in the period. During the year, the Group incurred a cash outflow of £186m as a result of needing to buy US Dollars to settle \$1,211m of foreign exchange contracts that were originally in place to sell US Dollar receipts. The Group also incurred a cash outflow of £16m to settle excess jet fuel hedges. Further detail is provided in notes 2 and 4.
- ⁷ Expenses of £79m, of which £1m was unpaid at 31 December, and the cost of the Employee Share Trust subscribing for the new shares of £10m have been deducted from the gross proceeds of £2,060m.
- ⁸ The Group considers overdrafts (repayable on demand) and cash held for sale 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.

The cash flow in the year includes the sale of goods and services to joint ventures and associates – see note 27.

	31 December 2020 £m	31 December 2019 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds/(debt)		
Change in cash and cash equivalents	(995)	(413)
Cash flow from (increase)/decrease in borrowings and leases	(1,606)	1,385
Less: settlement of related derivatives included in fair value of swaps below	50	–
Cash flow from decrease in short-term investments	(6)	–
Change in net (debt)/funds resulting from cash flows	(2,557)	972
New leases and other non-cash adjustments on lease liabilities and borrowings	(38)	(217)
Net (debt) (excluding cash and cash equivalents) of previously unconsolidated subsidiary	–	(1)
Exchange gains/(losses) on net funds/(debt)	143	(32)
Fair value adjustments	(126)	48
Debt assumed on acquisition of business	(24)	–
Transferred to liabilities associated with assets held for sale	11	3
Movement in net (debt)/funds	(2,591)	773
Net (debt)/funds at 1 January excluding the fair value of swaps (as previously reported)	(1,236)	318
Reclassifications ¹	–	(79)
Adoption of IFRS 16	–	(2,248)
Net debt at 1 January	(1,236)	(2,009)
Net debt at 31 December excluding the fair value of swaps	(3,827)	(1,236)
Fair value of swaps hedging fixed rate borrowings	251	243
Net debt at 31 December	(3,576)	(993)

¹ In 2019, the Group reclassified £79m as borrowings previously included in other financial liabilities. These borrowings mature during periods up to 2029.

The movement in net debt (defined by the Group as including the items shown below) is as follows:

	At 1 January £m	Funds flow £m	Net funds on acquisition/ disposal £m	Exchange differences £m	Fair value adjustments £m	Reclassifi- cations £m	Other movements £m	At 31 December £m
2020								
Cash at bank and in hand	825	163	–	3	–	(51)	–	940
Money market funds	1,095	(426)	–	–	–	–	–	669
Short-term deposits	2,523	(733)	–	53	–	–	–	1,843
Cash and cash equivalents (per balance sheet)	4,443	(996)	–	56	–	(51)	–	3,452
Cash and cash equivalents included within assets held for sale	–	–	–	–	–	51	–	51
Overdrafts	(8)	1	–	–	–	–	–	(7)
Cash and cash equivalents (per cash flow statement)	4,435	(995)	–	56	–	–	–	3,496
Short-term investments	6	(6)	–	–	–	–	–	–
Other current borrowings	(427)	134	(24)	(1)	–	(686)	(2)	(1,006)
Non-current borrowings	(2,896)	(1,974)	–	38	(126)	686	(2)	(4,274)
Lease liabilities	(2,354)	284	–	50	–	11	(34)	(2,043)
Financial liabilities	(5,677)	(1,556)	(24)	87	(126)	11	(38)	(7,323)
Net debt excluding the fair value of swaps	(1,236)	(2,557)	(24)	143	(126)	11	(38)	(3,827)
Fair value of swaps hedging fixed rate borrowings ¹	243	(50)	–	(42)	114	(14)	–	251
Net debt	(993)	(2,607)	(24)	101	(12)	(3)	(38)	(3,576)
Net funds/(debt) (excluding lease liabilities)								(1,533)

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated cash flow statement continued

For the year ended 31 December 2020

	At 1 January ² £m	Funds flow ³ £m	Net funds on acquisition/ disposal £m	Exchange differences £m	Fair value adjustments £m	Reclassifi- cations £m	Other movements in lease liabilities £m	At 31 December £m
2019								
Cash at bank and in hand	1,023	(179)	–	(19)	–	–	–	825
Money market funds	1,222	(124)	–	(3)	–	–	–	1,095
Short-term deposits	2,729	(124)	–	(82)	–	–	–	2,523
Cash and cash equivalents (per balance sheet)	4,974	(427)	–	(104)	–	–	–	4,443
Overdrafts	(22)	14	–	–	–	–	–	(8)
Cash and cash equivalents (per cash flow statement)	4,952	(413)	–	(104)	–	–	–	4,435
Short-term investments	6	–	–	–	–	–	–	6
Other current borrowings	(816)	799	–	2	5	(417)	–	(427)
Non-current borrowings	(3,674)	315	(1)	4	43	417	–	(2,896)
Lease liabilities	(2,477)	271	–	66	–	3	(217)	(2,354)
Financial liabilities	(6,967)	1,385	(1)	72	48	3	(217)	(5,677)
Net debt excluding fair value swaps	(2,009)	972	(1)	(32)	48	3	(217)	(1,236)
Fair value of swaps hedging fixed rate borrowings	293	–	–	–	(50)	–	–	243
Net debt	(1,716)	972	(1)	(32)	(2)	3	(217)	(993)
Net funds (excluding lease liabilities)		761						1,361

¹ Fair value of swaps hedging fixed rate borrowings reflect the impact of derivatives on repayments of the principal amount of debt. Net debt therefore includes the fair value of derivatives included in fair value hedges (2020 £293m, 2019 £229m) and the element of fair value relating to exchange differences on the underlying principal of derivatives in cash flow hedges (2020 £(42)m and 2019 £nil). During the year, the Group reclassified £14m relating to the fair value of derivatives for which hedge accounting was not applied as these relate to the future payments of interest only.

² In 2019, the Group reclassified £79m as borrowings previously included in other financial liabilities. These borrowings mature during periods up to 2029.

³ Includes Trent 1000 insurance receipts of £173m.

Consolidated statement of changes in equity

For the year ended 31 December 2020

The following describes the nature and purpose of each reserve within equity:

Share capital – The nominal value of ordinary shares of 20p each in issue.

Share premium – Proceeds received in excess of the nominal value of ordinary shares issued, less the costs of issue.

Capital redemption reserve – Amounts transferred from accumulated losses on the repurchase of ordinary shares or the redemption of C Shares. In Rolls-Royce Holdings plc's own Financial Statements, C Shares are issued from the merger reserve. This reserve was created by a scheme of arrangement in 2011. As this reserve is eliminated on consolidation, in the consolidated financial statements, the C Shares are shown as being issued from the capital redemption reserve.

Cash flow hedging reserve – Cumulative gains and losses on hedging instruments deemed effective in cash flow hedges.

Merger reserve – The premium on issuing shares to acquire a business where merger relief in accordance with the Companies Act 2006 applies.

Translation reserve – Gains and losses arising on retranslating the net assets of overseas operations into sterling.

Accumulated losses – All other net gains and losses and transactions with owners not recognised elsewhere and ordinary shares held for the purpose of share-based payment plans.

Non-controlling interests – The share of net assets or liabilities of subsidiaries held by third parties.

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 £m	Merger reserve £m	Translation reserve £m	Accumulated losses ¹ £m	Total £m		
At 1 January 2020	386	319	159	(96)	650	397	(5,191)	(3,376)	22	(3,354)
Loss for the year	–	–	–	–	–	–	(3,170)	(3,170)	1	(3,169)
Foreign exchange translation differences on foreign operations	–	–	–	–	–	121	–	121	–	121
Reclassified to income statement on disposal of businesses	28	–	–	–	–	6	–	6	–	6
Movement on post-retirement schemes	23	–	–	–	–	–	(590)	(590)	–	(590)
Fair value movement on cash flow hedges	–	–	–	(16)	–	–	–	(16)	–	(16)
Reclassified to income statement from cash flow hedge reserve	–	–	–	26	–	–	–	26	–	26
OCI of joint ventures and associates	13	–	–	(4)	–	–	(1)	(5)	–	(5)
Related tax movements	5	–	–	(4)	–	–	197	193	–	193
Total comprehensive expense for the year	–	–	–	2	–	127	(3,564)	(3,435)	1	(3,434)
Issues of ordinary shares										
– Rights issue ²	1,288	693	–	–	–	–	(10)	1,971	–	1,971
Issue of C Shares	21	–	(89)	–	–	–	1	(88)	–	(88)
Redemption of C Shares	21	–	92	–	–	–	(92)	–	–	–
Ordinary shares purchased	–	–	–	–	–	–	(1)	(1)	–	(1)
Share-based payments – direct to equity ³	–	–	–	–	–	–	27	27	–	27
Transactions with NCI	–	–	–	–	–	–	–	–	(1)	(1)
Related tax movements	–	–	–	–	–	–	5	5	–	5
Other changes in equity in the year	1,288	693	3	–	650	524	(8,825)	(4,897)	22	(4,875)
At 31 December 2020	1,674	1,012	162	(94)	650	524	(8,825)	(4,897)	22	(4,875)

¹ At 31 December 2020, 39,866,717 ordinary shares with a net book value of £89m (2019: 12,476,576 ordinary shares with a net book value of £108m) were held for the purpose of share-based payment plans and included in accumulated losses. During the year:

– 3,458,865 ordinary shares with a net book value of £29m (2019: 8,984,219 ordinary shares with a net book value of £82m) vested in share-based payment plans;

– the Company acquired 85,724 (2019: 118,831) of its ordinary shares via reinvestment of dividends received on its own shares and purchased 30,763,282 (2019: 1,673,143) of its ordinary shares through purchases on the London Stock Exchange; and

– the Company issued no new ordinary shares (2019: 7,803,043) to the Group's share trust for its employee share-based payment plans with a net book value of nil (2019: £66m) in respect of the rights issue.

² During the year, the Company issued 6,436,601,676 new ordinary shares with a net book value of £1,288m and Employee Share Trust subscribed for new shares at a value of £10m relating to the November 2020 rights issue. The amount credited to share premium is net of £79m in relation to transaction costs associated with the rights issue.

³ Share-based payments – direct to equity is the share-based payment charge for the year less actual cost of vesting excluding those vesting from own shares and cash received on share-based schemes vesting.

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated statement of changes in equity continued

For the year ended 31 December 2020

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 £m	Merger reserve £m	Translation reserve £m	Accumulated losses ¹ £m	Total £m		
At 1 January 2019 including the impact of IFRS 16	379	268	161	(106)	406	809	(3,031)	(1,114)	22	(1,092)
Loss for the year	–	–	–	–	–	–	(1,315)	(1,315)	4	(1,311)
Foreign exchange translation differences on foreign operations	–	–	–	–	–	(313)	–	(313)	–	(313)
Reclassified to income statement on disposal of Commercial Marine	28	–	–	–	–	(98)	–	(98)	–	(98)
Movement on post-retirement schemes	23	–	–	–	–	–	(934)	(934)	–	(934)
Fair value movement on cash flow hedges	–	–	–	12	–	–	–	12	–	12
Reclassified to income statement from cash flow hedge reserve	–	–	–	10	–	–	–	10	–	10
OCI of joint ventures and associates	13	–	–	(7)	–	–	(1)	(8)	–	(8)
Related tax movements	5	–	–	(5)	–	(1)	324	318	–	318
Total comprehensive expense for the year	–	–	–	10	–	(412)	(1,926)	(2,328)	4	(2,324)
Arising on issues of ordinary shares	1	51	–	–	–	–	–	52	–	52
Shares issued in respect of acquisition of ITP Aero ⁴	6	–	–	–	244	–	–	250	–	250
Issue of C Shares	21	–	–	(222)	–	–	1	(221)	–	(221)
Redemption of C Shares	21	–	–	220	–	–	(220)	–	–	–
Ordinary shares purchased	–	–	–	–	–	–	(15)	(15)	–	(15)
Shares issued to employee share trust	–	–	–	–	–	–	(51)	(51)	–	(51)
Share-based payments – direct to equity ³	–	–	–	–	–	–	50	50	–	50
Transactions with NCI	–	–	–	–	–	–	–	–	(4)	(4)
Related tax movements	–	–	–	–	–	–	1	1	–	1
Other changes in equity in the year	7	51	(2)	–	244	–	(234)	66	(4)	62
At 31 December 2019	386	319	159	(96)	650	397	(5,191)	(3,376)	22	(3,354)

⁴ During 2019, the Company issued 28,973,262 new ordinary shares relating to the final three (of eight) instalments for the acquisition of ITP Aero.

1 Accounting policies

The Company and the Group

Rolls-Royce Holdings plc (the 'Company') is a public company limited by shares incorporated under the Companies Act 2006 and domiciled in England in the United Kingdom. The Consolidated Financial Statements of the Company for the year ended 31 December 2020 consist of the audited consolidation of the Financial Statements of the Company and its subsidiaries (together referred to as the Group) together with the Group's interest in jointly controlled and associated entities.

Basis of preparation and statement of compliance

The Company has elected to prepare its individual Company Financial Statements under FRS 101 *Reduced Disclosure Framework*. They are set out on pages 177 to 182 with the associated accounting policies from page 179.

In accordance with the Companies Act 2006 and European Union (EU) regulations, the Consolidated Financial Statements have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006 and international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the EU.

The Consolidated Financial Statements have been prepared on a going concern basis as described on page 52. The historical cost basis has been used except where IFRS require 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*.

The Consolidated Financial Statements are presented in sterling which is the Company's functional currency.

The preparation of Consolidated Financial Statements requires management to make judgements and estimates that affect the reported amounts of assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenue and expenses during the reporting period. Actual future outcomes could differ from those estimates.

Going concern

Given the economic uncertainty of the COVID-19 pandemic, the Directors have undertaken a comprehensive going concern review over an eighteen-month period to September 2022, considering the forecast cash flows of the Group and the liquidity headroom available over that eighteen-month period. The Group has modelled two scenarios in its assessment of going concern which have been considered by the Directors, along with a likelihood assessment of these scenarios, being:

- base case, which reflects the Directors current expectations of future trading; and
- severe but plausible downside scenario, which envisages a 'stress' or 'downside' situation.

Further details are given in the Going Concern Statement on pages 52 to 54. After due consideration the Directors consider that the Group has sufficient liquidity headroom to continue in operational existence for a period of at least eighteen months from the date of this report and there are no material uncertainties that may cast doubt on the Company's going concern status, accordingly they are satisfied that it is appropriate to adopt the going concern basis of accounting in preparing the Consolidated and Company Financial Statements.

Climate change

In preparing the Consolidated Financial Statements management has considered the impact of climate change, particularly in the context of the disclosures included in the Strategic Report this year and the stated net zero targets. These considerations did not have a material impact on the financial reporting judgements and estimates, consistent with the assessment that climate change is not expected to have a significant impact on the Group's going concern assessment to September 2022 nor the viability of the Group over the next five years. The following specific points were considered:

- The Group continues to invest in new technologies including hybrid electric solutions in Power Systems, continued development of the more efficient UltraFan aero engine, testing of sustainable aviation fuels, SMRs and hybrid and fully electric propulsion.
- The Group continues to invest in onsite renewable energy generation solutions for our facilities and investment is included in our five year forecasts to enable us to meet our 2030 target for zero greenhouse gas emissions (scope 1 and 2) from our operations and facilities.
- Management has considered the impact of climate change on a number of key estimates within the financial statements, including:
 - the estimates of future cash flows used in impairment assessments of the carrying value of non-current assets (such as programme intangible assets and goodwill) (see note 9);
 - the estimates of future profitability used in our assessment of the recoverability of deferred tax assets in the UK (see note 5); and
 - the long-term contract accounting assumptions, such as the level of EFHs assumed, which consider our future expectations of consumer and airline customer behaviour (see note 16).

Presentation of underlying results

The Group measures financial performance on an underlying basis and discloses this information as an alternative performance measure. This is consistent with the way that financial performance is measured by management and reported to the Board in accordance with IFRS 8 *Operating Segments*. The Group believes this is the most appropriate basis to measure the in-year performance as underlying results reflect the substance of trading activity, including the impact of the Group's foreign exchange forward contracts, which economically hedge net foreign currency cash flows at predetermined exchange rates. In addition, underlying results exclude the accounting impact of business acquisitions and disposals, impairment charges where the reasons are outside of normal operating activities, exceptional items, and other items which are market driven and outside of the control of management. Further details are given in note 2.

Revisions to IFRS applicable in 2020

No new standards and interpretations issued by the IASB had a significant impact on the Consolidated Financial Statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies continued**Key areas of judgement and sources of estimation uncertainty**

The determination of the Group's accounting policies requires judgement. The subsequent application of these policies requires estimates and the actual outcome may differ from that calculated. The key judgements and key sources of estimation uncertainty at the balance sheet date, that were assessed as having a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year, are summarised below. Further details, together with sensitivities for key sources of estimation uncertainty where appropriate and practicable, are included within the significant accounting policies section of this note.

Area	Key judgements	Key sources of estimation uncertainty	Page
Revenue recognition and contract assets and liabilities	<ul style="list-style-type: none"> - Whether Civil Aerospace Original Equipment (OE) and aftermarket contracts should be combined - How performance on long-term aftermarket contracts should be measured - Whether any costs should be treated as wastage - Whether sales of spare engines to joint ventures are at fair value 	<ul style="list-style-type: none"> - Estimates of future revenue and costs of long-term contractual arrangements - Determination of the time period and profile over which the aerospace industry will recover 	116
Risk and revenue sharing arrangements	<ul style="list-style-type: none"> - Determination of the nature of entry fees received 		118
Taxation		<ul style="list-style-type: none"> - Estimates necessary to assess whether it is probable that sufficient suitable taxable profits will arise in the UK to utilise the deferred tax assets 	118
Business combinations and goodwill	<ul style="list-style-type: none"> - Identification of acquired assets and liabilities 		120
Research and development	<ul style="list-style-type: none"> - Determination of the point in time where costs incurred on an internal programme development meet the criteria for capitalisation - Determination of the basis for amortising capitalised development costs 		121
Leases	<ul style="list-style-type: none"> - Determination of lease term 	<ul style="list-style-type: none"> - Estimates of the payments required to meet residual value guarantees at the end of engine leases 	122
Impairment of non-current assets	<ul style="list-style-type: none"> - Determination of cash-generating units for assessing impairment of goodwill 	<ul style="list-style-type: none"> - Estimates of cash flow forecasts and discount rates to support the carrying value of intangible assets (including programme-related intangible assets) 	122
Provisions	<ul style="list-style-type: none"> - Whether any costs should be treated as wastage 	<ul style="list-style-type: none"> - Estimates of the time to resolve the technical issues on the Trent 1000, including the development of the modified HPT blade and estimates of the expenditure required to settle the obligation relating to Trent 1000 claims and to settle Trent 1000 long-term contracts assessed as onerous - Estimates of the future revenues and costs to fulfil onerous contracts 	124
Post-retirement benefits		<ul style="list-style-type: none"> - Estimates of the assumptions for valuing the defined benefit obligation 	124

1 Accounting policies continued

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.

Basis of consolidation

The Consolidated Financial Statements include the Company Financial Statements and its subsidiary undertakings together with the Group's share of the results in joint arrangements and associates made up to 31 December.

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. Subsidiaries are consolidated in accordance with IFRS 10 *Consolidated Financial Statements*.

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 investors under a contractual arrangement. Joint arrangements may be either joint ventures or joint operations. Joint ventures are accounted for using the equity method of accounting and joint operations are accounted for using proportionate accounting.

An associate is an entity that is 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 associates are accounted for using the equity method of accounting.

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 arrangements and associates to the extent of the Group's interest in the entity. Transactions with non-controlling interests are recorded directly in equity.

Any subsidiary undertaking, joint arrangement or associate sold or acquired during the year are included up to, or from, the date of change of control. Details of transactions in the year are set out in note 28.

Revenue recognition and contract assets and liabilities

Revenue recognised comprises sales to the Group's customers after discounts and amounts payable to customers. Revenue excludes value added taxes. The transaction price of a contract is typically clearly stated within the contract, although the absolute amount may be dependent on escalation indices and long-term contracts require the key estimates highlighted below. Refund liabilities where sales are made with a right of return are not typical in the Group's contracts. Where they do exist, and consideration has been received, a portion based on an assessment of the expected refund liability is recognised within other payables. The Group has elected to use the practical expedient not to adjust revenue for the effect of financing components where the expectation is that the period between the transfer of goods and services to customers and the receipt of payment is less than a year.

Sales of standard OE, spare parts and time and material overhaul services are generally recognised on transfer of control to the customer. This is generally on delivery to the customer, unless the specific contractual terms indicate a different point. The Directors consider whether there is a need to constrain the amount of revenue to be recognised on delivery based on the contractual position and any relevant facts, however, this is not typically required.

Sales of OE and services that are specifically designed for the contract (most significantly in the Defence business) are recognised by reference to the progress towards completion of the performance obligation, using the cost method described in the key judgements, provided the outcome of contracts can be assessed with reasonable certainty.

The Group generates a significant portion of its revenue on aftermarket arrangements arising from the installed OE fleet. As a consequence, in particular in the Civil Aerospace large engine business, the Group will often agree contractual prices for OE deliveries that take into account the anticipated aftermarket arrangements. Sometimes this may result in losses being incurred on OE. As described in the key judgements, these contracts are not combined. The consideration in the OE contract is therefore allocated to OE performance obligations and the consideration in the aftermarket contract to aftermarket performance obligations.

Key areas of the accounting policy are:

- Future variable revenue from long-term contracts is constrained to take account of the risk of non-recovery of resulting contract balances from reduced utilisation e.g. engine flying hours, based on historical forecasting experience and the risk of aircraft being parked by the customer.
- A significant amount of revenue and cost related to long-term contract accounting is denominated in currencies other than that of the relevant Group undertaking, most significantly US dollar transactions in sterling and euro denominated undertakings. These are translated at estimated long-term exchange rates.
- The assessment of stage of completion is generally measured for each contract. However, in certain cases, such as for CorporateCare agreements where there are many contracts covering aftermarket services each for a small number of engines, the Group accounts for a portfolio of contracts together as the effect on the Consolidated Financial Statements would not differ materially from applying the standard to the individual contracts in the portfolio. When accounting for a portfolio of long-term service arrangements the Group uses estimates and assumptions that reflect the size and composition of the portfolio.
- A contract asset/liability is recognised where payment is received in arrears/advance of the revenue recognised in meeting performance obligations.
- Where material, wastage costs (see key judgements below) are recorded as an exceptional non-underlying expense.

If the expected costs to fulfil a contract exceed the expected revenue, a contract loss provision is recognised for the excess costs.

The Group pays participation fees to airframe manufacturers, its customers for OE, on certain programmes. Amounts paid are initially treated as contract assets and subsequently charged as a reduction to the OE revenue when the engines are transferred to the customer.

1 Accounting policies continued

The Group has elected to use the practical expedient to expense as incurred any incremental costs of obtaining or fulfilling a contract if the amortisation period of an asset created would have been one year or less. Where costs to obtain a contract are recognised in the balance sheet, they are amortised over the performance of the related contract (average of three years).

Key judgement – Whether Civil Aerospace OE and aftermarket contracts should be combined

In the Civil Aerospace business, OE contracts for the sale of engines to be installed on new aircraft are with the airframers, while the contracts to provide spare engines and aftermarket goods and services are with the aircraft operators, although there may be interdependencies between them. IFRS 15 *Revenue from Contracts with Customers* includes guidance on the combination of contracts, in particular that contracts with unrelated parties should not be combined. Notwithstanding the interdependencies, the Directors consider that the engine contract should be considered separately from the aftermarket contract. In making this judgement, they also took account of industry practice.

Key judgement – How performance on long-term aftermarket contracts should be measured

The Group generates a significant proportion of its revenue from aftermarket arrangements. These aftermarket contracts, such as TotalCare and CorporateCare agreements in the Civil Aerospace business, cover a range of services and generally have contractual terms covering more than one year. Under these contracts, the Group's primary obligation is to maintain customers' engines in an operational condition and this is achieved by undertaking various activities, such as maintenance, repair and overhaul, and engine monitoring over the period of the contract. Revenue on these contracts is recognised over the period of the contract and the basis for measuring progress is a matter of judgement. The Directors consider that the stage of completion of the contract is best measured by using the actual costs incurred to date compared to the estimated costs to complete the performance obligations, as this reflects the extent of completion of the activities performed.

Key judgement – Whether any costs should be treated as wastage

In rare circumstances, the Group may incur costs of wasted material, labour or other resources to fulfil a contract where the level of cost was not reflected in the contract price. The identification of such costs is a matter of judgement and would only be expected to arise where there has been a series of abnormal events which give rise to a significant level of cost of a nature that the Group would not expect to incur and hence is not reflected in the contract price. Examples include technical issues that: require resolution to meet regulatory requirements; have a wide-ranging impact across a product type; and cause significant operational disruption to customers. Similarly, in these rare circumstances, significant disruption costs to support customers resulting from the actual performance of a delivered good or service may be treated as a wastage cost. Provision is made for any costs identified as wastage when the obligation to incur them arises – see note 22.

Key judgement – Whether sales of spare engines to joint ventures are at fair value

The Civil Aerospace business maintains a pool of spare engines to support its customers. Some of these engines are sold to, and held by, joint venture companies. The assessment of whether the sales price reflects fair value is a key judgement. The Group considers that based upon the terms and conditions of the sales, and by comparison to the sales price of spare engines to other third parties, the sales made to joint ventures reflect the fair value of the goods sold.

Key estimate – Estimates of future revenue and costs on long-term contractual arrangements

The Group has long-term contracts that fall into different accounting periods and which can extend over significant periods (generally up to 25 years), the most significant of these are long-term service arrangements (LTSA) in the Civil Aerospace business. The estimated revenue and costs are inherently imprecise and significant estimates are required to assess: engine flying hours (EFHs), time-on-wing and other operating parameters; the pattern of future maintenance activity and the costs to be incurred; lifecycle cost improvements over the term of the contracts; and escalation of revenue and costs. The estimates take account of the inherent uncertainties, constraining the expected level of revenue as appropriate. In addition, many of the revenues and costs are denominated in currencies other than that of the relevant Group undertaking. These are translated at an estimated long-term exchange rate, based on historical trends and economic forecasts. During the year, changes to the estimate resulted in catch-up adjustments to revenue of £1.0bn.

Key estimate – Determination of the time period and profile over which the aerospace industry will recover

The COVID-19 pandemic has resulted in significant uncertainty across the aerospace industry. Airline customers have grounded a significant number of their aircraft in response to COVID-19 which has resulted in a reduction to EFHs in Civil Aerospace during 2020. Further details have been included in the going concern disclosure on page 52. Estimates of future LTSA revenue within Civil Aerospace are based upon future EFH forecasts, influenced by assumptions over the recovery of the aerospace industry.

Based upon the stage of completion of all widebody LTSA contracts within Civil Aerospace as at 31 December 2020, the following changes in estimates would result in catch-up adjustments being recognised in the period in which the estimates change (at underlying rates):

- A further reduction in forecast EFHs of 15% over the remaining term of the contracts would decrease LTSA income and to a lesser extent costs, resulting in a catch-up adjustment of £100m – £130m. An estimated 90% of this would be expected to be a reduction in revenue with the remainder relating to onerous contracts which would be an increase in cost of sales.
- A 2% increase or decrease in revenue over the life of the contracts would lead to a catch-up adjustment of £200m.
- A 5% increase or decrease in shop visit costs over the life of the contracts would lead to a catch-up adjustment of £150m.

1 Accounting policies continued

Risk and revenue sharing arrangements (RRSAs)

Cash entry fees received are initially deferred on the balance sheet within trade payables and other liabilities. They are then recognised as a reduction in cost of sales incurred. Individual programme amounts are allocated pro rata to the estimated number of units to be produced. Amortisation commences as each unit is delivered and then charged on a 15-year straight-line basis.

The payments to suppliers of their shares of the programme cash flows for their production components are charged to cost of sales when OE sales are recognised or as LTSA costs are incurred.

The Group also has arrangements with third parties who invest in a programme and receive a return based on its performance, but do not undertake development work or supply parts. Such arrangements (financial RRSAs) are financial instruments as defined by IAS 32 *Financial Instruments: Presentation* and are accounted for using the amortised cost method.

Key judgement – Determination of the nature of entry fees received

RRSAs with key suppliers (workshare partners) are a feature of the 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 cash flows as a 'life of type' supplier (i.e. as long as the engine remains in service).

The non-refundable cash entry fee is judged by the Group to be a contribution towards the development expenditure incurred. These receipts are deferred on the balance sheet and recognised against the cost of sales over the estimated number of units to be delivered on a similar basis to the amortisation of development costs – see 121.

Royalty payments

Where a government or similar body has previously acquired an interest in the intellectual property of a programme, royalty payments are matched to the related sales.

Government grants

Government grants received are varied in nature and 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 initially recognised as liabilities within trade payables and other liabilities and released to match the related expenditure. 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 tax purposes and is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled. In the UK, the deferred tax liability on the pension scheme surplus is recognised consistently with the basis for recognising the surplus i.e. at the rate applicable to refunds from a trust.

Tax is charged or credited to the income statement or 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.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint arrangements, 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. Further details on the Group's tax position can be found on page 206.

Key estimate – Estimates necessary to assess whether it is probable that sufficient suitable taxable profits will arise in the UK to utilise the deferred tax assets

Deferred tax assets are recognised to the extent it is probable that future taxable profits will be available, against which the deductible temporary difference can be utilised, based on management's assumptions relating to the quantum of future taxable profits. Future taxable profits require significant estimates to be made, including the pattern of future maintenance activity and the costs to be incurred; lifecycle cost improvements over the term of the contracts; and escalation of revenue and costs. The estimates take account of the inherent uncertainties, constraining the expected level of profit as appropriate. Changes in these estimates will affect future profits and therefore the recoverability of the deferred tax assets. Further details can be found in note 5.

A 5% change in margin in the main Civil Aerospace widebody programmes or a 5% change in the number of shop visits (driven by EFHs which are influenced by a number of factors including climate change) over the remaining life of the programmes, would result in an increase/decrease in the deferred tax asset by around £100m.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies continued**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 average monthly exchange rate when the transaction occurs. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the rate prevailing at the year end. Exchange differences arising on foreign exchange transactions and the retranslation of monetary assets and liabilities into functional currencies at the rate prevailing at the year end are included in profit/(loss) 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 prevailing at the year end. Exchange adjustments arising from the retranslation of the opening net assets, and from the translation of the profits or losses at average rates, are recognised in OCI.

Financial instruments – Classification and measurement

Financial assets primarily include trade receivables, cash and cash equivalents, short-term investments, derivatives (foreign exchange, commodity and interest rate contracts), and unlisted investments.

- Trade receivables are classified either as held to collect and measured at amortised cost, or as held to collect and sell and measured at fair value, with movements in fair value recognised through other comprehensive income (FVOCI). The Group may sell trade receivables due from certain customers before the due date. Any trade receivables from such customers that are not sold at the reporting date are classified as 'held to collect and sell'.
- Cash and cash equivalents (consisting of balances with banks and other financial institutions, money-market funds, short-term deposits) and short-term investments are subject to low market risk. Cash balances, short-term deposits and short-term investments are measured at amortised cost. Money market funds are measured at fair value, with movements in fair value recognised in the income statement as a profit or loss (FVPL).
- Derivatives and unlisted investments are measured at FVPL.

Financial liabilities primarily consist of trade payables, borrowings, derivatives, financial RRSAs and C Shares.

- Derivatives are classified and measured at FVPL.
- All other financial liabilities are classified and measured at amortised cost.

Financial instruments – Impairment of financial assets and contract assets

IFRS 9 *Financial Instruments* sets out the basis for the accounting of expected credit losses (ECLs) on financial assets and contract assets resulting from transactions within the scope of IFRS 15 *Revenue from Contracts with Customers*. The Group has adopted the simplified approach to provide for ECLs, measuring the loss allowance at a probability weighted amount that considers reasonable and supportable information about past events, current conditions and forecasts of future economic conditions of customers. These are incorporated in the simplified model adopted by using credit ratings which are publicly available, or through internal risk assessments derived using the customer's latest available financial information. The ECLs are updated at each reporting date to reflect changes in credit risk since initial recognition. ECLs are calculated for all financial assets in scope, regardless of whether or not they are overdue.

Financial instruments – Hedge accounting

Forward foreign exchange contracts and commodity swaps (derivative financial instruments) are held to manage the cash flow exposures of forecast transactions denominated in foreign currencies or in commodities respectively. Derivative financial instruments qualify for hedge accounting when: (i) there is a formal designation and documentation of the hedging relationship and the Group's risk management objective and strategy for undertaking the hedge at the inception of the hedge; and (ii) the hedge is expected to be effective.

In general, the Group has chosen to not apply hedge accounting in respect of these exposures. Prior to its acquisition in 2017, ITP Aero adopted hedge accounting for its equivalent exposures. It has continued to do so, although the value of the derivatives is not significant relative to those held by the rest of the Group.

The Group economically hedges the fair value and cash flow exposures of its borrowings. Cross-currency interest rate swaps are held to manage the fair value or cash flow exposures of borrowings denominated in foreign currencies and are designated as fair value hedges or cash flow hedges as appropriate. Interest rate swaps are held to manage the interest rate exposures of fixed and floating rate borrowings and may be designated as fair value hedges or cash flow hedges as appropriate. If the swaps are not designated as fair value or cash flow hedges, the economic effect is included in the underlying results – see note 2.

Changes in the fair values of derivatives that are designated as fair value hedges are recognised directly in the income statement. The fair value changes of effective cash flow hedge derivatives are recognised in OCI and subsequently recycled in the income statement in the same period or periods during which the hedged expected future cash flows affect profit or loss. Any ineffectiveness in the hedging relationship is included in the income statement.

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 OCI is retained until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss is recycled to the income statement.

1 Accounting policies continued

Financial instruments – Replacement of benchmark interest rates

Following the financial crisis, the reform and replacement of benchmark interest rates such as GBP LIBOR and other interbank offered rates (IBORs) has become a priority for global regulators. There is currently uncertainty around the timing and precise nature of these changes. The Group's risk exposure that is directly affected by the interest rate benchmark reform is its portfolio of long-term borrowings of £4.1bn. These borrowings are hedged, using interest rate swaps and cross-currency interest rate swaps, for changes in fair value and cash flows attributable to the relevant benchmark interest rate. However, as part of the reforms noted above, the UK Financial Conduct Authority has decided to no longer compel panel banks to participate in the IBOR submission process after the end of 2021 and to cease oversight of these benchmark interest rates. Regulatory authorities and private sector working groups have been discussing alternative benchmark rates for IBOR. It is currently anticipated that IBOR rates will be replaced with a backward-looking risk-free rate based on actual transactions.

Management is continuing to monitor developments. When the future position is clearer, a transition project to assess and implement changes to systems, processes, risk and valuation models, as well as managing related tax and accounting implications will be initiated. The Group currently anticipates that the areas of greatest change will be amendments to the contractual terms of IBOR-referenced floating-rate debt and swaps, and updating hedge designations.

Due to the uncertainty around these changes the Group elected to early adopt in 2019 the Amendments to IFRS 9, IAS 39 and IFRS 7 *Interest Rate Benchmark Reform* issued in September 2019. In accordance with the transition provisions, the amendments were adopted retrospectively to hedging relationships that existed at the start of 2019 or were designated thereafter. The amendments provide temporary relief from applying specific hedge accounting requirements to hedging relationships directly affected by IBOR reform.

The reliefs have the effect that IBOR reform should not generally cause hedge accounting to terminate. However, any hedge ineffectiveness should continue to be recorded in the income statement. Furthermore, the amendments set out triggers for when the reliefs will end, which include the uncertainty arising from interest rate benchmark reform no longer being present.

In summary, the reliefs provided by the amendments that apply to the Group are:

- In assessing whether the hedge is expected to be highly effective on a forward-looking basis, the Group has assumed that the relevant IBOR interest rate on which the cash flows of the interest rate swap that hedges fixed-rate borrowings is not altered by IBOR reform.
- The Group has assessed whether the hedged IBOR risk component is a separately identifiable risk only when it first designates a borrowing as included in a hedging relationship and not on an ongoing basis. Any hedge ineffectiveness relating to fair value hedges is recognised immediately in the income statement.

Business combinations and goodwill

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 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 arrangements and associates is included in the carrying value of the investment.

Key judgement – Identification and valuation of acquired assets and liabilities

In allocating the purchase price to the acquired assets and liabilities, such as technology, patents and licences, customer relationships, trademarks and in-process development, judgement is required. The allocations are based on the Group's industry experience and the advice of third party valuers, if required. During the year the Group acquired intangible assets arising on acquisition of Kinolt Group S.A. of £61m including £37m of customer relationships and £22m of technology intangible assets. See note 28 for details.

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 is charged on a straight-line basis over its useful economic life, up to a maximum of 15 years.

Certification costs

Costs incurred in respect of meeting regulatory certification requirements for new Civil Aerospace aero-engine/aircraft combinations including payments made to airframe manufacturers for this are recognised as intangible assets to the extent that they can be recovered out of future sales. They are charged to the income statement over the programme life. Individual programme assets are allocated pro rata to the estimated number of units to be produced. Amortisation commences as each unit is delivered and then charged on a 15-year straight-line basis.

1 Accounting policies continued

Research and development

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 recognised as an internally generated intangible asset (programme asset) only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits.

More specifically, development costs are capitalised from the point at which the following conditions have been met:

- the technical feasibility of completing the programme and the intention and ability (availability of technical, financial and other resources) to complete the programme asset and use or sell it;
- the probability that future economic benefits will flow from the programme asset; and
- the ability to measure reliably the expenditure attributable to the programme asset during its development.

Capitalisation continues until the point at which the programme asset meets its originally contracted technical specification (defined internally as the point at which the asset is capable of operating in the manner intended by management).

Subsequent expenditure is capitalised where it enhances the functionality of the programme asset and demonstrably generates an enhanced economic benefit to the Group. All other subsequent expenditure on programme assets is expensed as incurred.

Individual programme assets are allocated pro rata to the estimated number of units to be produced. Amortisation commences as each unit is delivered and then charged on a 15-year straight-line basis. In accordance with IAS 38 *Intangible Assets*, the basis on which programme assets are amortised is assessed annually.

Key judgement – Determination of the point in time when costs incurred on an internal programme development meet the criteria for capitalisation

The Group incurs significant research and development expenditure in respect of various development programmes. Determining when capitalisation should commence and cease is a critical judgement, as is the determination of when subsequent expenditure on the programme assets should be capitalised. £232m of development expenditure was capitalised during the year.

Within the Group, there is an established Product Introduction and Lifecycle Management process (PILM) in place. Within this process, the technical feasibility, the commercial viability and financial assessment of the programme is assessed at certain milestones. When these are met, development expenditure is capitalised. Prior to this, expenditure is expensed as incurred.

Subsequent expenditure after entry into service which enhances the performance of the engine and the economic benefits to the Group is capitalised. This expenditure is referred to as enhanced performance and is governed by the PILM process referred to above. All other development costs are expensed as incurred.

Key judgement – Determination of the basis for amortising capitalised development costs

The economic benefits of the development costs are primarily those cash inflows arising from long-term service agreements, which are expected to be relatively consistent for each engine within a programme. Amortisation of development costs is recognised on a straight-line basis over the estimated period of operation of the engine by its initial operator.

Software

Software that is not specific to an item of property, plant and equipment is classified as an intangible asset, recognised at its acquisition cost and amortised on a straight-line basis over its useful economic life, up to a maximum of five years. The cost of internally developed software includes direct labour and an appropriate proportion of overheads.

Other intangible assets

These principally include intangible assets arising on acquisition of businesses, such as technology, patents and licences which are amortised on a straight-line basis over a maximum of 15 years and trademarks which are not amortised.

Property, plant and equipment

Property, plant and equipment are stated at acquisition cost less accumulated depreciation and any provision for impairment in value. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of overheads and, where appropriate, interest.

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 recorded on assets in the course of construction. Estimated useful lives are reassessed annually and are as follows:

- Land and buildings, as advised by the Group's professional advisers:
 - freehold buildings – five to 50 years (average 24 years); and
 - no depreciation is provided on freehold land.
- Plant and equipment – four to 25 years (average 11 years).
- Aircraft and engines – five to 20 years (average 16 years).

1 Accounting policies continued

Leases

Assets and liabilities arising from a lease are initially measured on a present value basis.

Lease liabilities include the net present value of the following lease payments:

- fixed payments less any lease incentive receivable;
- variable lease payments that are based on an index or a rate;
- amounts expected to be payable by the Group under residual value guarantees;
- the exercise price of a purchase option if the Group is reasonably certain to exercise that option; and
- payments of penalties for termination of the lease, if the lease term reflects the Group exercising that option.

Where leases commenced after the initial transition date, the lease payments are discounted using the interest rate implicit in the lease. If that rate cannot be determined, the Group's incremental borrowing rate is used, being the rate that the Group would have to pay to borrow the funds necessary to obtain an asset of similar value in a similar economic environment with similar terms and conditions. Where appropriate, lease liabilities are revalued at each reporting date using the spot exchange rate.

Right-of-use assets are measured at cost comprising the following:

- the amount of the initial measurement of lease liability or a revaluation of the liability;
- any lease payments made at or before the commencement date less any lease incentives received;
- any initial direct costs; and
- restoration costs.

Each right-of-use asset is depreciated over the shorter of its useful economic life and the lease term on a straight-line basis unless the lease is expected to transfer ownership of the underlying asset to the Group, in which case the asset is depreciated to the end of the useful life of the asset.

Short-term leases are leases with a lease term of 12 months or less. Payments associated with short-term leases and low-value leases are recognised on a straight-line basis as an expense in the income statement.

Key judgement – Determination of lease term

In determining the lease term, the Group considers all facts and circumstances that create an economic incentive to exercise an extension option, or not exercise a termination option. Extension options (or periods after termination) are only included in the lease term if the lease is reasonably certain to be extended (or not terminated). Certain land and building leases have renewal options with renewal dates for the most significant property leases evenly spread between 2022–2028 and in 2041. The Group reviews its judgements on lease terms annually, including the operational significance of the site, especially where utilised for manufacturing activities.

Key estimates – Estimates of the payments required to meet residual value guarantees at the end of engine leases

Engine leases in the Civil Aerospace segment often include clauses that require the engines to be returned to the lessor with specific levels of useable life remaining or cash payments to the lessor. The costs of meeting these requirements are included in the lease payments. The amounts payable are calculated based upon an estimate of the utilisation of the engines over the lease term, whether the engine is restored to the required condition by performing an overhaul at our own cost or through the payments of amounts specified in the contract and any new contractual arrangements arising when the current lease contracts end. Amounts due can vary depending on the level of utilisation of the engines, overhaul activity prior to the end of the contract, and decisions taken on whether ongoing access to the assets is required at the end of the lease term. During the year, adjustments to return conditions at the end of leases resulted in a credit of £102m to the income statement. The lease liability at 31 December 2020 included £347m relating to the cost of meeting these residual value guarantees in the Civil Aerospace business. Up to £19m is payable in the next 12 months, £133m is due over the following four years and the remaining balance after five years.

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 (CGU) to which the asset belongs. Goodwill, indefinite life intangible assets and intangible assets not yet available for use are tested for impairment annually. Other intangible assets (including programme-related 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 CGU) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss is recognised as an expense. The recoverable amount is the higher of value in use or fair value less costs to dispose, 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.

1 Accounting policies continued

Key judgement – Determination of CGUs for assessing impairment of goodwill

The Group conducts impairment reviews at the CGU level. As permitted by IAS 36 *Impairment of Assets*, impairment reviews for goodwill are performed at the groups of CGUs level, representing the lowest level at which the Group monitors goodwill for internal management purposes and no higher than the Group's operating segments. The main CGUs for which goodwill impairment reviews have been performed are Rolls-Royce Deutschland Ltd & Co KG, Kinolt Group S.A. and at an aggregated Rolls-Royce Power Systems AG level.

Key estimate – Estimates of cash flow forecasts and discount rates to support the carrying value of intangible assets (including programme-related intangible assets)

In accordance with IAS 36, COVID-19 is considered to be a trigger event to reassess whether an asset is impaired. The carrying value of intangible assets (including programme-related intangible assets) is dependent on the estimates of future cash flows which are influenced by assumptions over the recovery of the industries in which the Group operate and the discount rates applied. Details of the reviews performed are set out in note 12.

The carrying value of intangible assets on the balance sheet is dependent on the estimates of future cash flows arising from the Group's operations, in particular:

- The assessment of the recoverable value of certification costs, development expenditure and customer relationships recognised as intangible assets (31 December 2020: £3,220m, 2019: £3,612m) is dependent on estimates of cash flows generated by the relevant programme, the discount rate used to calculate a present value and assumptions on foreign exchange rates.
- In addition, in relation to programme intangible assets, estimates comprise: product performance related estimates (including EFHs and time-on-wing); and estimates for future market share, pricing and cost for uncontracted business.

It remains possible that a weaker than expected recovery could result in a deterioration in the future cash flow forecasts that support Civil Aerospace programme intangible assets:

- For intangible assets that have been impaired, a 5% deterioration in EFHs (and hence future cash flows) across the life of the programmes would result in these intangible assets incurring an additional impairment of £50m. An increase in the discount rate of 1% would reduce the recoverable amount of the programme assets (£108m) to nil.
- For intangible assets where there is existing headroom in the impairment test (and thus no impairment) but where deteriorations in key assumptions over the next 12 months could lead to an impairment, any of the following individual changes in assumptions would cause the recoverable amount of the programme assets to equal the carrying value:
 - A reduction in engine sales that are forecast but not contracted by 14%
 - An increase in costs of 2%
 - An increase in discount rates of 1%

Joint ventures and associates

Where the Group makes sales to joint venture companies (most significantly the sale of spare engines to leasing joint ventures), the share of the profit relating to the Group's share of the investment in the joint venture is deferred and subsequently released to match the depreciation of the engines in the share of the joint ventures' retained profit. These adjustments are included in share of the results of joint ventures and associates in the income statement and investments – joint ventures and associates in the balance sheet.

Inventories

Inventories are valued on a first-in, first-out basis, at the lower of cost and net realisable value. Cost comprises direct materials and, where applicable, direct labour costs and those direct and indirect 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. All inventories are classified as current as it is expected that they will be used in the Group's operating cycle, regardless of whether this is expected to be within 12 months of the balance sheet date.

Cash and cash equivalents

Cash and cash equivalents include 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. Where the Group operates pooled banking arrangements across multiple accounts, these are presented on a net basis when it has both a legal right and intention to settle the balances on a net basis.

On a periodic basis the Group undertakes the sale of certain trade receivables to banks. These trade receivables are factored on a non-recourse basis (invoice discounting) and therefore are derecognised from the Group's balance sheet at the point of sale to the bank. Further details are disclosed in note 15.

The Group offers a supply chain financing (SCF) programme in partnership with banks to enable suppliers, including joint ventures, who are on our standard 75 day or more payment terms to receive their payment sooner. As the Group continues to have a contractual obligation to pay its suppliers and it does not retain any ongoing involvement in the SCF, the related payables are retained on the Group's balance sheet and classified as trade payables. Further details are disclosed in note 20.

1 Accounting policies continued

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 discounted to present value where the effect is material.

The principal provisions are recognised as follows:

- Trent 1000 in-service issues when wastage costs are identified as described on page 117;
- contract losses based on an assessment of whether the direct costs to fulfil a contract are greater than the expected revenue;
- warranties and guarantees based on an assessment of future claims with reference to past experience and recognised at the earlier of when the underlying products and services are sold and when the likelihood of a future cost is identified; and
- restructuring when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has created a valid expectation to those affected.

Key judgement – Whether any costs should be treated as wastage

As described further on page 117, in rare circumstances, the Group may incur costs of wasted material, labour or other resources to fulfil a contract where the level of cost was not reflected in the contract price. The identification of such costs is a matter of judgement and would only be expected to arise where there has been a series of abnormal events which give rise to a significant level of cost of a nature that the Group would not expect to incur and hence is not reflected in the contract price. Provision is made for any costs identified as wastage when the obligation to incur them arises.

Specifically for the Trent 1000 wastage costs, provision has been made as the Group is an owner of an engine Type Certificate under which it has a present obligation to develop appropriate design changes to address certain engine conditions that have been noted in issued Airworthiness Directives. The Group is also required to ensure engine operators can continue to safely operate engines within the terms of their LTSA agreements with the Group, and this requires the engines to be compliant with the requirements of those issued Airworthiness Directives. These requirements cannot be met without the Group incurring significant costs in the form of replacement parts and customer claims. Given the significant activities of the Group in designing and overhauling aero engines it is very experienced in making the required estimates in relation to the number and timing of shop visits, parts costs, overhaul labour costs and customer claims.

Key estimates – Estimates of the time to resolve the technical issues on the Trent 1000, including the development of the modified HPT blade and estimates of the expenditure required to settle the obligation relating to Trent 1000 claims and to settle Trent 1000 long-term contracts assessed as onerous

The Group has provisions for Trent 1000 exceptional costs at 31 December 2020 of £321m (2019: £1,382m). These represent the Directors' best estimate of the expenditure required to settle the obligations at the balance sheet date. These estimates take account of information available and different possible outcomes.

The Group considers that at 31 December 2020 the Trent 1000 contract loss provisions and the Trent 1000 exceptional cost provision are most sensitive to changes in estimates. A 12-month delay in the availability of the modified HPT blade could lead to a £60–100m increase in the Trent 1000 exceptional costs provision.

Key estimates – Estimates of the future revenues and costs to fulfil onerous contracts

The Group has provisions for onerous contracts at 31 December 2020 of £791m (2019: £773m). A reduction in Civil Aerospace widebody flying hours of 15% over the remaining term of the contracts and the associated decrease in revenues and costs could lead to a £10m–£15m increase in the provision for contract losses across all programmes. Further details have been included in the going concern disclosure on page 52.

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. Actuarial gains and losses are recognised immediately in OCI. 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 and settlements are recognised immediately; and
- financing costs are recognised in the periods in which they arise.

In 2018 and 2020, following clarification provided by the UK High Court judgements on the Lloyds Banking Group on 26 October 2018 and 23 November 2020, the Group recognised the estimated impact of the obligation to equalise defined benefit pensions and transfer values respectively for men and women as a past-service cost – see note 23.

Payments to defined contribution schemes are charged as an expense as they fall due.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies continued**Key estimate – Estimates of the assumptions for valuing the defined benefit obligation**

The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19 *Employee Benefits*. The valuation, which is based on assumptions determined with independent actuarial advice, resulted in a net deficit of £686m before deferred taxation being recognised on the balance sheet at 31 December 2020 (31 December 2019: deficit of £208m). The size of the net surplus/deficit is sensitive to the actuarial assumptions, which include the discount rate, price inflation, pension and salary increases, longevity and the number of plan members who take the option to transfer their pension to a lump sum on retirement or who choose to take the newly implemented Bridging Pension Option. Following consultation, the UK scheme closed to future accrual on 31 December 2020. The Group is in discussions with the employees' representatives and the Trustee regarding possible additional transitional protections that could be granted from the scheme. Based on the progress of the talks up to 31 December 2020, the Group has allowed for some reductions in the change to the obligation recognised at 31 December. The final details are expected to be agreed in 2021 when any differences will be recognised.

A reduction in the discount rate from 1.45% by 0.25% could lead to an increase in the defined benefit obligations of the RR UK Pension Fund of approximately £530m. This would be expected to be broadly offset by changes in the value of scheme assets, as the scheme's investment policies are designed to mitigate this risk.

A one-year increase in life expectancy from 21.8 years (male aged 65) and from 23.2 years (male aged 45) would increase the defined benefit obligations of the RR UK Pension Fund by approximately £455m.

It is assumed that 40% (31 December 2019: 45%) of members of the RR UK Pension Fund will transfer out of the fund on retirement. The reduction in this assumption is a result of the introduction of the Bridging Pension Option. An increase of 5% in this assumption would increase the defined benefit obligation by £45m.

Further details and sensitivities are included in note 23.

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 long-term incentive plan (LTIP), where no adjustment is required as allowance for this is included in the initial fair value.

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 25 for a further description of the share-based payment plans.

Customer 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 IFRS 9 *Financial Instruments* 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 164, 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.

Costs of share issues

The costs of issuing ordinary shares are charged to the share premium account.

Revisions to IFRS not applicable in 2020

Standards and interpretations issued by the IASB are only applicable if endorsed by the UK. Other than IFRS 17 *Insurance Contracts* described below, the Group does not consider that any standards, amendments or interpretations issued by the IASB, but not yet applicable will have a significant impact on the Consolidated Financial Statements. The Group is not expecting to adopt the amendment to IFRS 16 *Leases*, effective in 2021, which provides a practical expedient to not treat COVID-19 rent concessions as lease modifications. The Group did not adopt the equivalent practical expedient during 2020.

IFRS 17 *Insurance Contracts*

IFRS 17 is effective from 1 January 2023. The new Standard establishes the principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the Standard. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. The Group is in the process of assessing whether the new standard will impact on the Consolidated Financial Statements.

Post balance sheet events

The Group has taken the latest legal position in relation to ongoing legal proceedings and reflected these in the 2020 results as appropriate. In addition, the Group entered into an agreement to sell Bergen Engines on 1 February 2021. Further details are included in note 28. The Spring Budget 2021 announced that the UK corporation tax rate will increase to 25% from 1 April 2023. Further details are included in note 5.

2 Segmental analysis

The analysis by 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 (who act as the Chief Operating Decision Maker as defined by IFRS 8). Our four divisions are set out below and referred to collectively as the core businesses.

Civil Aerospace	development, manufacture, marketing and sales of commercial aero engines and aftermarket services
Power Systems	development, manufacture, marketing and sales of reciprocating engines and power systems
Defence	development, manufacture, marketing and sales of military aero engines, naval engines, submarine nuclear power plants and aftermarket services
ITP Aero	design, research and development, manufacture and casting, assembly and test of aeronautical engines and gas turbines, and maintenance, repair and overhaul (MRO) services

Non-core businesses include the trading results of the Bergen Engines AS business (the Group signed a sales agreement on 1 February 2021), the results of the Civil Nuclear Instrumentation & Control business (the Group signed a sales agreement on 7 December 2020), the results of the North America Civil Nuclear business until the date of disposal on 31 January 2020, the results of the Knowledge Management System business until the date of disposal on 3 February 2020, the Commercial Marine business until the date of disposal on 1 April 2019, Rolls-Royce Power Development Limited (RRPD) until the date of disposal on 15 April 2019 and other smaller businesses including former Energy businesses not included in the disposal to Siemens in 2014 (Retained Energy). The segmental analysis for 2019 has been restated to reflect the 2020 definition of non-core.

From 1 January 2021, all non-core businesses will be referred to as other businesses, and the reporting of core and non-core will cease.

Underlying results

The Group present the financial performance of our businesses in accordance with IFRS 8 and consistently with the basis on which performance is communicated to the Board each month.

Underlying results are presented by recording all relevant revenue and cost of sales transactions at the average exchange rate achieved on settled derivative contracts in the period that the cash flow occurs. The impact of the revaluation of monetary assets and liabilities using the exchange rate that is expected to be achieved by the use of the hedge book is recorded in underlying cost of sales. Underlying financing excludes the impact of revaluing monetary assets and liabilities to period end exchange rates. Transactions between segments are presented on the same basis as underlying results and eliminated on consolidation. Unrealised fair value gains and losses on foreign exchange contracts, which are recognised as they arise in the reported results, are excluded from underlying results. To the extent that the previously forecast transactions are no longer expected to occur, an appropriate portion of the unrealised fair value gain/(loss) on foreign exchange contracts is recorded immediately in the underlying results.

Amounts receivable/(payable) on interest rate swaps which are not designated as hedge relationships for accounting purposes are reclassified from fair value movement on a reported basis to interest receivable/(payable) on an underlying basis, as if they were in an effective hedge relationship.

As a result of the reduction in Civil Aerospace US Dollar (USD) receipts, in the first half of the year the Group was a net purchaser of USD, with the consequence that the achieved exchange rate GBP:USD of 1.24 on settled contracts was similar to the average spot rate in the period. In the second half of 2020, the Group remained a net purchaser of USD with the consequence that the achieved exchange rate of GBP:USD of 1.33 on settled contracts was similar to the average spot rate in the period.

Estimates of future USD cash flows have been determined using the Group's base-case forecast, significantly influenced by the estimate of future EFH forecasts. These USD cash flows have been used to establish the extent of future USD hedge requirements and determine the need to close-out any over-hedged positions. In response to the deterioration in the medium-term outlook caused by COVID-19 and the related reduction in anticipated net USD cash inflows, the Group took action to reduce the size of the USD hedge book by \$1.8bn across 2020-2026. An underlying charge of £1,689m relating to the total \$1.8bn reduction in the size of the USD hedge book is included within underlying financing costs at 31 December 2020. Further detail on this is included within note 4.

Underlying performance excludes the following:

- the effect of acquisition accounting and business disposals;
- impairment of goodwill, other non-current and current assets where the reasons for the impairment are outside of normal operating activities;
- exceptional items; and
- other items which are market driven and outside of the control of management.

Acquisition accounting, business disposals and impairment

The Group excludes these from underlying results so that the current year and comparative results are directly comparable.

Exceptional items

The Group classifies items as exceptional where the Directors believe that presentation of our results in this way is more relevant to an understanding of our financial performance, as exceptional items are identified by virtue of their size, nature or incidence.

In determining whether an event or transaction is exceptional, management considers quantitative as well as qualitative factors such as the frequency or predictability of occurrence. Examples of exceptional items include one-time costs and charges in respect of aerospace programmes, costs of restructuring programmes and one-time past service charges and credits on our post-retirement schemes.

A risk-free discount rate is applied to exceptional onerous contract provisions. The risk-free rate is subject to movements in US bonds. Changes in the risk-free rate are market-driven and the impact of any increase or decrease in the rate is included as a reconciling difference between underlying and reported performance.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis continued

Subsequent changes in exceptional items recognised in a prior period will also be recognised as exceptional. All other changes will be recognised within underlying performance.

Exceptional items are not allocated to segments and may not be comparable to similarly titled measures used by other companies.

Other items

The financing component of the defined benefit pension scheme cost is determined by market conditions and has therefore been included as a reconciling difference between underlying performance and reported performance.

Penalties paid on agreements with investigating bodies are considered to be one-off in nature and are therefore excluded from underlying performance.

The tax effects of the adjustments above are excluded from the underlying tax charge. In addition, changes in tax rates or changes in the amount of recoverable advance corporation tax recognised are also excluded.

See page 131 for the reconciliation between underlying and reported performance.

The following analysis sets out the results of the core businesses on the basis described above and also includes a reconciliation of the underlying results to those reported in the consolidated income statement.

	Civil Aerospace £m	Power Systems ¹ £m	Defence £m	ITP Aero £m	Corporate and inter-segment £m	Core businesses £m
Year ended 31 December 2020						
Underlying revenue from sale of original equipment	2,298	1,794	1,436	537	(293)	5,772
Underlying revenue from aftermarket services	2,791	951	1,930	168	(96)	5,744
Total underlying revenue	5,089	2,745	3,366	705	(389)	11,516
Gross (loss)/profit	(2,005)	681	686	133	(18)	(523)
Commercial and administrative costs	(302)	(337)	(151)	(38)	(52)	(880)
Research and development costs	(436)	(167)	(96)	(27)	–	(726)
Share of results of joint ventures and associates	169	1	9	–	–	179
Underlying operating (loss)/profit	(2,574)	178	448	68	(70)	(1,950)
Year ended 31 December 2020						
Segment assets	16,723	3,497	3,127	1,988	(3,102)	22,233
Interests in joint ventures and associates	363	11	19	1	–	394
Segment liabilities	(22,331)	(1,358)	(3,085)	(1,036)	3,251	(24,559)
Net (liabilities)/assets	(5,245)	2,150	61	953	149	(1,932)
Investment in intangible assets, property, plant and equipment, right-of-use assets and joint ventures and associates	774	181	122	28	–	1,105
Depreciation, amortisation and impairment	1,915	267	128	139	12	2,461
Year ended 31 December 2019						
Underlying revenue from sale of original equipment	3,246	2,183	1,461	782	(502)	7,170
Underlying revenue from aftermarket services	4,861	1,001	1,789	154	(75)	7,730
Total underlying revenue	8,107	3,184	3,250	936	(577)	14,900
Gross profit/(loss)	622	878	669	206	(64)	2,311
Commercial and administrative costs	(306)	(343)	(158)	(62)	(53)	(922)
Research and development costs	(374)	(166)	(105)	(33)	–	(678)
Share of results of joint ventures and associates	102	(2)	9	–	–	109
Underlying operating profit/(loss)	44	367	415	111	(117)	820
Year ended 31 December 2019						
Segment assets	17,954	3,312	2,743	2,160	(2,476)	23,693
Interests in joint ventures and associates	365	18	19	–	–	402
Segment liabilities	(24,819)	(1,089)	(2,950)	(1,129)	2,645	(27,342)
Net (liabilities)/assets	(6,500)	2,241	(188)	1,031	169	(3,247)
Investment in intangible assets, property, plant and equipment, right-of-use assets and joint ventures and associates	1,274	181	110	53	–	1,618
Depreciation, amortisation and impairment	807	201	109	88	–	1,205

¹ The underlying results for Power Systems for 31 December 2019 have been restated to reflect the 2020 non-core businesses as described above.

2 Segmental analysis continued

Reconciliation to reported results

	Core businesses £m	Non-core businesses ¹ £m	Total underlying £m	Underlying adjustments and adjustments to foreign exchange £m	Group at actual exchange rates £m
For the year ended 31 December 2020					
Revenue from sale of original equipment	5,772	115	5,887	(68)	5,819
Revenue from aftermarket services	5,744	132	5,876	129	6,005
Total revenue	11,516	247	11,763	61	11,824
Gross (loss)/profit	(523)	11	(512)	302	(210)
Commercial and administrative costs	(880)	(24)	(904)	96	(808)
Research and development costs	(726)	(9)	(735)	(519)	(1,254)
Share of results of joint ventures and associates	179	–	179	12	191
Operating loss	(1,950)	(22)	(1,972)	(109)	(2,081)
Loss arising on the acquisition and disposal of businesses	–	–	–	(14)	(14)
Loss before financing and taxation	(1,950)	(22)	(1,972)	(123)	(2,095)
Net financing	(1,982)	(4)	(1,986)	1,171	(815)
Loss before taxation	(3,932)	(26)	(3,958)	1,048	(2,910)
Taxation	(37)	(2)	(39)	(220)	(259)
Loss for the year	(3,969)	(28)	(3,997)	828	(3,169)
Attributable to:					
Ordinary shareholders			(3,998)	828	(3,170)
Non-controlling interests			1	–	1
Year ended 31 December 2019					
Revenue from sale of original equipment	7,170	286	7,456	596	8,052
Revenue from aftermarket services	7,730	264	7,994	541	8,535
Total revenue	14,900	550	15,450	1,137	16,587
Gross profit/(loss)	2,311	76	2,387	(1,445)	942
Commercial and administrative costs	(922)	(71)	(993)	(135)	(1,128)
Research and development costs	(678)	(18)	(696)	(74)	(770)
Share of results of joint ventures and associates	109	1	110	(6)	104
Operating profit/(loss)	820	(12)	808	(1,660)	(852)
Gain arising on the disposal of businesses	–	–	–	139	139
Profit/(loss) before financing and taxation	820	(12)	808	(1,521)	(713)
Net financing	(221)	(4)	(225)	47	(178)
Profit/(loss) before taxation	599	(16)	583	(1,474)	(891)
Taxation	(280)	3	(277)	(143)	(420)
Profit/(loss) for the year	319	(13)	306	(1,617)	(1,311)
Attributable to:					
Ordinary shareholders			302	(1,617)	(1,315)
Non-controlling interests			4	–	4

¹ Non-core businesses are set out above. The underlying results for 31 December 2019 have been restated to reflect the 2020 non-core businesses.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis continued**Disaggregation of revenue from contracts with customers**

Analysis by type and basis of recognition

	Civil Aerospace £m	Power Systems ¹ £m	Defence £m	ITP Aero £m	Corporate and inter-segment £m	Core businesses £m
Year ended 31 December 2020						
Original equipment recognised at a point in time	2,293	1,771	523	471	(262)	4,796
Original equipment recognised over time	4	23	912	66	(32)	973
Aftermarket services recognised at a point in time	1,170	827	797	85	(58)	2,821
Aftermarket services recognised over time	1,398	123	1,132	83	(37)	2,699
Total underlying customer contract revenue²	4,865	2,744	3,364	705	(389)	11,289
Other underlying revenue	224	1	2	—	—	227
Total underlying revenue	5,089	2,745	3,366	705	(389)	11,516
Year ended 31 December 2019						
Original equipment recognised at a point in time	3,246	2,108	567	702	(478)	6,145
Original equipment recognised over time	—	75	894	80	(24)	1,025
Aftermarket services recognised at a point in time	1,599	874	696	48	(32)	3,185
Aftermarket services recognised over time	3,138	127	1,093	106	(43)	4,421
Total underlying customer contract revenue²	7,983	3,184	3,250	936	(577)	14,776
Other underlying revenue	124	—	—	—	—	124
Total underlying revenue	8,107	3,184	3,250	936	(577)	14,900

¹ The underlying results for Power Systems for 31 December 2019 have been restated to reflect the 2020 non-core businesses as described above.² Includes £(1,012)m (2019: £(93)m) of revenue recognised in the year relating to performance obligations satisfied in previous years.

	Core businesses £m	Non-core businesses ¹ £m	Total underlying £m	Underlying adjustments and adjustments to foreign exchange ² £m	Group at actual exchange rates £m
Year ended 31 December 2020					
Original equipment recognised at a point in time	4,796	114	4,910	(63)	4,847
Original equipment recognised over time	973	—	973	(6)	967
Aftermarket services recognised at a point in time	2,821	133	2,954	53	3,007
Aftermarket services recognised over time	2,699	—	2,699	110	2,809
Total customer contract revenue	11,289	247	11,536	94	11,630
Other revenue	227	—	227	(33)	194
Total revenue	11,516	247	11,763	61	11,824
Year ended 31 December 2019					
Original equipment recognised at a point in time	6,145	217	6,362	596	6,958
Original equipment recognised over time	1,025	69	1,094	—	1,094
Aftermarket services recognised at a point in time	3,185	246	3,431	313	3,744
Aftermarket services recognised over time	4,421	18	4,439	228	4,667
Total customer contract revenue	14,776	550	15,326	1,137	16,463
Other revenue	124	—	124	—	124
Total revenue	14,900	550	15,450	1,137	16,587

¹ Non-core businesses are set out above. The underlying results for 31 December 2019 have been restated to reflect the 2020 non-core businesses.² Includes £nil (2019: £(187)m) of revenue recognised in the year relating to performance obligations satisfied in previous years over and above that in underlying revenue.

2 Segmental analysis continued

Analysis by geographical destination

The Group's revenue by destination of the ultimate operator is as follows:

	2020 £m	2019 £m
United Kingdom	1,234	1,805
Germany	832	961
Switzerland	259	520
Spain	321	375
France	234	284
Italy	211	235
Russia	102	106
Norway	113	87
Rest of Europe	723	979
Europe	4,029	5,352
United States	3,805	4,720
Canada	322	298
North America	4,127	5,018
South America	133	377
Central America	63	78
United Arab Emirates	191	438
Rest of Middle East	719	714
Middle East	910	1,152
China	1,082	1,698
Singapore	341	702
Japan	327	607
South Korea	139	252
India	78	82
Rest of Asia	130	622
Asia	2,097	3,963
Africa	238	246
Australasia	225	361
Other	2	40
	11,824	16,587

Order backlog

Contracted consideration, translated at estimated long-term exchange rates, that is expected to be recognised as revenue when performance obligations are satisfied in the future (referred to as order backlog) is as follows:

	2020			2019		
	Within five years £bn	After five years £bn	Total £bn	Within five years £bn	After five years £bn	Total £bn
Civil Aerospace	17.6	24.8	42.4	22.9	25.6	48.5
Power Systems	2.2	0.2	2.4	2.1	0.3	2.4
Defence	7.1	0.4	7.5	7.7	0.9	8.6
ITP Aero	0.6	0.2	0.8	0.7	0.2	0.9
Non-core businesses	0.6	–	0.6	0.5	–	0.5
	28.1	25.6	53.7	33.9	27.0	60.9

The parties to these contracts have approved the contract and our customers do not have a unilateral enforceable right to terminate the contract without compensation. The Group excludes Civil Aerospace OE orders (for deliveries beyond the next 7-12 months) that customers have placed where they retain a right to cancel. The Group's expectation is based on historical experience is that these orders will be fulfilled. Within the 0-5 years category, contracted revenue in: Defence will largely be recognised in the next three years; Power Systems will be recognised over the next two years as it is a short cycle business; and ITP Aero (where internal Group revenues have been eliminated) evenly spread over the next five years.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis continued**Underlying adjustments**

	2020				2019			
	Revenue £m	Loss before financing £m	Net financing £m	Tax ¹⁴	Revenue £m	Profit/ (loss) before financing £m	Net financing £m	Tax ¹⁴
					2020	2019		
Underlying performance	11,763	(1,972)	(1,986)	(39)	15,450	808	(225)	(277)
Impact of settled derivative contracts on trading transactions ¹	A 61	998	(324)	(40)	1,137	145	80	(100)
Unrealised fair value changes on derivative contracts held for trading ²	A -	8	(85)	(182)	-	(1)	(6)	(88)
Unrealised net losses on closing future over-hedged position ³	A -	-	1,503	(106)	-	-	-	-
Realised net losses on closing over-hedged position ⁴	A -	-	202	(38)	-	-	-	-
Unrealised fair value change to derivative contracts held for financing ⁵	A -	-	(86)	-	-	-	1	-
Exceptional programme credits/(charges) ⁶	B -	620	(36)	-	-	(1,409)	-	-
Impact of discount rate changes ⁷	B -	-	3	-	-	-	(40)	-
Exceptional restructuring charge ⁸	B -	(489)	-	37	-	(136)	-	17
Impairments ⁹	C -	(1,293)	-	273	-	(84)	-	7
Other write-offs ¹⁰	C -	(124)	-	30	-	-	-	-
Effect of acquisition accounting ¹¹	C -	(133)	-	34	-	(163)	(8)	41
Pension past-service credit ¹²	D -	308	-	(108)	-	-	-	-
Other	D -	(4)	(6)	(7)	-	(12)	20	(20)
(Loss)/gains arising on the acquisitions and disposals of businesses ¹³	C -	(14)	-	3	-	139	-	-
Impact of tax rate change	-	-	-	160	-	-	-	-
De-recognition of UK losses	-	-	-	(276)	-	-	-	-
Total underlying adjustments	61	(123)	1,171	(220)	1,137	(1,521)	47	(143)
Reported performance per consolidated income statement	11,824	(2,095)	(815)	(259)	16,587	(713)	(178)	(420)

A = FX B = Exceptional C = M&A and impairment D = Other

¹ The impact of measuring revenues and costs and the impact of valuation of assets and liabilities using the period end exchange rate rather than the achieved rate or the exchange rate that is expected to be achieved by the use of the hedge book increased reported revenues by £61m (2019: £1,137m) and reduced loss before financing and taxation by £998m (2019: increased profit by £145m). Underlying financing excludes the impact of revaluing monetary assets and liabilities at the period end exchange rate.

² The underlying results exclude the fair value changes on derivative contracts held for trading. These fair value changes are subsequently recognised in the underlying results when the contracts are settled.

³ In response to the deterioration in the medium-term outlook caused by COVID-19 and the related reduction in anticipated net USD cash inflows, the Group has taken action to reduce the size of the USD hedge book by \$11.8bn predominately by transacting offsetting foreign exchange forward contracts across 2020-2026, resulting in a £1,689m charge to underlying results. The £1,503m included in unrealised loss (shown above) is the net cost of closing out the over-hedged position in future years. The cost related to future years has been included within the underlying performance. It is reversed in arriving at reported performance on the basis that, the cumulative fair value changes on these derivative contracts are recognised as they arise. Further detail is provided in note 4.

⁴ In 2020, the Group incurred cash outflows of £186m as a result of closing out \$1.2bn of the \$11.8bn hedge book reduction and £16m to settle an over-hedged jet fuel position. The realised loss of £202m is included in underlying financing costs.

⁵ Includes the losses on hedge ineffectiveness in the year of £11m (2019: losses £13m) and net fair value losses of £75m (2019: profit £14m) on any interest rate swaps not designated into hedging relationships for accounting purposes.

⁶ In 2019, abnormal wastage costs were recorded in respect of the Trent 1000, related to remediation shop visit costs, customer disruption costs and contract losses. During the year ended 31 December 2020, the total estimated Trent 1000 abnormal wastage costs have reduced by £620m as a result of COVID-19 and the work the Group have performed to reduce fleet AOG levels and improve the availability of spare engines, made up of £390m (a gross provision release of £560m, offset by the impact of expected actual exchange rates and the share of the costs borne by RRSA) related to remediation shop visit costs and customer disruption costs, and an improvement of £230m in the position on contract losses.

⁷ Discount rates have increased on exceptional contract loss provisions in relation to the Trent 900 and Trent 1000.

⁸ At 31 December 2020, the Group recorded an exceptional charge of £489m following the announcement in May 2020 of a fundamental restructuring to reshape and resize the Group due to the financial and operational impact of COVID-19 (see note 22 for more detail).

⁹ The Group has assessed the carrying value of its assets given the financial and operational impact of COVID-19 on the Group's future cash flow forecasts. Consequently, a number of impairments and write-offs have been recorded at 31 December 2020. Impairments comprise: intangible assets £567m, mainly related to programme intangibles; property, plant and equipment £318m (including £219m related to site rationalisation); right-of-use assets £384m, comprising engines of £311m, £69m of site rationalisation and £4m of other impairments; and £24m impairment on the carrying value of investments held. Further details are provided in notes 9, 10, 11, 12 and 13.

¹⁰ Other write-offs include £149m of participation fees in contract assets, £2m in provisions for site rationalisation, offset by £(27)m for RRSA deferred cost contributions in payables. These write-offs are primarily a result of the impact of COVID-19.

¹¹ The effect of acquisition accounting includes the amortisation of intangible assets arising on previous acquisitions.

¹² The Group recorded a past service gain of £308m (of which £248m was recorded at 30 June 2020) following changes to the pension benefits under the terms of the Rolls-Royce UK Pension Fund (RRUKPF), a defined benefit scheme. Of the £308m gain, £79m related to the restructuring described in footnote 8 above. The gain also comprises £134m on introduction of the Bridging Pension Option, £67m as a result of the scheme closure and £35m as a result of manager consultation offset by a £7m past-service cost. In respect of the £248m gain recorded at 30 June 2020, £127m was subsequently recognised as actuarial losses through other comprehensive income at 31 December 2020 – see note 23.

¹³ (Losses)/gains arising on the acquisitions and disposals of businesses includes the acquisition of Qinous GmbH (increasing the Group's shareholding from 24% to 100%), the sale of the North America Civil Nuclear business, the sale of the Knowledge Management Systems business and the sale of Trigono Energy Srl. During the year, sales proceeds received on the disposal of the L'Orange business in a prior period has been adjusted. See note 28 for further details.

¹⁴ Appropriate rates of tax have been applied to adjustments made to (loss)/profit before tax in the table above. Adjustments in 2020 which impact the UK tax loss have an effective tax rate of zero. See note 5 for more details. The total underlying adjustments to loss before tax in 2020 are a charge of £220m (2019: £143m). The overall charge in 2020 includes a tax credit of £160m in respect of the change in the UK tax rate and a tax charge of £276m relating to the derecognition of some of the deferred tax asset on UK losses previously recognised.

2 Segmental analysis continued

Reconciliation to the balance sheet

	2020 £m	2019 £m
Reportable segment assets	22,233	23,693
Interests in joint ventures and associates	394	402
Non-core businesses	7	359
Assets held for sale	288	18
Cash and cash equivalents and short-term investments	3,452	4,449
Fair value of swaps hedging fixed rate borrowings	293	249
Deferred and income tax assets	1,943	1,926
Post-retirement scheme surpluses	907	1,170
Total assets	29,517	32,266
Reportable segment liabilities	(24,559)	(27,342)
Non-core businesses	(5)	(404)
Liabilities associated with assets held for sale	(228)	(15)
Borrowings and lease liabilities	(7,330)	(5,685)
Fair value of swaps hedging fixed rate borrowings	(42)	(6)
Deferred and income tax liabilities	(648)	(790)
Post-retirement scheme deficits	(1,580)	(1,378)
Total liabilities	(34,392)	(35,620)
Net liabilities	(4,875)	(3,354)

The carrying amounts of the Group's non-current assets including investments but excluding financial instruments, deferred tax assets and post-employment benefit surpluses, by the geographical area in which the assets are located, are as follows:

	2020 £m	2019 £m
United Kingdom	5,823	6,446
Germany	2,269	2,568
Spain	1,267	1,506
United States	1,380	1,324
Other	739	826
	11,478	12,670

3 Research and development

	2020 £m	2019 £m
Gross research and development costs	(1,252)	(1,459)
Contributions and fees ¹	353	341
Expenditure in the year	(899)	(1,118)
Capitalised as intangible assets	232	481
Amortisation and impairment of capitalised costs ²	(587)	(133)
Net cost recognised in the income statement	(1,254)	(770)
Underlying adjustments relating to effects of acquisition accounting, impairment and foreign exchange ³	519	74
Net underlying cost recognised in the income statement	(735)	(696)

¹ Includes funding from local governments.

² See note 9 for analysis of amortisation and impairment.

³ During the year, impairment of research and development of £481m was recorded. Of this, £1m was charged to underlying results and £480m was charged as exceptional. See note 2 and note 9 for more information.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

4 Net financing

	2020	2019		
	Per consolidated income statement £m	Underlying financing ¹ £m	Per consolidated income statement £m	Underlying financing ¹ £m
Interest receivable	22	22	31	31
Net fair value gains on non-hedge accounted interest rate swaps ²	–	–	14	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	17	–	11	–
Net fair value gains on commodity contracts	–	–	36	–
Financing on post-retirement scheme surpluses	28	–	60	–
Net foreign exchange gains	–	–	100	–
Financing income	67	22	252	31
Interest payable	(180)	(175)	(182)	(163)
Net fair value losses on foreign currency contracts	(23)	–	(43)	–
Net fair value losses on non-hedge accounted interest rate swaps ²	(75)	–	–	–
Unrealised net losses on closing future over-hedged position ³	–	(1,503)	–	–
Realised net losses on closing over-hedged position ^{3, 4}	–	(202)	–	–
Financial RRSAs – foreign exchange differences and changes in forecast payments	(20)	–	(10)	–
Financial charge relating to financial RRSAs	(3)	(3)	(3)	(3)
Net fair value losses on commodity contracts	(62)	–	–	–
Financing on post-retirement scheme deficits	(29)	–	(37)	–
Net foreign exchange losses	(324)	–	–	–
Other financing charges	(166)	(125)	(155)	(90)
Financing costs	(882)	(2,008)	(430)	(256)
Net financing costs	(815)	(1,986)	(178)	(225)
Analysed as:				
Net interest payable	(158)	(153)	(151)	(132)
Net fair value (losses)/gains on derivative contracts	(160)	(1,705)	7	–
Net post-retirement scheme financing	(1)	–	23	–
Net foreign exchange (losses)/gains	(324)	–	100	–
Net other financing	(172)	(128)	(157)	(93)
Net financing costs	(815)	(1,986)	(178)	(225)

¹ See note 2 for definition of underlying results.² The consolidated income statement shows the net fair value loss on any interest rate swaps not designated into hedging relationships for accounting purposes. Underlying financing reclassifies the interest payable (2019: receivable) on these interest rates swaps from fair value movement to interest payable.³ In response to the deterioration in the medium-term outlook caused by COVID-19 and the related reduction in anticipated net US Dollar cash inflows, the Group took action during the year to reduce the size of the US Dollar hedge book by \$11bn by transacting offsetting foreign exchange contracts across 2020–2026. A further \$0.8bn of hedges have also been closed out in early 2021. An underlying charge of £1,689m relating to the total \$11.8bn reduction in the size of the US Dollar hedge book is included within underlying financing costs. These costs are already recognised in the reported results as fair value losses on foreign currency contacts.⁴ In 2020, the Group incurred a cash outflow of £186m as a result of closing out an over-hedged position of \$1,211m and a cash outflow of £16m to settle an over-hedged jet fuel position. The realised loss of £202m is included in underlying financing costs.

In response to the deterioration in the medium-term outlook caused by COVID-19 and the related reduction in anticipated net US Dollar cash inflows, the Group took action during the year to reduce the size of the US Dollar hedge book by \$11.0bn by transacting offsetting foreign exchange contracts across 2020–2026. A further \$0.8bn of hedges have also been closed out in early 2021. An underlying charge of £1,689m relating to the total \$11.8bn reduction in the size of the US Dollar hedge book is included within underlying financing costs. These costs are already recognised in the reported results as fair value losses on foreign currency contacts. The cash settlement costs of the £1,689m will occur over the period 2020–2026, including £186m of cash costs incurred in 2020. The Group estimates that future cash outflows of £460m will occur in 2021, £327m in 2022, and £716m spread over 2023 to 2026. Subsequent to year-end, the Group took action to align the contractual settlement of derivatives in future periods with the forecast of net US Dollar cash inflows by extending \$2bn of £/US Dollar hedging contracts from 2024–26 into 2027.

After taking into account the actions described above the Group is forecast to be 100% hedged from 2021 to 2026 and approximately 90% hedged in 2027, based on Board approved forecasts. In the severe but plausible downside scenario forecast, the Group has modelled a further reduction in net US Dollar cash inflows. This would lead to an additional charge to underlying finance costs of £222m, with the associated cash cost unwinding across 2021–2027.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 Taxation

	UK		Overseas		Total	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Current tax charge for the year	12	15	167	228	179	243
Adjustments in respect of prior years	–	(4)	(27)	(3)	(27)	(7)
Current tax	12	11	140	225	152	236
Deferred tax charge/(credit) for the year	177	117	(373)	(24)	(196)	93
Adjustments in respect of prior years	(12)	20	42	(15)	30	5
Derecognition of deferred tax	433	86	–	–	433	86
Deferred tax credit resulting from increase in UK tax rate	(160)	–	–	–	(160)	–
Deferred tax	438	223	(331)	(39)	107	184
Charged/(credited) in the income statement	450	234	(191)	186	259	420

Other tax (charges)/credits

	OCI		Equity			
	Items that will not be reclassified		Items that may be reclassified		2020 £m	2019 £m
	2020 £m	2019 £m	2020 £m	2019 £m		
Deferred tax:						
Movement in post-retirement schemes	195	324	–	–	–	–
Share-based payments – direct to equity	–	–	–	–	5	1
Cash flow hedge	–	–	(4)	(5)	–	–
Net investment hedge	–	–	2	(1)	–	–
Other tax credits/(charges)	195	324	(2)	(6)	5	1

Tax reconciliation

	2020 £m	2019 £m
Loss before taxation	(2,910)	(891)
Less share of results of joint ventures and associates (note 13)	(133)	(141)
Loss before taxation excluding joint ventures and associates	(3,043)	(1,032)
Nominal tax credit at UK corporation tax rate 19% (2019: 19%)	(578)	(196)
UK tax rate differential ¹	33	56
Overseas rate differences ²	(67)	58
Impairments	21	1
Exempt gain on the disposal of Commercial Marine	–	(20)
R&D credits	(22)	(34)
Other permanent differences	10	8
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	(2)	–
Tax losses in year not recognised in deferred tax ³	588	463
Derecognition of deferred tax ⁴	433	86
Adjustments in respect of prior years	3	(2)
Increase in closing deferred taxes resulting from a change in the UK tax rate ⁵	(160)	–
Underlying items (note 2)	259	420
Non-underlying items	39	277
	220	143
	259	420

¹ The UK tax rate differential arises on the difference between the deferred tax rate and the UK statutory tax rate.

² Overseas rate differences mainly relate to tax on profits or losses in countries such as the US and Germany which have higher tax rates than the UK. In 2020 the impact is negative because of the loss in Germany relating to the impairment of the Business Aviation programme intangible assets.

³ Tax losses not recognised mainly relate to the UK – see page 136.

⁴ Derecognition of deferred tax assets relating to foreign exchange and commodity financial assets and liabilities and UK losses – see page 136.

⁵ UK deferred tax was previously measured at 17%. The Spring Budget 2020 announced that the UK corporate tax rate would remain at 19% rather than reducing to 17%. The UK deferred tax balances have therefore been re-measured at 19%.

5 Taxation continued

Deferred taxation assets and liabilities

	2020 £m	2019 £m
At 1 January	1,269	1,130
Impact of adopting IFRS 16	-	8
Amount charged to income statement	(107)	(184)
Amount credited to other comprehensive income	197	323
Amount charged to cash flow hedge reserve	(4)	(5)
Amount credited to equity	5	1
On disposal/acquisition of businesses ¹	(20)	(3)
Transferred to assets held for sale ²	(4)	(2)
Exchange differences	(4)	1
At 31 December	1,332	1,269
Deferred tax assets	1,826	1,887
Deferred tax liabilities	(494)	(618)
	1,332	1,269

¹ The 2020 deferred tax relates to the acquisition of businesses detailed in note 28. The 2019 deferred tax on disposal of businesses relates to Commercial Marine.

² The 2020 deferred tax transferred to assets held for sale relates to the Bergen Engines AS and Civil Nuclear Instrumentation & Control business. The 2019 deferred tax transferred to assets held for sale relates to the North America Civil Nuclear business.

The analysis of the deferred tax position is as follows:

	At 1 January £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Merger and acquisition related activity £m	Transferred to held for sale £m	Exchange differences £m	At 31 December £m
2020								
Intangible assets	(726)	160	-	-	(20)	-	19	(567)
Property, plant and equipment	(138)	153	-	-	(2)	-	21	34
Other temporary differences	374	48	5	(1)	6	(4)	(85)	343
Net contract liabilities	55	1	-	-	-	-	-	56
Pensions and other post-retirement scheme benefits	(154)	(48)	195	-	-	-	(1)	(8)
Foreign exchange and commodity financial assets and liabilities	425	(251)	(7)	-	(6)	-	26	187
Losses	1,017	(178)	-	6	2	-	3	850
R&D credit	253	8	-	-	-	-	13	274
Advance corporation tax	163	-	-	-	-	-	-	163
	1,269	(107)	193	5	(20)	(4)	(4)	1,332

	At 1 January £m	Impact of adopting IFRS 16 £m	At 1 January restated £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Merger and acquisition related activity £m	Transferred to held for sale £m	Exchange differences £m	At 31 December £m
2019										
Intangible assets	(620)	-	(620)	(135)	-	-	(2)	-	31	(726)
Property, plant and equipment	(85)	(74)	(159)	10	-	-	(1)	-	12	(138)
Other temporary differences	164	82	246	147	(6)	1	2	-	(16)	374
Net contract liabilities	57	-	57	(2)	-	-	-	-	-	55
Pensions and other post-retirement scheme benefits	(461)	-	(461)	(1)	324	-	(3)	-	(13)	(154)
Foreign exchange and commodity financial assets and liabilities	625	-	625	(200)	-	-	-	-	-	425
Losses	1,010	-	1,010	9	-	-	(1)	-	(1)	1,017
R&D credit	277	-	277	(12)	-	-	-	-	(12)	253
Advance corporation tax	163	-	163	-	-	-	-	-	-	163
	1,130	8	1,138	(184)	318	1	(5)	-	1	1,269

5 Taxation continued

Unrecognised deferred tax assets

	2020 £m	2019 £m
Advance corporation tax	19	19
UK losses	1,181	438
Foreign exchange and commodity financial assets and liabilities	369	86
Losses and other unrecognised deferred tax assets	68	68
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	1,637	611

Gross amount and expiry of losses and other deductible temporary differences for which no deferred tax asset has been recognised

	2020				2019			
	Total gross losses and deductible temporary differences £m	UK losses £m	Foreign exchange and commodity financial assets and liabilities £m	Other deductible temporary differences £m	Total gross losses and deductible temporary differences £m	UK losses £m	Foreign exchange and commodity financial assets and liabilities £m	Other deductible temporary differences £m
Expiry within 5 years	26	—	—	26	—	—	—	—
Expiry within 6 to 30 years	281	—	—	281	—	273	—	273
No expiry	8,381	6,214	1,940	44	183	3,314	2,575	503
	8,688	6,214	1,940	351	183	3,587	2,575	507
								2

In addition to the gross balances shown above, advance corporation tax of £19m (2019: £19m) has not been recognised. Advance corporation tax has no expiry.

Deferred tax assets of £1,826m include £801m (2019: £1,010m) relating to UK tax losses and £163m (2019: £163m) relating to Advance Corporation Tax (ACT). These assets have been recognised based on the expectation that the business will generate taxable profits and tax liabilities in the future against which the losses and ACT can be utilised.

Most of the tax losses relate to the Civil Aerospace widebody business which makes initial losses through the investment period of a programme and then makes a profit through its contracts for services. The programme lifecycles typically range between 30 and 55 years with more of the widebody engine programmes forecast at the upper end of that range. In the past few years there have been four new engines that have entered into service (Trent 1000-TEN, Trent 7000 and Trent XWB-84 and Trent XWB-97).

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. A recoverability assessment has been undertaken, taking account of deferred tax liabilities against which the reversal can be offset and using latest UK forecasts, which are mainly driven by the Civil Aerospace widebody business, to assess the level of future taxable profits.

The recoverability of deferred tax assets relating to tax losses and ACT has been assessed in 2020 on the following basis:

- Using the most recent UK profit forecasts prepared by management, which are consistent with past experience and external sources on market conditions. These forecasts cover the next five years;
- the long-term forecast profit profile of certain of the major widebody engine programmes which is typically between 30 and 55 years from initial investment to retirement of the fleet, including the aftermarket revenues earned from airline customers; and
- the long-term forecast profit and cost profile of the other parts of the business.

The assessment takes into account UK tax laws that, in broad terms, restrict the offset of the carried forward tax losses to 50% of current year profits. Based on this assessment, the Group has recognised a deferred tax asset of £801m relating to losses and £163m relating to ACT. This reflects the conclusions that:

- It is probable that the business will generate taxable income and tax liabilities in the future against which these losses and the ACT can be utilised.
- Based on current forecasts and using various scenarios these losses and the ACT will be used in full within the expected widebody engine programme lifecycles.
- The Group has not recognised any deferred tax assets in respect of 2020 UK losses and de-recognised £327m of the deferred tax asset on the balance sheet at 31 December 2019. Of the total charge, £51m is underlying with the balance of £276m non-underlying
- This is based on management's assumptions relating to the amounts and timing of future taxable profits and takes into account the impact of COVID-19 and climate change on existing widebody engine programmes.

Changes in future profits will impact the recoverability of the deferred tax assets and as explained in note 1, the key assumptions impact contract margins. A 5% change in such margins over the remaining life of the programmes, against which the recovery of the tax losses and ACT is assessed, would result in a variance of around £100m in the related deferred tax balances recorded on the balance sheet, assuming a 19% tax rate and the 50% loss offset restriction mentioned above.

The assessment also considered the potential impact of climate change on profit forecasts, including additional taxes and levies that could arise and changes in consumer behaviour which could result in a reduction in shop visits (driven by EFHs, which are influenced by a number of factors including climate change). A 5% reduction in shop visits over the remaining life of the programmes would result in a variance of around £100m in the related deferred tax balances.

The Group has also reassessed the recovery of other deferred tax assets, including those arising on unrealised losses on derivative contracts. Any future changes in tax law or the structure of the Group could have a significant effect on the use of losses and ACT, including the period over which they can be used. In view of this and the significant judgement involved the Board continuously reassess this area.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 Taxation continued

In 2020 a net DTA also arises for the first time in respect of tax losses and other deductible temporary differences arising in Rolls-Royce Deutschland Ltd & Co KG, where the main business is Business Aviation. The total net DTA is £252m which has been recognised in full as it is considered probable that the business will generate taxable income in the future against which these assets can be utilised.

The Spring Budget 2020 announced that the UK corporation tax rate would remain at 19% rather than reducing to 17% from 1 April 2020. The new law was substantively enacted on 17 March 2020. The prior year UK deferred tax assets and liabilities were calculated at 17%, as this was the enacted rate at the 2019 balance sheet date. As the 19% rate has been substantively enacted before 31 December 2020, the UK deferred tax assets and liabilities have been re-measured at 19%.

The resulting credits and charges have been recognised in the income statement except to the extent that they relate to items previously credited or charged to equity. Accordingly, in 2020, £160m has been credited to the income statement and £6m has been credited directly to equity.

The Spring Budget 2021 announced that the UK corporation tax rate will increase to 25% from 1 April 2023. The deferred tax assets and liabilities of UK companies within the Group have been calculated at 19% as this rate has been substantively enacted at the balance sheet date. Had the 25% rate been substantively enacted on or before 31 December 2020 it would have had the effect of increasing the net deferred tax asset by £342m.

The unrecognised deferred tax assets on UK losses, foreign exchange financial assets and liabilities and other deductible temporary differences would increase by £373m, £116m, and £11m respectively if the 25% had been substantively enacted at the balance sheet date.

The temporary differences associated with investments in subsidiaries, joint ventures and associates, for which a deferred tax liability has not been recognised, aggregate to £907m (2019 restated: £770m). 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) is calculated by dividing the loss 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. As there is a loss, the effect of potentially dilutive ordinary shares is anti-dilutive.

	2020			2019 (restated)		
	Basic	Potentially dilutive share options	Diluted	Basic	Potentially dilutive share options	Diluted
Loss attributable to ordinary shareholders (£m)	(3,170)		(3,170)	(1,315)		(1,315)
Weighted average number of ordinary shares (millions)	5,987	-	5,987	5,548	-	5,548
EPS (pence)	(52.95)	-	(52.95)	(23.70)	-	(23.70)

The reconciliation between underlying EPS and basic EPS is as follows:

	2020		2019 (restated)	
	Pence	£m	Pence	£m
Underlying EPS/Underlying (loss)/profit attributable to ordinary shareholders	(66.78)	(3,998)	5.44	302
Total underlying adjustments to (loss)/profit before tax (note 2)	17.50	1,048	(26.56)	(1,474)
Related tax effects	(3.67)	(220)	(2.58)	(143)
EPS/Loss attributable to ordinary shareholders	(52.95)	(3,170)	(23.70)	(1,315)
Diluted underlying EPS	(66.78)		5.44	

Basic and diluted earnings per share figures for the comparative period have been restated and adjusted for the bonus factor of 2.91 to reflect the bonus element of the November 2020 rights issue, in accordance with IAS 33 *Earnings per Share*. Amounts as originally stated at 31 December 2019 were (69.07)p basic and diluted earnings per share and 15.86p basic and diluted underlying earnings per share.

7 Auditors' remuneration

	2020 £m	2019 £m
Fees payable to the Company's auditor for the audit of the Company's annual Financial Statements	2.7	2.8
Fees payable to the Company's auditor and its associates for the audit of the Company's subsidiaries pursuant to legislation	7.6	7.0
Total fees payable for audit services	10.3	9.8
Fees payable to the Company's auditor and its associates for other services:		
Audit related assurance services ¹	1.6	1.0
Taxation compliance services ²	0.1	-
Other assurance services ³	1.0	0.1
Total fees payable to the Company's auditor and its associates⁴	13.0	10.9
Fees payable in respect of the Group's pension schemes:		
Audit	0.1	0.1

¹ This includes £1.0m (2019: £0.5m) for the review of the half-year report and £0.6m (2019: £0.5m) in respect of the reporting on grant claims.

² This includes £0.1m for tax compliance services in respect of Kinolt Group S.A. where the auditor was engaged prior to the acquisition by the Group. These services ceased following the acquisition.

³ This includes £0.5m (2019: £nil) in respect of Reporting Accountant services for the rights issue and £0.5m in respect of the bond issuance.

⁴ Audit fees for overseas entities are reported at the average exchange rate for the year.

8 Employee information

	2020 Number	2019 Number
United Kingdom	22,000	23,300
Germany	9,800	9,800
United States	5,400	6,000
Spain	3,000	3,200
Nordics	700	1,300
Singapore	1,100	1,300
Canada	800	1,000
India	1,000	1,000
Italy	800	900
France	700	700
Rest of world	2,900	3,200
Monthly average number of employees	48,200	51,700
Civil Aerospace	23,300	26,100
Power Systems ¹	8,900	8,700
Defence	10,600	9,900
ITP Aero	3,800	3,900
Corporate ²	100	100
Core businesses	46,700	48,700
Non-core businesses ³	1,500	3,000
Monthly average number of employees	48,200	51,700
	£m	£m
Wages, salaries and benefits	2,568	3,075
Social security costs	433	473
Share-based payments (note 25)	25	30
Pensions and other post-retirement scheme benefits (note 23)	97	356
Group employment costs⁴	<b style="text-align: right;">3,123	<b style="text-align: right;">3,934

¹ Power Systems for 2019 has been restated to reflect the 2020 non-core businesses.

² Corporate consists of employees who do not provide a shared service to the segments. Where corporate functions provide such a service, employees have been allocated to the segments on an appropriate basis.

³ Non-core businesses are set out in note 2 on page 126. The employee analysis for 2019 has been restated to reflect the 2020 definition of non-core.

⁴ Remuneration of key management personnel is shown in note 27.

9 Intangible assets

	Goodwill £m	Certification costs £m	Development expenditure £m	Customer relationships £m	Software ⁴ £m	Other £m	Total £m
Cost							
At 1 January 2019	1,087	948	2,883	1,384	964	811	8,077
Additions	–	15	481	–	101	43	640
Acquisition of businesses	11	–	–	–	4	23	38
Transferred to assets held for sale ¹	(34)	–	(11)	(16)	(3)	(11)	(75)
Disposals	–	–	(8)	(1)	(111)	(19)	(139)
Reclassifications from PPE	–	–	17	–	19	(18)	18
Exchange differences	(40)	(1)	(68)	(64)	(7)	(26)	(206)
At 31 December 2019	1,024	962	3,294	1,303	967	803	8,353
Additions	–	3	232	–	89	40	364
Acquisition of businesses (see note 28)	57	–	3	41	–	36	137
Transferred to assets held for sale ¹	(3)	–	(33)	–	(12)	(4)	(52)
Disposals	–	(1)	–	–	(93)	(2)	(96)
Reclassifications	4	(4)	(8)	–	10	(6)	(4)
Reclassifications from PPE	–	–	–	–	5	–	5
Exchange differences	30	3	76	59	2	26	196
At 31 December 2020	1,112	963	3,564	1,403	968	893	8,903
Accumulated amortisation and impairment							
At 1 January 2019	42	373	1,111	304	607	345	2,782
Charge for the year ²	–	19	113	72	88	26	318
Impairment	18	–	20	9	7	–	54
Transferred to assets held for sale ¹	(34)	–	(11)	(16)	(3)	(11)	(75)
Disposals	–	–	(7)	(1)	(99)	(19)	(126)
Reclassifications from PPE	–	–	–	–	10	(1)	9
Exchange differences	4	–	(25)	(14)	(5)	(11)	(51)
At 31 December 2019	30	392	1,201	354	605	329	2,911
Charge for the year ²	–	21	106	82	81	33	323
Impairment ³	8	17	481	31	5	37	579
Transferred to assets held for sale ¹	–	–	(20)	–	(12)	(4)	(36)
Disposals	–	(1)	–	–	(75)	(2)	(78)
Reclassifications	–	–	(2)	–	2	–	–
Exchange differences	–	–	37	11	1	10	59
At 31 December 2020	38	429	1,803	478	607	403	3,758
Net book value							
At 31 December 2020	1,074	534	1,761	925	361	490	5,145
At 31 December 2019	994	570	2,093	949	362	474	5,442

¹ Bergen Engines AS and the Civil Nuclear Instrumentation & Control business have been classified as disposal groups held for sale at 31 December 2020. The North America Civil Nuclear business was classified as a disposal group held for sale on 26 September 2019, prior to this an impairment of goodwill of £15m was recognised – see note 28.

² Charged to cost of sales and commercial and administrative costs except development costs, which are charged to research and development costs.

³ As a result of the financial and operational impact of COVID-19 the Group has assessed the carrying value of its intangible assets. Consequently, impairments have been recorded at 31 December 2020. The impairment of development expenditure has arisen as a result of the anticipated reduction in OE volumes and future engine flying hours, and the consequential recoverability of these assets. The impairment charge of £579m includes £12m charged to the income statement through underlying and £567m charged to non-underlying. See note 12 for further details.

⁴ Includes £110m (2019: £129m) of software under course of construction which is not amortised.

9 Intangible assets continued

Goodwill

In accordance with the requirements of IAS 36 *Impairment of Assets*, goodwill is allocated to the Group's CGUs, or groups of CGUs, 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	2020 £m	2019 £m
Rolls-Royce Power Systems AG ¹	Power Systems	792	718
Rolls-Royce Deutschland Ltd & Co KG	Civil Aerospace	245	234
Other	Various	37	42
		1,074	994

¹ Power Systems CGU contains goodwill of Kinolt Group S.A. of £46m which has been tested for impairment separately in 2020 but is expected to be tested within Power Systems in 2021 when the integration activities have been completed.

The carrying amount and the residual life of the material intangible assets (excluding goodwill) for the Group is as follows:

	Residual life	Net book value	
		2020 £m	2019 £m
Trent programme intangible assets ¹	7-15 years	1,770	1,720
Business Aviation programme intangible assets ²	15 years	256	587
Customer relationship assets on acquisition of ITP Aero	typically 13-35 years	651	676
Intangible assets from acquisition of Power Systems ³		531	489
		3,208	3,472

¹ Included within the Trent programmes are the Trent 1000, Trent 7000 and Trent XWB.

² Included within Business Aviation are the Pearl 700 and Pearl 15.

³ Includes £115m (2019: £109m) in respect of a brand intangible asset which is not amortised. Remaining assets are amortised over a range of 2-10 years.

The carrying amount of goodwill or intangible assets allocated across multiple CGUs is not significant in comparison with the Group's total carrying amount of goodwill or intangible assets with indefinite useful lives.

At 31 December, the Group had expenditure commitments for software of £34m (2019: £35m). In 2019, committed spend for software was presented in note 10.

10 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost					
At 1 January 2019	1,904	5,285	762	693	8,644
Additions	27	286	126	328	767
Acquisition of businesses	-	3	-	-	3
Transferred to assets held for sale ¹	(5)	(9)	-	(2)	(16)
Disposal of businesses	(4)	(168)	-	-	(172)
Disposals/write-offs	(54)	(187)	(17)	(4)	(262)
Reclassifications ²	186	390	11	(605)	(18)
Reclassifications of joint ventures to joint operations	5	3	-	-	8
Exchange differences	(39)	(106)	(6)	(9)	(160)
At 31 December 2019	2,020	5,497	876	401	8,794
Additions	14	145	162	232	553
Acquisition of businesses	9	7	-	1	17
Transferred to assets held for sale ¹	(32)	(77)	-	(9)	(118)
Disposal of businesses	-	(19)	-	-	(19)
Disposals/write-offs	(52)	(264)	(19)	(24)	(359)
Reclassifications ²	25	122	3	(150)	-
Reclassifications to intangible assets ²	-	(5)	-	-	(5)
Exchange differences	10	36	3	-	49
At 31 December 2020	1,994	5,442	1,025	451	8,912

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

10 Property, plant and equipment continued

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Accumulated depreciation					
At 1 January 2019	572	3,129	204	7	3,912
Charge for the year ³	67	381	43	–	491
Impairment	1	29	–	11	41
Transferred to assets held for sale ¹	(5)	(9)	–	(1)	(15)
Disposal of businesses	–	(165)	–	–	(165)
Disposals/write-offs	(45)	(150)	(5)	(1)	(201)
Reclassifications ²	9	6	(19)	(5)	(9)
Reclassification of joint venture to joint operations	1	3	–	–	4
Exchange differences	(10)	(57)	–	–	(67)
At 31 December 2019	590	3,167	223	11	3,991
Charge for the year ³	71	362	56	–	489
Impairment ⁴	71	137	97	27	332
Transferred to assets held for sale ¹	(29)	(74)	–	(8)	(111)
Disposal of businesses	–	(19)	–	–	(19)
Disposals/write-offs	(33)	(248)	(2)	(13)	(296)
Reclassifications ²	10	(1)	–	(9)	–
Exchange differences	(1)	12	–	–	11
At 31 December 2020	679	3,336	374	8	4,397

Net book value

At 31 December 2020	1,315	2,106	651	443	4,515
At 31 December 2019	1,430	2,330	653	390	4,803

¹ Bergen Engines AS and the Civil Nuclear Instrumentation & Control business have been classified as disposal groups held for sale at 31 December 2020. In 2019, the North America Civil Nuclear business was classified as a disposal group held for sale on 26 September 2019.

² Includes reclassifications of assets under construction to the relevant classification in property, plant and equipment or intangible assets when available for use.

³ Depreciation is charged to cost of sales or included in the cost of inventory as appropriate.

⁴ As a result of the financial and operational impact of COVID-19 the Group has assessed the carrying value of its property, plant and equipment. In addition, following the announcement on 20 May 2020 to reshape and resize the Group due to the financial and operational impact of COVID-19, certain assets have been impaired to their recoverable amount where the Group expects to exit the site. The impairment of £332m includes £14m charged to the income statement through underlying and £318m charged to non-underlying. See note 12 for further details.

Property, plant and equipment includes:

	2020 £m	2019 £m
Assets held for use in leases where the Group is the lessor:		
Cost	824	720
Depreciation	(277)	(214)
Net book value	547	506
Capital expenditure commitments ¹		
Cost of fully depreciated assets	145	282
	1,853	1,666

¹ Total committed spend in 2019 was £317m comprising £282m for property, plant and equipment and £35m for software. In 2020, expenditure commitment for software has been presented in note 9.

The Group's share of equity accounted entities' capital commitments is £8m (2019: £30m).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

11 Right-of-use assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	Total £m
Cost				
At 1 January 2019	453	106	1,654	2,213
Additions/modification of leases	70	28	129	227
Transferred to assets held for sale ¹	(4)	–	–	(4)
Disposals	(2)	(4)	(13)	(19)
Exchange differences	(13)	(2)	(3)	(18)
At 31 December 2019	504	128	1,767	2,399
Additions/modification of leases	(27)	33	129	135
Acquisition of businesses	–	1	–	1
Transferred to assets held for sale ¹	(13)	(3)	–	(16)
Disposals	(18)	(10)	(67)	(95)
Exchange differences	1	1	4	6
At 31 December 2020	447	150	1,833	2,430
Accumulated depreciation and impairment				
At 1 January 2019	–	–	–	–
Charge for the year	58	32	309	399
Impairment	1	1	10	12
Transferred to assets held for sale ¹	(1)	–	–	(1)
Disposals	(2)	(4)	(13)	(19)
Exchange differences	(1)	–	–	(1)
At 31 December 2019	55	29	306	390
Charge for the year	56	35	255	346
Impairment ²	66	9	311	386
Transferred to assets held for sale ¹	(5)	(2)	–	(7)
Disposals	(10)	(10)	(67)	(87)
Exchange differences	(3)	(1)	1	(3)
At 31 December 2020	159	60	806	1,025
Net book value				
At 31 December 2020	288	90	1,027	1,405
At 31 December 2019	449	99	1,461	2,009
Right-of-use assets held for use in operating leases where the Group is the lessor				
Cost	2	1	1,833	1,836
Depreciation	(1)	(1)	(806)	(808)
Net book value at 31 December 2020	1	–	1,027	1,028
Cost	4	2	1,767	1,773
Depreciation	(2)	(1)	(306)	(309)
Net book value at 31 December 2019	2	1	1,461	1,464

¹ Bergen Engines AS and the Civil Nuclear Instrumentation & Control business have been classified as disposal groups held for sale at 31 December 2020. In 2019, the North America Civil Nuclear business was classified as a disposal group held for sale on 26 September 2019 – see note 28.

² The impairment of £386m includes £2m charged to the income statement through underlying and £384m charged to non-underlying and is a result of the impact of COVID-19. See note 12 for further details.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12 Impairment of intangible assets, property, plant and equipment, right-of-use assets and investments**a) Summary**

An impairment charge of £1,321m (2019: £108m) was recognised in the year. This was due to the impact of COVID-19, other market driven events and adverse foreign exchange movements reducing the recoverable amount of certain assets, as a result of reductions in the estimated OE volumes and aftermarket volumes (e.g. from lower EFHs) within the forecasts of future cash flows of each programme or CGU. These cash flow forecasts are discounted to generate the value in use of the programme intangible assets, lease engines (within property, plant and equipment), right-of-use assets and investments. The recoverable amount of other property, plant and equipment has been measured on a fair value less cost of disposal basis.

The impairment charges recognised in the year are as follows:

	Impairment charge in the year						Recoverable amount £m	Discount rate at 31 December 2020 (31 December 2019) ¹ £m
	Goodwill £m	Other intangible assets £m	Property, plant and equipment £m	Right-of-use assets £m	Investments	Total ³ £m		
Civil Aerospace – Trent programme assets (where impairment recognised)	–	39	86	311	–	436	–	11.0% (12%)
Civil Aerospace – Business Aviation programme assets (where impairment recognised)	–	437	–	–	–	437	108	11.9% (11%)
Civil Aerospace – specific assets	–	–	219	69	15	303	397	n/a ² (n/a)
Power Systems – specific assets	–	35	7	1	9	52	96	11.7% (n/a)
ITP Aero – specific assets	–	49	11	–	–	60	229	10.6% (11%)
Other	8	11	9	5	–	33	–	Various
Total	8	571	332	386	24	1,321		

¹ Discount rate for 31 December 2019 disclosed where an impairment test was performed.

² The impairment charge for Civil Aerospace specific assets, other than investments (10.5% discount rate), has been calculated on a fair value less cost of disposal basis.

³ The impairment charge of £1,321m includes £28m charged to the income statement through underlying and £1,293m charged to non-underlying.

b) Intangible assets (see note 9)**Goodwill**

Goodwill of £1,074m (31 December 2019: £994m) has been tested for impairment during 2020 on the following basis:

- The carrying values of goodwill have been assessed by reference to value in use, estimated using the expected cash flow approach allowable under IAS 36 *Impairment of Assets*. Cash flow forecasts used to derive value in use have been prepared by management using the most recent forecasts, which are consistent with external sources of information on market conditions. These forecasts generally cover the next five years, with cash flows beyond this period based on a growth rate of 2.0% that reflects the products, industries and countries in which the relevant CGU or group of CGUs operate. Whilst these forecasts represent management's best estimate, in addition, the impact on the cash flows of (i) a severe but plausible downside scenario and (ii) various sensitivities have also been considered.
- 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 principal value in use assumptions for goodwill balances considered to be individually significant are:

Rolls-Royce Power Systems AG

- Trading assumptions (e.g. volume of equipment deliveries, pricing achieved and cost escalation) that are based on current and known future programmes, estimates of market share and long-term economic forecasts;
- Plausible downside scenario included with a 15% weighting;
- Cash flows beyond the five-year forecasts that are assumed to grow at 2.0% (2019: 1.0%); and
- Pre-tax discount rate of 11.7% (2019: 12.0%).

The Directors do not consider that any reasonably possible changes in the key assumptions would cause the value in use of the goodwill to fall below its carrying value.

Rolls-Royce Deutschland Ltd & Co KG

- Trading assumptions (e.g. volume of engine deliveries, flying hours of installed fleet, including assumptions on the recovery of the aerospace industry, and cost escalation) that are based on current and known future programmes, estimates of market share and long-term economic forecasts;
- Plausible downside scenario included with a 25% weighting;
- Cash flows beyond the five-year forecasts that are assumed to grow at 2.0% (2019: 1.0%); and
- Pre-tax discount rate of 11.9% (2019: 12.0%).

The Directors do not consider that any reasonably possible changes in the key assumptions would cause the value in use of the goodwill to fall below its carrying value.

Other cash generating units

Goodwill balances across the Group that are not considered to be individually significant were also tested for impairment, resulting in an impairment charge of £8m being recognised at 31 December 2020 (2019: £18m).

12 Impairment of intangible assets, property, plant and equipment, right-of-use assets and investments continued

Other intangible assets (including programme-related intangible assets)

As a result of the impact of COVID-19 on expected OE and aftermarket volumes and adverse foreign exchange movements, other intangible assets have been reviewed for impairment in accordance with the requirements of IAS 36. Where there is a triggering event, and for indefinite life brand assets, impairment tests have been performed on the following basis:

- The carrying values have been assessed by reference to value in use as this represents the highest value to the Group in terms of the future cash flows that it can generate. Values in use have been estimated using the expected cash flow approach allowable under IAS 36. Cash flow forecast scenarios have been prepared by management using the most recent forecasts, which are consistent with external sources of information on market conditions over the lives of the respective programmes and incorporate management's best estimate of key assumptions utilising a stochastic analysis to allow for variation in the actual outcome where appropriate. A severe but plausible scenario was also modelled and, in order to risk adjust the cash flows, a weighting (25%/15% downside for Civil Aerospace/Power Systems respectively) was taken between the two scenarios based on management judgement.
- These forecasts include contracted business and management's expectation of speculative business over the life of the programme, together with the cash outflows that are necessary to maintain the current level of economic benefit expected to arise from the asset in its current condition.
- The key programme assumptions underlying the cash flow projections are forecast market share and pricing, programme timings, unit cost assumptions, EFHs, number of shop visits, cost of each shop visit, R&D, capital investment, discount rates and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at **9.6%–11.9%** (31 December 2019: 7.0%–15.0%), based on the weighted average cost of capital of the relevant business.

It remains possible that a weaker than expected recovery could result in a deterioration in the future cash flow forecasts that support Civil Aerospace programme intangible assets:

- For intangible assets that have been impaired, a 5% deterioration in EFHs (and hence future cash flows) across the life of the programmes would result in these intangible assets incurring an additional impairment of £50m. An increase in the discount rate of 1% would reduce the recoverable amount of the programme assets (£108m) to nil.
- For intangible assets where there is existing headroom in the impairment test (and thus no impairment) but where deteriorations in key assumptions over the next 12 months could lead to an impairment, any of the following individual changes in assumptions would cause the recoverable amount of the programme assets to equal the carrying value:
 - A reduction in engines sales that are forecast but not contracted by 14%;
 - An increase in costs of 2%; or
 - An increase in discount rates of 1%.

c) Property, plant and equipment (see note 10)

Property, plant and equipment has been reviewed for impairment in accordance with the requirements of IAS 36. Following the announcement on the 20 May 2020 to reshape and resize the Group given the financial and operational impact of COVID-19, a strategic review of the Group's sites has been performed. Where the Group expects to exit a Civil Aerospace site, the carrying value of the land and buildings and related plant and equipment have been impaired to their recoverable amount by reference to their fair value (based on professional advice – Level 3 in the IFRS 13 hierarchy) less cost of disposal. The Group has also reviewed whether plant and equipment and assets under construction relating to these locations can be relocated to other parts of the Group for future use. Where no alternative use has been identified, the carrying value of these assets have been impaired to their recoverable amount by reference to their scrap values. An impairment charge of £219m has been recognised.

Impairment tests were also considered necessary for Civil Aerospace and ITP Aero engines. An impairment charge of £97m was recognised. The impairment tests were performed on the following basis:

- The carrying value of assets have been assessed by reference to their value in use, together with other assets as part of a larger CGU. These have been estimated using the expected cash flow approach allowable under IAS 36 as set out in note 12b above.
- The key assumptions underlying cash flow projections in relation to engines are utilisation of the asset, lease rate, condition of the engine and cost of maintaining, discount rates and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at **10.6%–11.0%** based on the weighted average cost of capital of the relevant business.

Other smaller impairments totalling £16m were also recognised.

d) Right-of-use assets (see note 11)

Right-of-use (RoU) assets have been reviewed for impairment in accordance with the requirements of IAS 36. RoU assets have typically been assessed together with other assets as part of a larger CGU. Other than the items referred to below there have been no impairments of RoU assets.

Impairment tests were considered necessary for lease engines as a result of the impact of COVID-19 on expected future EFHs, operators' fleet plans and the resultant requirement for fewer lease engines to support the aircraft fleets. An impairment charge of £31m was recognised against lease engine RoU assets.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12 Impairment of intangible assets, property, plant and equipment, right-of-use assets and investments continued

Impairment tests were performed on the following basis:

- The carrying values of assets have been assessed by reference to their value in use as set out in note 12b above.
- The key assumptions underlying cash flow projections in relation to the lease engines are utilisation of the asset, lease rate, condition of the engine and cost of maintaining, discount rates and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at 11.0% based on the weighted average cost of capital of the relevant business.

The Civil Aerospace specific asset impairments in the period of £69m primarily relate to land and buildings and are a consequence of the strategic review of the Group's sites described above. Assets have been written down to reflect the higher of their revised value in use (11.0% discount rate) or fair value less cost of disposal.

Other smaller impairments totalling £6m were also recognised.

e) Investments (see note 13)

As a result of reduced EFHs caused by COVID-19, joint venture investments in Civil Aerospace repair and overhaul facilities were tested for impairment. The value in use was estimated by discounting expected future dividends at 10.5% (cost of equity for the Civil Aerospace business). An impairment of £15m was recognised.

As a result of changes in the local market due to climate regulations impacting the offered product, and the impact of COVID-19 on market demand and the liquidity of the business, a Power Systems joint venture was tested for impairment. The value in use of the investment was estimated using the expected cash flow approach. The pre-tax cash flow projections were discounted at 11.7%. An impairment of £9m was recognised.

13 Investments

Composition of the Group

The entities contributing to the Group's financial results are listed on pages 183 to 189.

Where the Group does not own 100% of the shares of a Group undertaking, there are a number of arrangements with the other shareholder(s) that give the Group the option or potential obligation to acquire the third parties' shares. These arrangements have been assessed and are not considered to have a significant value, individually or in aggregate.

Non-controlling interests

The Group does not have any material non-wholly owned subsidiaries.

Equity accounted and other investments

	Equity accounted			Other Unlisted £m
	Joint ventures £m	Associates £m	Total £m	
At 1 January 2019	412	–	412	22
Additions	8	–	8	2
Disposals	(4)	–	(4)	(6)
Transfer from joint venture to joint operation	(3)	–	(3)	–
Impairment	–	–	–	(1)
Consolidation of previously non-consolidated subsidiary	–	–	–	(4)
Share of retained profit ¹	12	–	12	–
Reclassification of deferred profit to deferred income ²	4	–	4	–
Exchange differences	(19)	–	(19)	1
Share of OCI	(8)	–	(8)	–
At 1 January 2020	402	–	402	14
Additions ³	19	–	19	5
Disposals ⁴	(6)	–	(6)	–
Impairment ⁵	(24)	–	(24)	–
Share of retained profit ¹	130	1	131	–
Reclassification of deferred profit from deferred income ²	(96)	–	(96)	–
Transfer to subsidiary ⁴	(4)	–	(4)	–
Exchange differences	(23)	–	(23)	–
Share of OCI	(5)	–	(5)	–
At 31 December 2020	393	1	394	19

¹ See table below.

² The Group's share of unrealised profit on sales to joint ventures is eliminated against the carrying value of the investment in the entity. Any excess amount, once the carrying value is reduced to nil, is recorded as deferred income.

³ On 18 May 2020, the Group increased its shareholding in Reaction Engines Limited from 2% to 10.1%.

⁴ On 15 January 2020, the Group completed the acquisition of Qinous GmbH (increasing its shareholding from 24% to 100%) and was transferred to a subsidiary. On 6 July 2020, the Group completed the disposal of its 18% shareholding in Exostar LLC. See note 28.

⁵ During the year, the Group recognised an impairment of £24m charged to the income statement through non-underlying. See note 12.

13 Investments continued

Reconciliation of share of retained profit/(loss) to the income statement and cash flow statement:

	2020 £m	2019 £m
Share of results of joint ventures and associates	133	141
Adjustments for intercompany trading ¹	58	(37)
Share of results of joint ventures and associates to the Group (income statement)	191	104
Dividends paid by joint ventures and associates to the Group (cash flow statement)	(60)	(92)
Share of retained profit	131	12

¹ During the year, the Group sold spare engines to Rolls-Royce & Partners Finance, a joint venture company. The Group's share of the profit on these sales is deferred and released to match the depreciation of the engines in the joint venture's financial statements. In 2020, profit deferred on the sale of engines was lower than the release of that deferred in prior years.

The following joint ventures are considered to be individually material to the Group:

	Principal location	Activity	Ownership 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	50.0%
Singapore Aero Engine Services Pte Limited (SAESL)	Singapore	Aero engine repair and overhaul	50.0%

Summarised financial information of the Group's individually material joint ventures is as follows:

	APL		HAESL		SAESL	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Revenue	330	322	1,995	1,907	1,178	1,529
Profit and total comprehensive income for the year	44	107	71	81	32	47
Dividends paid during the year	–	(29)	(62)	(76)	(14)	(42)
Profit for the year included the following:						
Depreciation and amortisation	(165)	(146)	(15)	(15)	(21)	(16)
Interest income	–	4	–	–	–	–
Interest expense	(83)	(89)	(2)	(3)	(5)	(6)
Income tax expense	(35)	(22)	(13)	(16)	(4)	(3)
Current assets	172	119	461	453	256	433
Non-current assets	3,191	3,319	102	113	164	172
Current liabilities	(201)	(230)	(287)	(269)	(156)	(264)
Non-current liabilities	(2,551)	(2,617)	(78)	(103)	(74)	(163)
Net assets	611	591	198	194	190	178
Included in the above:						
Cash and cash equivalents	64	25	29	4	47	14
Current financial liabilities ¹	(143)	(182)	(22)	–	–	–
Non-current financial liabilities ¹	(2,245)	(2,364)	(66)	(89)	(73)	(163)
Reconciliation to the carrying amount recognised in the Consolidated Financial Statements						
Ownership interest	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%
Group share of net assets above	306	296	99	97	95	89
Goodwill	–	–	34	35	77	94
Adjustments for intercompany trading	(306)	(296)	(3)	(7)	–	(1)
Included in the balance sheet	–	–	130	125	172	182

¹ Excluding trade payables and other liabilities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

13 Investments continued

The summarised aggregated results of the Group's share of equity accounted investments is as follows:

	Individually material joint ventures (above)		Other joint ventures		Associates		Total	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Assets:								
Non-current assets	1,729	1,802	734	745	—	—	2,463	2,547
Current assets	444	503	514	456	1	—	959	959
Liabilities: ¹								
Current liabilities	(322)	(382)	(303)	(322)	—	—	(625)	(704)
Non-current liabilities	(1,351)	(1,441)	(758)	(703)	—	—	(2,109)	(2,144)
Group adjustment for goodwill	111	129	17	—	—	—	128	129
Adjustment for intercompany trading	(309)	(304)	(113)	(81)	—	—	(422)	(385)
	302	307	91	95	1	—	394	402
¹ Liabilities include borrowings of:	(1,263)	(1,399)	(548)	(627)	—	—	(1,811)	(2,026)

14 Inventories

	2020 £m	2019 £m
Raw materials	417	522
Work in progress	1,139	1,652
Finished goods	2,111	2,119
Payments on account	23	27
	3,690	4,320
 Inventories stated at net realisable value		
	305	227
Amount of inventory write-down	95	69
Reversal of inventory write-down	16	12

15 Trade receivables and other assets

	Current		Non-current		Total	
	2020 £m	2019 ⁴ £m	2020 £m	2019 ⁴ £m	2020 £m	2019 ⁴ £m
Trade receivables ¹	2,479	2,354	—	—	2,479	2,354
Receivables due on RRSAs	603	719	82	150	685	869
Amounts owed by joint ventures and associates ¹	486	197	16	12	502	209
Costs to obtain contracts with customers ²	12	12	50	33	62	45
Other taxation and social security receivable	225	187	6	29	231	216
Other receivables ³	639	766	20	2	659	768
Prepayments	412	356	425	248	837	604
	4,856	4,591	599	474	5,455	5,065

Trade receivables and other assets are analysed as follows:

Financial instruments (note 21):

Trade receivables and similar items ⁴	3,584	3,386
Other non-derivative financial assets ⁴	740	815
Non-financial instruments ⁴	1,131	864
	5,455	5,065

¹ Includes £577m (2019: £267m) of trade receivables held to collect or sell and £361m (2019: £76m) of receivables from joint ventures and associates held to collect or sell.

² These are amortised over the term of the related contract, resulting in amortisation of £10m (2019: £8m) in the year. There were no impairment losses.

³ Includes £2m of amounts owed by the UK Government at 31 December 2020 for amounts claimed by the Group under furlough arrangements. In addition, other receivables includes unbilled recoveries relating to overhaul activity.

⁴ During the year the presentation of trade receivables and other assets has been analysed in greater detail, without changing the total amount previously reported. As a consequence some comparative balances and currency movements have been represented in additional and more appropriate line items. Trade receivables has decreased by £184m, costs to obtain contracts with customers has increased by £2m and other receivables has decreased by £903m. Receivables due on RRSAs and other taxation & social security receivable totalling £1,085m are now presented as separate lines. This has also resulted in an associated re-presentation between financial and non-financial assets, with an increase of non-financial instruments of £2m and a decrease in financial instruments of £2m (trade receivables and similar items £91m and other non-derivative financial assets £89m). The total amount of trade receivables and other assets from 2019 remains unchanged.

15 Trade receivables and other assets continued

The Group has historically undertaken the sale of trade receivables, without recourse, to banks (commonly known as invoice discounting or factoring). This activity has previously been used to normalise customer receipts as certain aerospace customers have extended their payment terms. This in turn has helped normalise Group cash flows in line with physical delivery volumes. During the year to 31 December 2020, invoice discounting has substantially reduced. At 31 December 2020, £54m was drawn under factoring facilities, a decrease of £1,063m compared to 2019, representing cash collected before it was contractually due from the customer. Trade receivables factored are generally due within the following quarter.

The expected credit losses for trade receivables and other assets has increased by £114m to £252m (2019: £138m). This increase is mainly driven by the impact of COVID-19 on the Civil Aerospace business of £97m, of which £46m relates to the deterioration of the market credit ratings of customers and £51m relates to updates to the recoverability of other receivables.

The assumptions and inputs used for the estimation of the expected credit losses are disclosed in the table below:

	2020			2019		
	Trade receivables and other financial assets £m	Loss allowance £m	Average expected credit loss rate %	Trade receivables and other financial assets £m	Loss allowance £m	Average expected credit loss rate %
Investment grade	1,611	(33)	2%	1,230	(40)	3%
Non-investment grade	149	(7)	5%	271	(2)	1%
Without credit rating	2,816	(212)	8%	2,636	(96)	4%
	4,576	(252)	5%	4,137	(138)	3%

The movements of the Group expected credit losses provision are as follows:

	2020 £m	2019 £m
At 1 January	(138)	(126)
Increases in loss allowance recognised in the income statement during the year	(119)	(54)
Loss allowance utilised	5	12
Releases of loss allowance previously provided	13	19
Other net movements	(13)	11
At 31 December	(252)	(138)

16 Contract assets and liabilities

	Current		Non-current ¹		Total ²	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Contract assets						
Contract assets with customers	416	404	660	1,092	1,076	1,496
Participation fee contract assets	48	57	386	542	434	599
	464	461	1,046	1,634	1,510	2,095

¹ Contract assets and contract liabilities have been presented on the face of the balance sheet in line with the operating cycle of the business. Contract liabilities is further split according to when the related performance obligation is expected to be satisfied and therefore when revenue is estimated to be recognised in the income statement. Further disclosure of contract assets is provided in the table above, which shows within current the element of consideration that will become unconditional in the next year.

² Contract assets are classified as non-financial instruments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 Contract assets and liabilities continued

Contract assets with customers includes £726m (2019: £1,086m) of Civil Aerospace LTSA assets, with most of the remainder relating to Defence. The main driver of the decrease in the Group balance is a result of revenue relating to performance obligations satisfied in previous years being adjusted by £599m in Civil Aerospace, primarily as a result of COVID-19 reducing engine flying hours (resulting in a reduction in total contract price) below the levels previously estimated over the term of the contracts with a corresponding reduction in the contract asset.

Participation fee contract assets have reduced by £(165)m (2019: reduced by £(55)m) due to the impairment of engine programme participation fees of £(149)m, amortisation exceeding additions by £(36)m and foreign exchange on consolidation of overseas entities of £20m.

The absolute value of expected credit losses for contract assets has increased by £1m to £14m (2019: £13m).

No impairment losses of contract assets (2019: none) have arisen during the year to 31 December 2020.

	Current		Non-current		Total	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Contract liabilities	4,187	4,228	6,245	6,612	10,432	10,840

Contract liabilities are analysed as follows:

Financial instruments (note 21)	186	131
Non-financial instruments	10,246	10,709
	10,432	10,840

During the year £2,792m (2019: £3,491m) of the opening contract liability was recognised as revenue. Contract liabilities have decreased by £408m. The main driver of the change in the Group balance is as a result of a reduction in deposits held, reflecting utilisation of amounts received in previous years as engines and aftermarket services were delivered in 2020. As a result of COVID-19 the level of new deposits received were at lower than normal levels.

The Civil Aerospace LTSA liabilities increased by £58m to £6,841m (2019: £6,783m). LTSA revenue recognised as the performance obligations have been completed has exceeded cash receipts in the year due to the lower level of flying hours that drive cash receipts, decreasing the contract liability. This has been offset due to the 54% decrease in current year Civil Aerospace EFHs, together with a phased recovery, resulting in revenue relating to performance obligations satisfied in previous years being adjusted downwards by £462m which increases the contract liability.

17 Cash and cash equivalents

	2020 £m	2019 £m
Cash at bank and in hand	940	825
Money-market funds	669	1,095
Short-term deposits	1,843	2,523
Cash and cash equivalents per the balance sheet	3,452	4,443
Cash and cash equivalents included within assets held for sale	51	-
Cash and cash equivalents per note 21	3,503	4,443
Overdrafts (note 18)	(7)	(8)
Cash and cash equivalents per cash flow statement (page 109)	3,496	4,435

Cash and cash equivalents at 31 December 2020 includes £143m (2019: £34m) that is not available for general use by the Group. This balance includes £103m which is held in an account that is exclusively for the general use of Rolls-Royce Submarines Limited. This cash is not available for use by other entities within the Group. The remaining balance relates to cash held in non-wholly owned subsidiaries and joint arrangements.

Balances are presented on a net basis when the Group has both a legal right of offset and the intention to either settle on a net basis or realise the asset and settle the liability simultaneously.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 Borrowings and lease liabilities

	Current		Non-current		Total	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Unsecured						
Overdrafts	7	8	–	–	7	8
Bank loans	9	27	10	16	19	43
Commercial paper ¹	300	–	–	–	300	–
2.375% Notes 2020 US\$500m ²	–	378	–	–	–	378
2.125% Notes 2021 €750m ²	680	–	–	655	680	655
0.875% Notes 2024 €550m ³	–	–	511	481	511	481
3.625% Notes 2025 US\$1,000m ³	–	–	800	781	800	781
3.375% Notes 2026 £375m ⁴	–	–	420	410	420	410
4.625% Notes 2026 €750m ⁵	–	–	667	–	667	–
5.75% Notes 2027 \$1,000m ⁵	–	–	724	–	724	–
5.75% Notes 2027 £545m	–	–	539	–	539	–
1.625% Notes 2028 €550m ³	–	–	545	501	545	501
Other loans	17	22	58	52	75	74
Total unsecured	1,013	435	4,274	2,896	5,287	3,331
Lease liability – Land and buildings	44	50	392	473	436	523
Lease liability – Plant and equipment	30	29	72	78	102	107
Lease liability – Aircraft and engines	185	261	1,320	1,463	1,505	1,724
Total lease liabilities	259	340	1,784	2,014	2,043	2,354
Total borrowings and lease liabilities	1,272	775	6,058	4,910	7,330	5,685

All outstanding items described as notes above are listed on the London Stock Exchange.

¹ On 27 April 2020, the Group issued Commercial paper of £300m to the Covid Corporate Financing Facility (CCFF), a fund operated by the Bank of England on behalf of HM Treasury. The borrowings are repayable on 17 March 2021 and are held on the balance sheet at amortised cost.

² These notes are the subject of cross-currency interest rate swap agreements under which the Group has undertaken to pay floating rates of GBP interest, which form a fair value hedge.

³ These notes are the subject of cross-currency interest rate swap agreements under which the Group has undertaken to pay floating rates of GBP interest, which form a fair value hedge. They are also subject to interest rate swap agreements under which the Group has undertaken to pay fixed rates of interest, which are classified as fair value through profit and loss.

⁴ 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. They are also subject to interest rate swap agreements under which the Group has undertaken to pay fixed rates of interest, which are classified as fair value through profit and loss.

⁵ These notes are the subject of cross-currency interest rate swap agreements under which the Group has undertaken to pay fixed rates of GBP interest, which form a cash flow hedge.

During the year, the Group issued \$1,000m, €750m and £545m of bond notes, €750m of which matures in 2026 and \$1,000m and £545m in 2027. The Group also repaid a \$500m bond during the year. The Group issued £300m of commercial paper under the Covid Corporate Financing Facility made available by the Bank of England in response to COVID-19.

The Group also entered into a new £1,000m bank loan maturing in 2022 and a new committed £2,000m loan maturing in 2025 (supported by an 80% guarantee from UK Export Finance and available to draw until June 2021). Also during 2020 the Group extended the maturity of the £2,500m committed revolving credit facility from 2024 to 2025. These facilities were undrawn at the year end. None of these facilities are subject to any financial covenant.

Under the terms of certain of its recent loan facilities, the Company is restricted from declaring, making or paying distributions to shareholders on or prior to 31 December 2022 and from declaring, making or paying distributions to shareholders from 1 January 2023 unless certain conditions are satisfied. The restrictions on distributions do not prevent shareholders from redeeming C Shares issued in January 2020 or prior to that.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

19 Leases**Leases as lessee**

The net book value of right-of-use assets at 31 December 2020 was £1,405m (2019: £2,009m), with a lease liability of £2,043m (2019: £2,354m), see notes 11 and 18 respectively. Leases that have not yet commenced to which the Group is committed have a future liability of £2m and consist of mainly properties and cars. The consolidated income statement shows the following amounts relating to leases:

	2020 £m	2019 £m
Land and buildings depreciation and impairment ¹	(122)	(59)
Plant and equipment depreciation ²	(44)	(33)
Aircraft and engines depreciation and impairment ³	(566)	(319)
Total depreciation and impairment charge for right-of-use assets	(732)	(411)
Adjustment of amounts payable under residual value guarantees within lease liabilities ^{3, 4}	102	–
Expense relating to short-term leases of 12 months or less recognised as an expense on a straight line basis ²	(18)	(23)
Expense relating to variable lease payments not included in lease liabilities ^{3, 5}	(1)	(1)
Total operating costs	(649)	(435)
Interest expense ⁶	(74)	(88)
Total lease expense	(723)	(523)
Income from sub-leasing right-of-use assets	97	79
Total amount recognised in the income statement	(626)	(444)

¹ Included in cost of sales and commercial and administration costs depending on the nature and the use of the right-of-use asset.

² Included in cost of sales, commercial and administration costs, or research and development depending on the nature and use of the right-of-use asset.

³ Included in cost of sales.

⁴ Where the cost of meeting residual value guarantees is less than that previously estimated, as costs have been mitigated or liabilities waived by the lessor, the lease liability has been remeasured. Where the value of this remeasurement exceeds the value of the right-of-use asset, the reduction in the lease liability is credited to cost of sales.

⁵ Variable lease payments primarily arise on a small number of contracts where engine lease payments are dependent upon utilisation rather than a periodic charge.

⁶ Included in financing costs.

The total cash outflow for leases in 2020 was £377m (2019: £383m). Of this, £358m related to leases reflected in the lease liability, £18m to short-term leases where lease payments are expensed on a straight-line basis and £1m for variable lease payments where obligations are only due when the assets are used. The timing difference between income statement charge and cash flow relates to costs incurred at the end of leases for residual value guarantees and restoration costs that are recognised within depreciation over the term of the lease, the most significant amounts relate to engine leases.

The Group's leasing activities as a lessee and how they are accounted for

The Group leases aero engines that are used to support customers' aircraft fleets; land and buildings used for production, administration or training purposes; and equipment used in the manufacturing process and to support commercial and administrative activities. Lease terms are negotiated on an individual basis and contain a wide range of different terms and conditions. The lease arrangements do not impose any covenants, but leased assets may not be used as security for borrowing purposes.

Right-of-use assets and lease liabilities arising over the lease term are initially measured on a present value basis. The lease term represented is the non-cancellable period of the lease together with periods covered by an option to extend the lease where the Group is reasonably certain to extend. Lease liabilities include the net present value of the following lease payments where such flows exist:

- fixed payments less any lease incentive;
- variable lease payments that are based on an index or a rate;
- amounts expected to be payable by the Group under residual value guarantees;
- the exercise price of a purchase option if the Group is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease, if the lease term reflects the Group exercising that option.

Leases for engines typically contain no specific contractual right to renew. Certain land and building leases have renewal options with renewal dates for the most significant property leases evenly spread between 2022–2028 and in 2041. Such judgements on lease terms are made each period end and consider the specific terms of the lease and the operational significance of the site, especially where utilised for manufacturing activities. Lease obligations beyond the renewal dates are included in the lease liability where the Group is reasonably certain to extend the lease.

Engine leases in the Civil Aerospace business often include clauses that require the engines to be returned to the lessor with specific levels of useable life remaining. The cost of meeting these requirements are included in the estimate of the lease payments set out above. The amount payable is dependent upon the utilisation of the engines over the lease term, whether the engine is restored to the required condition by performing an overhaul at our own cost or through the payment of amounts specified in the contract and any new contractual arrangements arising when the current lease contracts end. Where estimates of payments change, an adjustment is made to the lease liability and the right-of-use asset. If the adjustment exceeds the value of the right-of-use asset, the balance is credited to the income statement. Liabilities in USD and other non-functional currencies are reported at the closing spot rates with changes arising from a change in exchange rates reported within financing.

On transition to IFRS 16 *Leases* on 1 January 2019, finance leases continued to be recognised at their 2018 closing value and operating leases were measured at the present value of the remaining lease payments discounted using an incremental borrowing rate appropriate to the lease. For new leases, the lease payments are discounted using the interest rate implicit in the lease or if that rate cannot be readily determined, which is generally the case for leases in the Group, the incremental borrowing rate, being the rate required to pay to borrow the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment with similar terms, security and conditions.

19 Leases continued

To determine the incremental borrowing rate, the Group uses a build-up approach that starts with the risk-free interest rate which is then adjusted for credit risk to reflect the nature of the borrowing based on empirical evidence of similar external borrowings undertaken by the Group. The rate used reflects the term and currency of the lease.

The Group is exposed to potential future increases in lease payments where the amount paid is based on an index (such as LIBOR) or rate, which are not included in the lease liability until they take effect. When adjustments to lease payments based on an index or rate take effect, the lease liability is remeasured and an equivalent adjustment is made to the right-of-use asset except where the change results from a change in the floating interest rates when a revised discount rate is used that reflects changes in those rates.

Right-of-use assets are measured at cost comprising the following:

- the amount of the initial measurement of the lease liability or revaluation of the liability;
- any lease payments made at or before the commencement date less any lease incentives received;
- any initial direct costs; and
- restoration costs.

Each right-of-use asset is depreciated over the shorter of its useful life and the lease term on a straight-line basis unless the lease is expected to transfer ownership of the underlying asset to the Group, in which case the asset is depreciated to the end of the useful life of the asset.

Income from sub-leasing right-of-use assets is primarily generated from the use of engines by our Civil Aerospace customers. In a small number of circumstances current excess property capacity is sub-let at market rates.

Leases as lessor

The Group acts as lessor for engines to Civil Aerospace customers when they require engines to support their fleets. Lease agreements with the lessee provide protection over our assets. Usage in excess of specified limits and damage to the engine while on lease are covered by variable lease payment structures. Lessee bankruptcy risk is managed through the Cape Town Convention on International Interests in Mobile Equipment (including a specific protocol relating to aircraft equipment); an international treaty that creates common standards for the registration of lease contracts and establishes various legal remedies for default in financing agreements, including repossession and the effect of particular states' bankruptcy laws. Engines are only leased once the Group confirms that appropriate insurance documentation is established that covers the engine assets to pre-agreed amounts. All such contracts where we are lessor are operating leases. The Group also leases out a small number of properties, or parts of properties, where there is excess capacity under operating leases.

	2020 £m	2019 £m
Operating lease income – credited within revenue from aftermarket services ^{1,2}	194	127

¹ Includes variable lease payments received of £179m (2019: £97m) that do not depend on an index or a rate.

² Items of property, plant and equipment subject to an operating lease are disclosed in note 10.

Non-cancellable future operating lease rentals (undiscounted) are receivable as follows:

	2020 £m	2019 £m
Within one year	13	13
Between one and two years	12	14
Between two and three years	10	12
Between three and four years	6	8
Between four and five years	6	5
After five years	21	17
	68	69

In a limited number of circumstances the Group sublets properties that are treated as finance leases when the arrangement transfers substantially all the risks and rewards of ownership of the asset. At 31 December 2020, the total undiscounted lease payments receivable is £22m on annual lease income of £3m. The discounted finance lease receivable at 31 December 2020 is £19m (2019: nil). There was no (2019: nil) finance income recognised during the year.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

20 Trade payables and other liabilities

	Current		Non-current		Total	
	2020 £m	2019 ³ £m	2020 £m	2019 ³ £m	2020 £m	2019 ³ £m
Trade payables	1,418	1,906	–	62	1,418	1,968
Payables due on RRSAs	697	1,029	–	–	697	1,029
Amounts owed to joint ventures and associates	583	916	–	36	583	952
Customer concession credits	1,536	1,463	514	495	2,050	1,958
Warranty credits	173	185	196	218	369	403
Accruals	1,322	1,712	117	89	1,439	1,801
Deferred receipts from RRSA workshare partners	17	17	507	516	524	533
Government grants ¹	16	12	66	71	82	83
Other taxation and social security	127	128	7	–	134	128
Other payables ²	764	1,082	515	584	1,279	1,666
	6,653	8,450	1,922	2,071	8,575	10,521

Trade payables and other liabilities are analysed as follows:

Financial instruments (note 21):

Trade payables and similar items ³	4,128	5,766
Other non-derivative financial liabilities ³	3,021	3,279
Non-financial instruments ³	1,426	1,476
	8,575	10,521

¹ During the year, £10m (2019: £12m) of government grants were released to the income statement.

² Other payables includes financial penalties from agreements with investigating bodies, parts purchase obligations, payroll liabilities, HMG levies and deferred consideration for recent acquisitions.

³ During the year the presentation of trade payables and other liabilities has been analysed in greater detail, without changing the total amount previously reported. As a consequence some comparative balances and currency movements have been represented in additional and more appropriate line items. Trade payables has decreased by £332m, amounts owed to joint ventures and associates increased by £118m, accruals has decreased by £39m and other payables has decreased by £3,137m. Payables due on RRSAs, customer concession credits and warranty credits totalling £3,390m are now presented as separate lines. This has also resulted in an associated representation between financial and non-financial liabilities, with an increase of financial instruments of £1,655m (trade payables and similar items £(83)m and other non-derivative financial liabilities £1,738m) and a decrease in non-financial instruments of £1,655m. The total amount of trade payables and other liabilities from 2019 remains unchanged.

Our payment terms with suppliers vary on the products and services being sourced, the competitive global markets the Group operates in and other commercial aspects of suppliers' relationships. Industry average payment terms vary between 90-120 days. The Group offers reduced payment terms for smaller suppliers, including joint ventures, so that they are paid in 30 days. In line with aerospace industry practice, we offer a supply chain financing (SCF) programme in partnership with banks to enable suppliers, including joint ventures, who are on our standard 75-day payment terms to receive their payments sooner. The SCF programme is available to suppliers at their discretion and does not change our rights and obligations with suppliers nor the timing of our payment of suppliers. At 31 December 2020 suppliers had drawn £582m under the SCF scheme (2019: £859m).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

21 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	Fair value through OCI £m	Amortised cost £m	Fair value through profit or loss £m	Other £m	
2020								
Unlisted non-current asset investments	13	A	19	—	—	—	—	19
Trade receivables and similar items	15	B/C	—	938	2,646	—	—	3,584
Other non-derivative financial assets	15	B	—	—	740	—	—	740
Other assets		D	28	—	—	—	—	28
Derivative financial assets ¹		C	766	—	—	—	—	766
Short-term investments		B	—	—	—	—	—	—
Cash and cash equivalents including cash held for sale	17	B	669	—	2,834	—	—	3,503
Borrowings	18	E/F	—	—	—	—	(5,287)	(5,287)
Lease liabilities	18	G	—	—	—	—	(2,043)	(2,043)
Derivative financial liabilities ¹		C	—	—	—	(3,472)	—	(3,472)
Financial RRSAs		H	—	—	—	—	(81)	(81)
Other liabilities		H	—	—	—	—	(73)	(73)
C Shares		B	—	—	—	—	(28)	(28)
Trade payables and similar items	20	B	—	—	—	—	(4,128)	(4,128)
Other non-derivative financial liabilities	20	B	—	—	—	—	(3,021)	(3,021)
Contract liabilities	16	B	—	—	—	—	(186)	(186)
			1,482	938	6,220	(3,472)	(14,847)	(9,679)
2019								
Unlisted non-current asset investments	13	A	14	—	—	—	—	14
Trade receivables and similar items ²	15	B/C	—	344	3,042	—	—	3,386
Other non-derivative financial assets ²	15	B	—	—	815	—	—	815
Other assets		D	28	—	—	—	—	28
Derivative financial assets ¹		C	525	—	—	—	—	525
Short-term investments		B	—	—	6	—	—	6
Cash and cash equivalents	17	B	1,095	—	3,348	—	—	4,443
Borrowings	18	E/F	—	—	—	—	(3,331)	(3,331)
Lease liabilities	18	G	—	—	—	—	(2,354)	(2,354)
Derivative financial liabilities ¹		C	—	—	—	(3,374)	—	(3,374)
Financial RRSAs		H	—	—	—	—	(110)	(110)
Other		H	—	—	—	—	(72)	(72)
C Shares		B	—	—	—	—	(31)	(31)
Trade payables and similar items ²	20	B	—	—	—	—	(5,766)	(5,766)
Other non-derivative financial liabilities ²	20	B	—	—	—	—	(3,279)	(3,279)
Contract liabilities	16	B	—	—	—	—	(131)	(131)
			1,662	344	7,211	(3,374)	(15,074)	(9,231)

¹ In the event of counterparty default relating to derivative financial assets and liabilities, offsetting 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 £43m (2019: £13m) and liabilities £2,749m (2019: £2,862m).

² Balances as at 31 December 2019 have been re-presented. See note 15 and 20.

Fair values equate to book values for both 2020 and 2019, with the following exceptions:

	Basis for determining fair value	2020		2019	
		Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	E	(4,886)	(4,814)	(3,206)	(3,147)
Borrowings	F	(401)	(403)	(125)	(130)
Financial RRSAs	H	(81)	(89)	(110)	(112)

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 on page 155.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

21 Financial instruments continued

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. Money market funds are valued using level 1 methodology.

C Fair values of derivative financial assets and liabilities and trade receivables held to collect or sell are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. For commodity derivatives forward commodity prices are used to determine expected future cash flows. 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 Other assets are included on the balance sheet at fair value, derived from observable market prices or latest forecast (Level 2/Level 3 as defined by IFRS 13). At 31 December 2020, Level 3 assets totalled £15m (2019: £16m).

E Borrowings are carried at amortised cost. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. The fair value of borrowings is estimated using quoted prices (Level 1 as defined by IFRS 13).

F Borrowings are carried at amortised cost. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. The fair value of borrowings is estimated by discounting contractual future cash flows (Level 2 as defined by IFRS 13).

G The fair value of lease liabilities are estimated by discounting future contractual cash flows using either the interest rate implicit in the lease or the Group's incremental cost of borrowing (Level 2 as defined by IFRS 13).

H The fair value of RRSAs and other liabilities are 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).

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

Level 3 – inputs not based on observable market data

Carrying values of other financial assets and liabilities

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts ¹ £m	Total derivatives £m	Financial RRSAs £m	Other £m	C Shares £m	Total £m
2020								
Non-current assets	396	18	258	672	–	15	–	687
Current assets	45	7	42	94	–	13	–	107
Assets	441	25	300	766	–	28	–	794
Current liabilities	(522)	(17)	(11)	(550)	(5)	(25)	(28)	(608)
Non-current liabilities	(2,790)	(19)	(113)	(2,922)	(76)	(48)	–	(3,046)
Liabilities	(3,312)	(36)	(124)	(3,472)	(81)	(73)	(28)	(3,654)
	(2,871)	(11)	176	(2,706)	(81)	(45)	(28)	(2,860)
2019								
Non-current assets	234	14	203	451	–	16	–	467
Current assets	16	9	49	74	–	12	–	86
Assets	250	23	252	525	–	28	–	553
Current liabilities	(394)	(5)	–	(399)	(31)	(32)	(31)	(493)
Non-current liabilities	(2,960)	(6)	(9)	(2,975)	(79)	(40)	–	(3,094)
Liabilities	(3,354)	(11)	(9)	(3,374)	(110)	(72)	(31)	(3,587)
	(3,104)	12	243	(2,849)	(110)	(44)	(31)	(3,034)

¹ Includes the foreign exchange impact of cross-currency interest rate swaps.**Derivative financial instruments**

The Group uses various financial instruments to manage its exposure to movements in foreign exchange rates. 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 a foreign currency, the Group has currency derivatives designated as part of fair value or cash flow hedges. The Group uses interest rate swaps and forward rate agreements 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 – hedge accounted ²		Interest rate instruments – non-hedge accounted		Total	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
At 1 January	(3,104)	(3,764)	12	(34)	229	292	14	–	(2,849)	(3,506)
Movements in fair value hedges	–	–	–	–	139	(27)	–	–	139	(27)
Movements in cash flow hedges	18	(4)	6	13	(60)	–	–	–	(36)	9
Movements in other derivative contracts ¹	(23)	(43)	(62)	36	–	–	(75)	14	(160)	7
Contracts settled	238	707	33	(3)	(75)	(36)	4	–	200	668
At 31 December	(2,871)	(3,104)	(11)	12	233	229	(57)	14	(2,706)	(2,849)

¹ Included in net financing.² Includes the foreign exchange impact of cross-currency interest rate swaps.

21 Financial instruments continued

Financial risk and revenue sharing arrangements (RRSAs) and other financial liabilities

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.

Movements in the carrying values were as follows:

	Financial RRSAs		Other - assets		Other - liabilities	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
At 1 January as previously reported	(110)	(227)	16	–	(72)	(62)
Reclassification to borrowings ¹	–	79	–	–	–	–
At 1 January restated	(110)	(148)	16	–	(72)	(62)
Exchange adjustments included in OCI	(6)	10	–	–	(2)	1
Additions	–	(4)	–	–	(17)	(37)
Financing charge ²	(3)	(3)	–	–	(13)	(3)
Excluded from underlying profit:						
Changes in forecast payments ²	(3)	1	–	–	–	–
Exchange adjustments ²	–	6	–	–	–	–
Cash paid	39	28	(1)	–	18	29
Other	–	–	–	–	13	–
Reclassification from trade receivables	–	–	–	16	–	–
Reclassification to held for sale	2	–	–	–	–	–
At 31 December	(81)	(110)	15	16	(73)	(72)

¹ In 2019, the Group reclassified £79m as borrowings previously included in other financial liabilities.

² Included in financing.

Effect of hedging instruments on the financial position and performance

To manage the risk of changes in the fair values of fixed rate borrowings (the hedged items) the Group has entered into fixed-to-floating interest rate swaps (the hedging instruments) which for accounting purposes are designated as fair value hedges. The impact of fair value hedges on the financial position and performance of the Group is as follows:

	Hedged item ¹				Hedging instrument ²						
	Nominal £m	FV movement in the period £m	FV adjustment since inception £m	Carrying amount £m	Nominal £m	Carrying amount asset £m	Carrying amount liability £m	FV movement in the period £m	Hedge ineffect- iveness in the period ³ £m	Weighted average FX rate	Weighted average interest rate
At 31 December 2020											
Sterling	(375)	(10)	(46)	(420)	375	46	–	10	–	1.00	GBP LIBOR + 0.893
US Dollar	(658)	(18)	(144)	(800)	658	136	–	14	(4)	1.52	GBP LIBOR + 1.4658
Euro	(1,607)	(97)	(131)	(1,735)	1,607	111	–	90	(7)	1.15	GBP LIBOR + 0.8301
At 31 December 2019											
Sterling	(375)	(3)	(36)	(410)	375	36	–	3	–	1.00	GBP LIBOR + 0.893
US Dollar	(987)	(10)	(175)	(1,159)	987	172	–	2	(8)	1.52	GBP LIBOR + 1.2575
Euro	(1,607)	63	(34)	(1,637)	1,607	27	(6)	(69)	(6)	1.15	GBP LIBOR + 0.8301

¹ Hedged items are included in borrowings in the balance sheet.

² Hedging instruments are included in other financial assets or liabilities in the balance sheet.

³ Hedge ineffectiveness is included in net financing in the income statement.

To manage the foreign exchange rate risk in cash flows on fixed rate non-GBP borrowings (the hedged items) the Group has entered into fixed-to-fixed cross-currency interest rate swaps (the hedging instruments) to hedge the cash flows into GBP, which for accounting purposes are designated as cash flow hedges. The impact of cash flow hedges on the financial position and performance of the Group is as follows:

	Hedged item			Hedging instrument ^{1,2}				Cash flow hedge reserve		
	FV movement Nominal in the period	Nominal	Carrying amount liability	FV movement in the period	Weighted average FX rate	Weighted average interest rate	Amount recognised in OCI	Recycled to net financing	Closing cash flow hedge reserve	
At 31 December 2020										
US Dollar	(772)	55	772	(55)	(55)	1.29	5.3263	55	(39)	16
Euro	(677)	5	677	(5)	(5)	1.11	5.4463	5	(3)	2

¹ Hedging instruments are included in other financial assets or liabilities in the balance sheet.

² No ineffectiveness during the period.

21 Financial instruments continued

The Group has adopted the 'Amendments to IFRS 9, IAS 39 and IFRS 7 Interest Rate Benchmark Reform' issued in September 2019. In calculating the change in fair value attributable to the hedged risk for the fixed-rate borrowings, the Group has made the following assumptions that reflect its current expectations:

- the Group has assumed that pre-existing fallback provisions in the borrowings do not apply to IBOR reform;
- borrowings move to a risk-free rate during 2022, and the spread will be similar to the spread included in the interest rate swaps used as hedging instruments; and
- no other changes to the terms of the hedged borrowings are anticipated.

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 denominated in currencies other than the functional currency of the relevant trading entity (most significantly USD, followed by the euro). 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.

The Group economically hedges its GBP/USD exposure by forecasting highly probable net USD receipts up to ten years forward. Hedges are taken out within prescribed maximum and minimum hedge positions set out in the Group FX Policy. The maximum and minimum policy bands decline gradually over the ten year horizon and are calculated as a percentage of forecast net income. A similar policy is operated for the Group's EUR/USD exposure. For accounting purposes, these derivative contracts are not designated in hedging relationships with the exception of those taken out by the Group's Spanish subsidiary, ITP Aero, where they are designated in cash flow hedges. ITP Aero is exposed predominantly to net USD receipts that it hedges against EUR using foreign exchange forward contracts.

The Group also has exposures to cash flows on EUR and USD denominated fixed rate borrowings. To manage its exposures to changes in values of future foreign currency cash flows, the Group has entered into fixed-to-fixed cross-currency interest rate swaps which for accounting purposes are designated as cash flow hedges. The swaps have similar critical terms to the hedged items, such as the initial exchange amounts, payment dates and maturities. Therefore there is an economic relationship and the hedge ratio is established as 1:1. Possible sources of ineffectiveness in the cash flow hedge relationship are changes in the credit risk of either party to the interest rate swap. Another possible source of ineffectiveness would be if the notional of the borrowings is less than the notional of the derivative, for example in the event of a partial repayment of hedged debt prior to its maturity.

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.

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 Group's revenue is generated from customers located across multiple geographical locations (see note 2), these customers are typically: airframers and airline operators relating to Civil Aerospace; government defence departments for the UK and US; multiple smaller entities for Power Systems; and aero engine manufacturers for ITP Aero. Whilst there are a limited number of customers related to Civil Aerospace and Defence, they are spread across various geographical locations. 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 of the Group. The fixed or floating interest rate decision on long-term borrowings is determined for each new agreement at the point it is entered into. The aggregate interest rate position of the Group is reviewed regularly and can be revised at any time in order to react to changes in market conditions or circumstances.

The Group also has exposures to the fair values of non-derivative financial instruments such as EUR, GBP and USD fixed rate borrowings. To manage the risk of changes in these fair values, the Group has entered into fixed-to-floating interest rate swaps and cross-currency interest rate swaps which for accounting purposes are designated as fair value hedges. The swaps have similar critical terms to the hedged items, such as the reference rate, reset dates, notional amounts, payment dates and maturities. Therefore there is an economic relationship and the hedge ratio is established as 1:1. Possible sources of ineffectiveness in the fair value hedge relationship are changes in the credit risk of either party to the interest rate swap and, for cross-currency interest rate swaps, the cross-currency basis risk as this risk is present in the hedging instrument only. Another possible source of ineffectiveness would be if the notional of the borrowings is less than the notional of the derivative, for example in the event of a partial repayment of hedged debt prior to its maturity.

The Group has exposure to changes in cash flows due to changes in interest rates. To manage this risk the Group has entered into floating-to-fixed interest rate swaps to hedge a proportion of its floating rate exposure to fixed rates. The swaps have similar critical terms to the

21 Financial instruments continued

floating leg of swaps that form part of the fair value hedges, such as the reference rate, reset dates, notional amounts, payment dates and maturities. For accounting purposes, these derivative contracts are generally not designated as hedging instruments.

ITP Aero has also entered into a floating-to-fixed interest rate swap to hedge the cash flow risk on a floating rate borrowing which for accounting purposes is designated as a cash flow hedge.

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. The commodity hedging policy is similar to the Group FX policy, in that the Group forecasts highly probable exposures to commodities, and takes out hedges within prescribed maximum and minimum levels as set out in the policy. The maximum and minimum policy bands decline gradually over time. For accounting purposes, these derivative contracts are generally not designated in hedging relationships.

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 two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
At 31 December 2020							
Foreign exchange contracts:							
Cash flow hedges	544	206	187	151	–	30	(4)
Non-hedge accounted	35,715	6,172	6,495	17,956	5,092	411	(3,308)
Interest rate contracts:							
Fair value hedges	2,640	639	–	1,142	859	293	–
Cash flow hedges	1,461	4	4	4	1,449	–	(60)
Non-hedge accounted	2,001	–	–	1,142	859	7	(64)
Commodity contracts:							
Cash flow hedges	41	6	7	19	9	12	–
Non-hedge accounted	217	97	77	43	–	13	(36)
	42,619	7,124	6,770	20,457	8,268	766	(3,472)

At 31 December 2019

Foreign exchange contracts:

Cash flow hedges	646	266	206	174	–	13	(17)
Non-hedge accounted	29,878	5,151	4,704	13,300	6,723	237	(3,337)
Interest rate contracts:							
Fair value hedges	2,969	329	639	484	1,517	235	(6)
Cash flow hedges	15	4	4	7	–	–	–
Non-hedge accounted	2,001	–	–	484	1,517	17	(3)
Commodity contracts:							
Cash flow hedges	54	11	9	21	13	8	(1)
Non-hedge accounted	342	125	101	116	–	15	(10)
	35,905	5,886	5,663	14,586	9,770	525	(3,374)

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

Foreign exchange contracts are denominated in the following currencies:

	Nominal amount of currencies purchased forward				
	Sterling £m	US dollar ¹ £m	Euro £m	Other £m	Total £m
At 31 December 2020					
Currencies sold forward:					
Sterling ¹	–	7,132	–	226	7,358
US dollar	23,857	–	3,910	486	28,253
Euro	5	306	–	161	472
Other	10	116	47	3	176

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

21 Financial instruments continued

	Nominal amount of currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2019					
Currencies sold forward:					
Sterling	–	4	–	221	225
US dollar	24,411	–	4,468	581	29,460
Euro	21	297	–	264	582
Other	8	91	152	6	257

¹ The amount of USD purchased forward has increased at 31 December 2020 due to offsetting foreign exchange contracts taken out to reduce the size of the USD hedge book. See note 4.

The nominal value of interest rate and commodity contracts are denominated in the following currencies:

	2020 £m	2019 £m
Sterling	2,376	2,376
US dollar	1,676	1,370
Euro	2,308	1,635

Non-derivative financial instruments are denominated in the following currencies:

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2020					
Unlisted non-current investments	1	15	3	–	19
Trade receivables and similar items	154	2,933	440	57	3,584
Other non-derivative financial assets	80	599	44	17	740
Other assets	–	28	–	–	28
Cash and cash equivalents	1,439	560	1,416	88	3,503
Assets	1,674	4,135	1,903	162	7,874
Borrowings	(1,266)	(1,526)	(2,494)	(1)	(5,287)
Lease liabilities	(211)	(1,559)	(67)	(206)	(2,043)
Financial RRSAs	–	–	(81)	–	(81)
Other liabilities	(16)	(57)	–	–	(73)
C Shares	(28)	–	–	–	(28)
Trade payables and similar items	(682)	(2,707)	(554)	(185)	(4,128)
Other non-derivative financial liabilities	(333)	(2,540)	(125)	(23)	(3,021)
Contract liabilities	–	(186)	–	–	(186)
Liabilities	(2,536)	(8,575)	(3,321)	(415)	(14,847)
	(862)	(4,440)	(1,418)	(253)	(6,973)

	2019 £m	2018 £m	2017 £m	2016 £m	2015 £m
Unlisted non-current investments	4	8	2	–	14
Trade receivables and similar items ¹	139	2,644	541	62	3,386
Other non-derivative financial assets ¹	33	738	23	21	815
Other assets	–	28	–	–	28
Short-term investments	–	–	6	–	6
Cash and cash equivalents	2,269	853	1,224	97	4,443
Assets	2,445	4,271	1,796	180	8,692
Borrowings	(416)	(1,172)	(1,739)	(4)	(3,331)
Lease liabilities	(225)	(1,784)	(76)	(269)	(2,354)
Financial RRSAs	–	(25)	(85)	–	(110)
Other liabilities	(29)	(43)	–	–	(72)
C Shares	(31)	–	–	–	(31)
Trade payables and similar items ¹	(2,008)	(2,955)	(730)	(73)	(5,766)
Other non-derivative financial liabilities ¹	(526)	(2,546)	(136)	(71)	(3,279)
Contract liabilities	–	(131)	–	–	(131)
Liabilities	(3,235)	(8,656)	(2,766)	(417)	(15,074)
	(790)	(4,385)	(970)	(237)	(6,382)

¹ Balances as at 31 December 2019 have been re-presented. See note 15 and 20.

21 Financial instruments continued

Currency exposures

The Group's actual currency exposures on financial instruments 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
At 31 December 2020					
Sterling	-	-	-	(4)	(4)
US dollar	(11)	-	(2)	2	(11)
Euro	1	3	-	(17)	(13)
Other	78	9	59	-	146
At 31 December 2019					
Sterling	-	2	2	(4)	-
US dollar	-	-	(1)	-	(1)
Euro	1	(3)	-	(1)	(3)
Other	70	12	69	4	155

Ageing beyond contractual due date of financial assets

	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
At 31 December 2020					
Unlisted non-current asset investments	19	-	-	-	19
Trade receivables and similar items ¹	2,673	467	373	71	3,584
Other non-derivative financial assets	738	1	-	1	740
Other assets	28	-	-	-	28
Derivative financial assets	766	-	-	-	766
Short-term investments	-	-	-	-	-
Cash and cash equivalents	3,503	-	-	-	3,503
	7,727	468	373	72	8,640
At 31 December 2019					
Unlisted non-current asset investments	14	-	-	-	14
Trade receivables and similar items ²	3,011	210	92	73	3,386
Other non-derivative financial assets ²	811	2	1	1	815
Other assets	28	-	-	-	28
Derivative financial assets	525	-	-	-	525
Short-term investments	6	-	-	-	6
Cash and cash equivalents	4,443	-	-	-	4,443
	8,838	212	93	74	9,217

¹ Ageing on trade receivables and similar items beyond the contractual due date has increased as at 31 December 2020 due to the impact of COVID-19. See note 15.

² Balances as at 31 December 2019 have been re-presented. See note 15 and 20.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

21 Financial instruments continued**Contractual maturity analysis of non-derivative financial liabilities**

	Gross values				
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Carrying value £m
At 31 December 2020					
Borrowings	(1,174)	(183)	(1,722)	(3,041)	(5,287)
Lease liabilities	(320)	(373)	(746)	(1,091)	(2,043)
Financial RRSAs	(6)	(5)	(7)	(69)	(81)
Other liabilities	(25)	(8)	(23)	(17)	(73)
C Shares	(28)	—	—	—	(28)
Trade payables and similar items	(3,969)	(53)	(23)	(83)	(4,128)
Other non-derivative financial liabilities	(2,260)	(228)	(176)	(357)	(3,021)
Contract liabilities	(186)	—	—	—	(186)
	(7,968)	(850)	(2,697)	(4,658)	(14,847)
At 31 December 2019					
Borrowings	(511)	(722)	(662)	(1,704)	(3,331)
Lease liabilities	(425)	(306)	(872)	(1,258)	(2,354)
Financial RRSAs	(35)	(7)	(14)	(63)	(110)
Other liabilities	(34)	(23)	(10)	(5)	(72)
C Shares	(31)	—	—	—	(31)
Trade payables and similar items ¹	(5,532)	(124)	(20)	(90)	(5,766)
Other non-derivative financial liabilities ¹	(2,465)	(381)	(160)	(273)	(3,279)
Contract liabilities	(131)	—	—	—	(131)
	(9,164)	(1,563)	(1,738)	(3,393)	(15,074)

¹ Balances as at 31 December 2019 have been re-presented. See note 15 and 20.

Expected maturity analysis of derivative financial instruments

	Gross values				
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Carrying value £m
At 31 December 2020					
Derivative financial assets:					
Cash inflows	2,153	984	6,358	2,777	
Cash outflows	(2,038)	(937)	(6,122)	(2,634)	
Other net cash flows ¹	18	20	35	12	
	133	67	271	155	766
Derivative financial liabilities:					
Cash inflows	5,019	5,810	13,308	4,340	
Cash outflows	(5,557)	(6,398)	(15,189)	(4,993)	
Other net cash flows ¹	(36)	(27)	(40)	(4)	
	(574)	(615)	(1,921)	(657)	(3,472)
At 31 December 2019					
Derivative financial assets:					
Cash inflows	1,475	1,487	2,072	3,202	
Cash outflows	(1,376)	(1,448)	(2,035)	(3,085)	
Other net cash flows ¹	17	12	34	24	
	116	51	71	141	525
Derivative financial liabilities:					
Cash inflows	4,383	4,113	11,987	4,804	
Cash outflows	(4,960)	(4,737)	(13,872)	(6,186)	
Other net cash flows ¹	(5)	(5)	(4)	—	
	(582)	(629)	(1,889)	(1,382)	(3,374)

¹ Derivative financial assets and liabilities are settled on a net cash basis.

21 Financial instruments continued

Interest rate risk

In respect of income-earning financial assets and interest-bearing financial liabilities, the following table indicates their effective interest rates. The value shown is the carrying amount before taking account of swaps.

	2020			2019		
	Fixed rate £m	Floating rate £m	Total £m	Fixed rate £m	Floating rate £m	Total £m
Short-term investments	–	–	–	–	6	6
Cash and cash equivalents ¹	–	3,503	3,503	–	4,443	4,443
Borrowings	(4,576)	(711)	(5,287)	(2,252)	(1,079)	(3,331)
Lease liabilities	(1,224)	(819)	(2,043)	(1,578)	(776)	(2,354)
	(5,800)	1,973	(3,827)	(3,830)	2,594	(1,236)
Weighted average interest rates						
Borrowings	3.1%	1.3%		1.9%	1.6%	
Lease liabilities ²	3.8%	2.4%		3.6%	3.1%	

¹ Cash and cash equivalents comprises bank balances and term deposits and earn interest based on short-term floating market interest rates.

² Interest rates for lease liabilities are considered to be the discount rates at the balance sheet date.

£15m 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. At 31 December 2020 none of these were in breach (2019: none). 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.

£166m of the Group's lease liabilities include a customary loan-to-value covenant. The Group has several contractual cures available in the event the stipulated loan-to-value ratio is exceeded. Failure by the Group to satisfy its contractual obligations under the covenant gives rights to the lessor to terminate its lease and claim termination amounts for the outstanding lease balance. At 31 December 2020 the Group had not breached its contractual obligations under the covenant on any lease (2019: none).

Sensitivity analysis

Sensitivities at 31 December (all other variables held constant) – impact on profit after tax and equity	2020 £m	2019 £m
Sterling 10% weaker against the US dollar	(1,992)	(2,557)
Sterling 10% stronger against the US dollar	1,642	2,105
Euro 10% weaker against the US dollar	(315)	(376)
Euro 10% stronger against the US dollar	258	307
Sterling 10% weaker against the Euro	(14)	(32)
Sterling 10% stronger against the Euro	12	26
Commodity prices 10% lower	(20)	(32)
Commodity prices 10% higher	20	32
Interest rates 50 basis points lower	(77)	(82)
Interest rates 50 basis points higher	82	85

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

21 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 issued and fully paid C Shares during the year were as follows:

	2020		2019	
	Millions	Nominal value £m	Millions	Nominal value £m
At 1 January	30,608	31	29,071	29
Issued	88,825	89	221,954	222
Redeemed	(91,893)	(92)	(220,417)	(220)
At 31 December	27,540	28	30,608	31

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.

	2020		2019 (restated)	
	Pence per share	£m	Pence per share	£m
Interim	–	–	1.58	87
Final ¹	–	–	–	–
	–	–	1.58	87

¹ On the 6 April 2020, the Group announced that the final shareholder payment of 7.1 pence per share in respect of 2019 that was declared on 28 February 2020 would not be paid. This decision was in response to the macro-economic situation and uncertainty caused by COVID-19, preserving £137m of cash. The 2019 interim payment above has been adjusted for the bonus element of the rights issue – see note 6.

22 Provisions for liabilities and charges

	At 1 January 2020 £m	Business acquisition	Charged to income statement ¹ £m	Reversed £m	Utilised £m	Transfers to held for sale £m	Exchange differences £m	At 31 December 2020 £m
Trent 1000 exceptional costs	1,382	–	40	(560)	(541)	–	–	321
Contract losses	773	–	438	(345)	(58)	(4)	4	808
Restructuring	68	–	411	(38)	(206)	–	1	236
Warranty and guarantees	345	3	95	(9)	(104)	(14)	11	327
Customer financing	22	–	–	(5)	–	–	–	17
Insurance	70	–	10	(12)	(8)	–	–	60
Tax related interest and penalties	55	–	16	(24)	(15)	–	1	33
Employer liability claims	49	–	4	(1)	(2)	–	–	50
Other	40	1	97	(15)	(29)	–	(1)	93
	2,804	4	1,111	(1,009)	(963)	(18)	16	1,945
Current liabilities	858							826
Non-current liabilities	1,946							1,119

¹ The charge to the income statement includes £48m as a result of the unwinding of the discounting of provisions previously recognised of which £15m has been charged to underlying and £33m charged to non-underlying.

Trent 1000 exceptional costs

In November 2019, the Group announced the outcome of testing and a thorough technical and financial review of the Trent 1000 TEN programme, following technical issues which were identified in 2019, resulting in a revised timeline and a more conservative estimate of durability for the improved HP turbine blade for the TEN variant. An exceptional charge of £1,361m (at underlying exchange rates) was recorded in 2019, £1,531m at prevailing exchange rates and net of £203m reflecting insurance receipts and contract accounting adjustments. Of the charge, £1,275m was recorded in relation to Trent 1000 exceptional costs, and £459m in relation to contract losses (see below). During the year ended 31 December 2020, and reflecting the impact of COVID-19 and the work the Group has performed to reduce fleet AOG levels and improve the availability of spare engines, the total estimated Trent 1000 cash costs relating to remediation shop visits and customer disruption reduced the provision by £560m, taking into account the expected underlying exchange rates and a share of the costs borne by the RRSAs the income statement impact was £390m (see note 2). In the year the Group has utilised £541m of the Trent 1000 exceptional costs provision. This represents customer disruption costs settled in cash and credit notes, and remediation shop visit costs. The remaining provision is expected to be utilised over the period 2021 to 2023.

A 12-month delay in the availability of the modified HP turbine blade could lead to a £60m–£100m increase in the Trent 1000 provision.

22 Provisions for liabilities and charges continued

Contract losses

Provisions for contract losses are recorded when the direct costs to fulfil a contract are assessed as being greater than the expected revenue. Provisions for contract losses are expected to be utilised over the term of the customer contracts, typically within 10–15 years.

During 2019, contract losses of £459m (at prevailing exchange rates) were recognised relating to the upfront recognition of future losses on a small number of contracts which became loss making as a result of the margin impact of the updated HP turbine durability expectations on the Trent 1000 TEN. During the year, these Trent 1000 TEN loss-making contracts have improved by £230m (see note 2). For these contracts, a reduction in EFHs resulting from COVID-19 has allowed for a reassessment of shop visits required and the cost savings identified have more than offset the reduction in future revenue leading to an improvement in the overall position of these contracts.

EFHs have reduced as a result of the impact of COVID-19. For certain Civil Aerospace contracts, the impact of this reduction across the contract term has been to significantly reduce revenue without an associated reduction in shop visit costs. Consequently, during the year there have been an increased number of contracts that have become loss-making. A reduction in Civil Aerospace widebody engine flying hours of 15% and the associated decrease in revenues and costs could lead to a £10m–£15m increase in the onerous contract provision.

Additional contract losses for the Group of £406m have been recognised in the year, together with £36m relating to changes in foreign exchange and the effect of discounting.

Warranties and guarantees

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.

Restructuring

In May 2020, the Group announced a fundamental restructuring programme in response to the financial and operational impact caused by COVID-19. This activity will reshape and resize the Group with an anticipated headcount reduction of at least 9,000. As a consequence of this announcement, and based on the detailed plans communicated during 2020, a provision (net of reversals) of £373m has been recorded and recognised in cost of sales and commercial and administrative costs. During the year, £206m has been utilised as part of these plans. At 31 December 2020, the provision of £236m is expected to be utilised over the period 2021–2022. Included within the exceptional charge of £489m are costs of £116m associated with other initiatives to enable the restructuring which have been charged directly to the income statement.

Customer financing

Customer financing provisions have been made to cover guarantees provided for asset value and/or financing where it is probable that a payment will be made.

In addition to the provisions recognised, where it is not probable that a payment will be made the Group has contingent liabilities for customer financing arrangements as described below.

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 \$1.9bn (2019: \$2.8bn) (on a discounted basis) to provide facilities to enable customers to purchase aircraft (of which approximately \$630m could be called during 2021). 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. Significant events impacting the international aircraft financing market, including the COVID-19 pandemic, the failure by customers to meet their obligations under such financing agreements, or inadequate provisions for customer financing liabilities may adversely affect the Group's financial position.

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 better reflect 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 USD. 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.

	2020		2019	
	£m	\$m	£m	\$m
Gross commitments	38	52	60	79
Value of security	(14)	(19)	(9)	(11)
Indemnities	(5)	(6)	(8)	(11)
Net commitments	19	27	43	57
Net commitments with security reduced by 20% ¹	22	30	43	57

¹ Although sensitivity calculations are complex, the reduction of relevant security by 20% illustrates the sensitivity of the contingent liability to changes in this assumption.

22 Provisions for liabilities and charges continued

Insurance

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.

Tax-related interest and penalties

Provisions for tax-related interest and penalties relate to uncertain tax positions in some of the jurisdictions in which the Group operates. Utilisation of the provisions will depend on the timing of resolution of the issues with the relevant tax authorities.

Employer liability claims

The provision relating to employer healthcare liability claims is as a result of an historical insolvency of the previous provider and is expected to be utilised over the next 30 years.

Other

Other provisions comprise a number of liabilities with varying expected utilisation rates.

23 Post-retirement benefits

The Group operates a number of defined benefit and defined contribution schemes:

- The UK defined benefit scheme is funded, with the assets held in a separate trustee administered fund. Employees are entitled to retirement benefits based on either their final or career average salaries and length of service. On 31 December 2020, the scheme was closed to future accrual.
- 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 results of the most recent funding valuation, where relevant, updated by the scheme actuaries to 31 December 2020. In the UK, although the 31 March 2020 valuation is not yet finalised; the initial results have been used.

Changes to the UK defined benefit scheme

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 and Canadian 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 during 2019, the scheme completed a partial buy-in/buy-out of UK pensioner liabilities.

On 5 June 2019, the Group entered into a partial buy-in with Legal and General Assurance Society Limited covering the benefits of circa 33,000 in-payment pensioners. The buy-in was in anticipation of a buy-out, the final 10% of which concluded on 1 February 2020. Pension assets and liabilities of £422m were derecognised from the Group's balance sheet on this date and this had no impact on the income statement or OCI in the current period. In relation to this transaction, at 31 December 2019, an asset remeasurement net loss estimated at £600m was recognised within Actuarial gains/(losses) recognised in OCI.

A consultation with active managers in the UK scheme was concluded in January 2020. The consultation process agreed certain changes for the relevant manager group which would mitigate future funding cost increases. The changes gave rise to a past service gain of £35m which has been recognised as a non-underlying profit (see note 2).

On the 20 May 2020, the Group announced its intention to reshape and resize the Group due to the financial and operational impact of COVID-19. As part of this restructuring programme, a voluntary severance programme was offered to certain UK employees and pension liabilities were remeasured as at 30 June 2020 to reflect the number of members who were expected to leave the scheme. In addition, the Group agreed with the Trustee of the RRUKPF to offer a new Bridging Pension Option (BPO) to both active members and also those members leaving on severance. This option allows members to take a larger proportion of their pension prior to reaching the state retirement age and a lower amount thereafter. The accounting impact of these changes gave rise to a past service gain of £213m which was been recognised as a non-underlying profit in the period to 30 June 2020 (see note 2). The assumptions for members remaining employed have subsequently been updated to reflect actual experience, resulting in a demographic loss of £80m, which is included in Actuarial gains/(losses) recognised in OCI. In addition, for members leaving on severance, an experience loss of £47m is also included in Actuarial gains/(losses) recognised in OCI.

On the 29 July 2020, the Group announced a consultation with the active members of the UK scheme on a proposal to close the scheme to future accrual on 31 December 2020. Following the conclusion of this consultation, the closure of the scheme was confirmed, which gave rise to a non-underlying past-service credit of £67m. This primarily arises from the breakage of the link between accrued pensions and salaries for non-manager members (this link had already been largely broken for manager members as a result of the January 2020 consultation described below). Following the confirmation of the scheme closure, the Group is in discussions with the employees' representatives regarding possible additional transitional protections that could be granted from the scheme. Based on the progress of the talks up to 31 December 2020, the Group has allowed for some reductions in the change to the obligation recognised at 31 December. The final details are expected to be agreed in 2021 when any differences will be recognised.

23 Post-retirement benefits continued

Amounts recognised in the income statement

	2020			2019		
	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	153	67	220	164	52	216
Past-service (credit)/cost ¹	(308)	20	(288)	–	6	6
	(155)	87	(68)	164	58	222
Defined contribution schemes	80	84	164	66	91	157
Operating (credit)/cost	(75)	171	96	230	149	379
Net financing (credit)/charge in respect of defined benefit schemes	(26)	27	1	(59)	36	(23)
Total income statement charge	(101)	198	97	171	185	356

¹ The UK past-service credit of £308m comprises: £213m arising from the restructuring programme and the introduction of the BPO – see above; £67m as a result of the closure of the scheme to future accrual – see above; £35m as a result of the manager consultation – see above; offset by a £7m past-service cost recognised as a result of the 20 November High Court judgement that previous statutory transfer values including guaranteed minimum pensions built up between May 1990 and April 1997 must be equalised between men and women.

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2020 £m	2019 £m	2020 £m	2019 £m	2020 £m	2019 £m
Cost of sales	170	158	115	113	285	271
Commercial and administrative costs	(271)	40	26	26	(245)	66
Research and development costs	33	24	23	18	56	42
	(68)	222	164	157	96	379

Pension contributions to UK pension arrangements are generally paid via a salary sacrifice scheme under which employees agree to a reduction in gross contractual pay in return for the Group making additional pension contributions on their behalf. As a result, there is a decrease in wages and salaries and a corresponding increase in pension costs of £46m (2019: £47m) in the year.

Net financing comprises:

	2020			2019		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Financing on scheme obligations	148	54	202	303	66	369
Financing on scheme assets	(174)	(27)	(201)	(362)	(30)	(392)
Net financing (income)/charge in respect of defined benefit schemes	(26)	27	1	(59)	36	(23)
Financing income on scheme surpluses	(26)	(2)	(28)	(59)	(1)	(60)
Financing cost on scheme deficits	–	29	29	–	37	37

Amounts recognised in OCI in respect of defined benefit schemes

	2020			2019		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Actuarial gains and losses arising from:						
Demographic assumptions ¹	(85)	34	(51)	309	38	347
Financial assumptions ²	(1,387)	(246)	(1,633)	(1,723)	(228)	(1,951)
Experience adjustments ³	(157)	(7)	(164)	79	29	108
Return on scheme assets excluding financing income ²	1,166	92	1,258	456	106	562
	(463)	(127)	(590)	(879)	(55)	(934)

¹ For the UK Scheme, this includes the change in assumption on the take-up rate for the BPO (see above) and reflects latest available CMI mortality projections and an update of the post-retirement mortality assumptions based on an analysis prepared for the 31 March 2020 funding valuation.

² These arise primarily due to changes in interest rates and inflation.

³ This reflects updated membership data available from the 31 March 2020 funding valuation, actual experience of options selected by members leaving employment under the voluntary severance arrangements (see above) offset by lower than expected pension and deferred pension increases.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

23 Post-retirement benefits continued**Amounts recognised in the balance sheet in respect of defined benefit schemes**

	2020			2019		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(8,879)	(895)	(9,774)	(8,499)	(842)	(9,341)
Fair value of scheme assets	9,762	894	10,656	9,640	845	10,485
Net asset/(liability) on funded schemes	883	(1)	882	1,141	3	1,144
Present value of unfunded obligations	–	(1,568)	(1,568)	–	(1,352)	(1,352)
Net asset/(liability) recognised in the balance sheet	883	(1,569)	(686)	1,141	(1,349)	(208)
Post-retirement scheme surpluses ¹	883	24	907	1,141	29	1,170
Post-retirement scheme deficits	–	(1,580)	(1,580)	–	(1,378)	(1,378)
Included in liabilities associated with assets held for sale	–	(13)	(13)	–	–	–

¹ The surplus in the UK scheme is recognised as on an ultimate wind-up when there are no longer any remaining members, any surplus would be returned to the Group, which has the power to prevent the surplus being used for other purposes in advance of this event.

Overseas schemes are located in the following countries:

	2020			2019		
	Assets £m	Obligations £m	Net £m	Assets £m	Obligations £m	Net £m
Canada	243	(293)	(50)	227	(275)	(48)
Germany	2	(1,016)	(1,014)	2	(853)	(851)
US pension schemes	649	(669)	(20)	616	(635)	(19)
US healthcare schemes	–	(469)	(469)	–	(420)	(420)
Other	–	(16)	(16)	–	(11)	(11)
Net asset/(liability) recognised in the balance sheet	894	(2,463)	(1,569)	845	(2,194)	(1,349)

Defined benefit schemes**Assumptions**

Significant actuarial assumptions for the UK scheme at the balance sheet date were as follows:

	2020	2019
Discount rate	1.45%	2.15%
Inflation assumption (RPI) ¹	3.10%	3.15%
Rate of increase in salaries ²	2.55%	3.15%
Transfer assumption (active/deferred)	40%/40%	45%/35%
Bridging Pension Option assumption	30%	n/a
Life expectancy from age 65: current male pensioner	21.8 years	21.8 years
future male pensioner currently aged 45	23.2 years	23.1 years
current female pensioner	23.6 years	23.1 years
future female pensioner currently aged 45	25.4 years	25.0 years

¹ This is the assumption for the Retail Price Index. The Consumer Price Index is assumed to be on average 0.55% lower, taking account of the announcement in 2020 that from 2030, RPI will be replaced by CPIH (2019: 1.0% lower).

² Following the closure to future accrual, future salaries do not affect the defined benefit obligation. This assumption (with zero increase in 2021) was made to determine the split between past-service credit arising from the closure included in the income statement and the actuarial gain or loss included in OCI.

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.

The inflation assumption is determined by the market-implied assumption based on the yields on long-term index-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 SAPS S3 'All' actuarial tables, with future improvements in line with the CMI 2019 core projections updated to reflect use of an 'A' parameter of 0.25% for future improvements and long-term improvements of 1.25%. Where appropriate, these are adjusted to take account of the scheme's actual experience.

The assumption for transfers and the BPO is based on actual experience and actuarial advice. The reduction in the transfer assumption is a result of the introduction of the BPO, and assumes that 15% of retiring members opt for the BPO rather than transfer.

Other assumptions have been set on advice from the 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 scheme, combined with the inflation assumption where the increase is capped.

23 Post-retirement benefits continued

Assumptions for overseas schemes are less significant and are based on advice from local actuaries. The principal assumptions are:

	2020	2019
Discount rate	1.80%	2.40%
Inflation assumption	1.90%	1.90%
Long-term healthcare cost trend rate	4.73%	4.80%
Male life expectancy from age 65: current pensioner	20.8 years	21.4 years
future pensioner currently aged 45	22.4 years	21.7 years

Changes in present value of defined benefit obligations

	2020			2019		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	(8,499)	(2,194)	(10,693)	(10,847)	(2,047)	(12,894)
Exchange differences	–	(5)	(5)	–	71	71
Current service cost	(147)	(65)	(212)	(158)	(50)	(208)
Past-service credit/(cost)	308	(15)	293	–	–	–
Finance cost	(148)	(53)	(201)	(303)	(65)	(368)
Contributions by employees	(2)	(3)	(5)	(2)	(3)	(5)
Benefits paid out	816	100	916	571	79	650
Acquisition of businesses	–	–	–	–	(2)	(2)
Disposal of businesses	–	–	–	–	28	28
Actuarial losses	(1,629)	(225)	(1,854)	(1,335)	(168)	(1,503)
Transfers	–	(3)	(3)	–	(37)	(37)
Settlement	422	–	422	3,575	–	3,575
At 31 December	(8,879)	(2,463)	(11,342)	(8,499)	(2,194)	(10,693)
Funded schemes	(8,879)	(895)	(9,774)	(8,499)	(842)	(9,341)
Unfunded schemes	–	(1,568)	(1,568)	–	(1,352)	(1,352)

The defined benefit obligations are in respect of:

Active plan participants ¹	(4,369)	(1,362)	(5,731)	(4,751)	(1,185)	(5,936)
Deferred plan participants	(2,750)	(197)	(2,947)	(2,154)	(171)	(2,325)
Pensioners	(1,760)	(904)	(2,664)	(1,594)	(838)	(2,432)
Weighted average duration of obligations (years)	23	16	22	23	16	22

¹ Although the UK scheme closed to future accrual on 31 December 2020, members who became deferred as a result of the closure and remain employed by the Group retain some additional benefits compared to other deferred members. The obligations for these members are shown as active plan participants.

Changes in fair value of scheme assets

	2020			2019		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	9,640	845	10,485	12,773	735	13,508
Exchange differences	–	(27)	(27)	–	(17)	(17)
Administrative expenses	(6)	(2)	(8)	(6)	(2)	(8)
Financing	174	27	201	362	30	392
Return on plan assets excluding financing	1,166	92	1,258	456	106	562
Contributions by employer	24	56	80	199	67	266
Contributions by employees	2	3	5	2	3	5
Benefits paid out	(816)	(100)	(916)	(571)	(79)	(650)
Acquisition of businesses	–	–	–	–	2	2
Settlement	(422)	–	(422)	(3,575)	–	(3,575)
At 31 December	9,762	894	10,656	9,640	845	10,485
Total return on scheme assets	1,340	119	1,459	818	136	954

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

23 Post-retirement benefits continued

Fair value of scheme assets at 31 December

	2020			2019		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Sovereign debt	7,220	276	7,496	5,799	277	6,076
Corporate debt instruments	2,878	521	3,399	3,135	467	3,602
Interest rate swaps	52	–	52	14	–	14
Inflation swaps	(55)	–	(55)	(18)	–	(18)
Cash and similar instruments ¹	(1,156)	10	(1,146)	(784)	13	(771)
Liability driven investment (LDI) portfolios ²	8,939	807	9,746	8,146	757	8,903
Listed equities	–	71	71	323	76	399
Unlisted equities	64	–	64	95	–	95
Synthetic equities ³	41	12	53	3	5	8
Corporate debt instruments	709	–	709	662	4	666
Cash	–	6	6	–	4	4
Partial buy-in insurance policy	–	–	–	408	–	408
Other	9	(2)	7	3	(1)	2
At 31 December	9,762	894	10,656	9,640	845	10,485

¹ Cash and similar instruments include repurchase agreements on UK Government bonds amounting to £(1,539)m (2019: £(1,308)m). The latest maturity date for these short-term borrowings is September 2022.

² A portfolio of gilt and swap contracts, backed by investment-grade credit instruments and LIBOR-generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

³ Portfolios of swap contracts designed to provide investment returns in line with global equity markets. The maximum exposure (notional value and accrued returns) on the portfolios was £727m (2019: £328m).

The investment strategy for the UK scheme is controlled by the Trustee in consultation with the Group. The scheme assets do not directly include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group. At 31 December 2020, there was no indirect holding of the Group's financial instruments (2019: £0.1m).

Future contributions

The Group expects to contribute approximately £160m to its defined benefit schemes in 2021 (2020: £170m): UK: £100m, Overseas: £60m (2019: UK: £100m, Overseas: £70m).

In the UK, the funding is based on a statutory triennial funding valuation process. This includes a negotiation between the Group and the Trustee on actuarial assumptions used to value obligations (Technical Provisions) which may differ from those used for accounting set out above. The assumptions used to value Technical Provisions must be prudent rather than a best estimate of the liability. Most notably, the Technical Provision discount rate is currently based upon UK Government yields plus a margin (0.5% at the 31 March 2017 valuation) rather than being based on yields of AA corporate bonds. Following the triennial valuation process, a Schedule of Contributions (SoC) must be agreed which sets out the agreed rate of cash contributions and any contributions from the employer to eliminate a deficit. The most recent valuation, as at 31 March 2017, agreed by the Trustee in December 2017, showed that the UK scheme was estimated to be 112% funded on the Technical Provisions basis. Following the closure of the scheme to future accrual on 31 December 2020, no contributions will be made in respect of future accrual and there are no deficit reduction contributions. The 2021 contributions included above are in respect of 2020 accrual, payment of some of which was deferred in agreement with the Trustee as a result of the COVID-19 pandemic. The current SoC (amended in 2020) includes an arrangement for potential contributions during 2024 to 2027 (capped at £48.3m a year) if the Technical Provisions funding position is below 107% at 31 March 2023. As at 31 December 2020 discussions on the 31 March 2020 triennial valuation were ongoing and the Technical Provisions funding position cannot be estimated until these discussions are concluded in the first half of 2021.

23 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 2020, 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 hedge the risks from interest rates and inflation measured on a proxy solvency basis.

For the UK scheme, the interest rate and inflation hedging is currently based on UK Government bond yields without any adjustment for any credit spread. The sensitivity analysis set out below have been determined based on a method that estimates the impact on the defined benefit obligation as a result of reasonable changes in key assumptions occurring at the end of the reporting period.

		2020 £m	2019 £m
Reduction in the discount rate of 0.25% ¹	Obligation	(530)	(495)
	Plan assets (LDI portfolio)	602	502
Increase in inflation of 0.25% ¹	Obligation	(290)	(290)
	Plan assets (LDI portfolio)	267	235
Increase in real increase in salaries of 0.25%	Obligations	n/a	(80)
Increase of 1% in transfer value assumption	Obligations	(67)	(64)
Increase of 5% of transfers instead of BPO	Obligations	(45)	n/a
One year increase in life expectancy	Obligations	(455)	(408)

¹ The differences between the sensitivities on obligations and plan assets arise largely due to differences in the methods used to value the obligations for accounting purposes and the adopted proxy solvency basis.

24 Share capital

	Non-equity		Equity	
	Special Share of £1	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid				
At 1 January 2019	1	–	1,896	379
Shares issued to employee share trust	–	–	6	1
Shares issued in relation to the acquisition of ITP Aero	–	–	29	6
At 31 December 2019	1	–	1,931	386
Shares issued on rights issue	–	–	6,437	1,288
At 31 December 2020	1	–	8,368	1,674

The rights attaching to each class of share are set out on page 208.

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 21.

Issue of new shares

On 12 November 2020, the Company completed a rights issue to existing shareholders on the basis of ten ordinary shares for every three fully paid ordinary shares held. As a result, 6,436,601,676 ordinary shares with an aggregate nominal value of £1,288m were issued for cash consideration of £2,060m. Transaction costs directly attributable to the rights issue of £79m were incurred and have been accounted for as a deduction from share premium.

25 Share-based payments

Effect of share-based payment transactions on the Group's results and financial position

	2020 £m	2019 £m
Total expense recognised for equity-settled share-based payments transactions	27	30
Total expense recognised for cash-settled share-based payments transactions	(2)	–
Share-based payments recognised in the consolidated income statement	25	30
Liability for cash-settled share-based payment	–	1

A description of the share-based payment plans is included in the Directors' Remuneration Report on pages 81 to 100.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

25 Share-based payments continued**Movements in the Group's share-based payment plans during the year**

	ShareSave		LTIP	APRA
	Number Millions	Weighted average exercise price ¹ Pence		
Outstanding at 1 January 2019	26.1	713	13.9	0.4
Granted	16.6	677	5.3	0.2
Forfeited	(5.1)	814	(0.9)	–
Exercised	(5.7)	627	(5.1)	(0.2)
Outstanding at 1 January 2020	31.9	693	13.2	0.4
Granted	–	–	23.0	0.3
Forfeited	(15.9)	237	(2.8)	–
Exercised	–	–	(3.2)	(0.2)
Changes as a result of the rights issue ¹	33.6	239	37.4	0.9
Outstanding at 31 December 2020	49.6	239	67.6	1.4
Exercisable at 31 December 2020	–	–	–	–
Exercisable at 31 December 2019	–	–	–	–

¹ The weighted average exercise price for share movements during 2020 has been re-based following the rights issue in November 2020.

The weighted average share price at the date share options were exercised was 203p (2019 adjusted: 311p). The closing price at 31 December 2020 was 111p (2019 adjusted: 234p). The number of shares and, where relevant, the exercise prices have been adjusted to reflect the impact of the rights issue which completed on 12 November 2020.

The weighted average remaining contractual life for the share options as at 31 December 2020 was two years (2019: one year).

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:

	2020	2019
LTIP	388p	851p
LTIP (ELT & Board)	354p	774p
ShareSave – three year grant	n/a	165p
ShareSave – five year grant	n/a	176p
APRA	490p	892p

LTIP

The fair value of shares awarded 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 decreases the fair value of the award relative to the share price at the date of grant.

ShareSave

The fair value of the options granted is calculated using a 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).

26 Contingent liabilities

Contingent liabilities in respect of customer financing commitments are described in note 22.

In January 2017, after full cooperation, the Company concluded deferred prosecution agreements (DPA) with the SFO and the US Department of Justice (DoJ) and a leniency agreement with the MPF, the Brazilian federal prosecutors. Following the expiry of its term the DPA with the DoJ was dismissed by the US District Court on 19 May 2020. Certain authorities are investigating members of the Group for matters relating to misconduct in relation to historical matters. The Group is responding appropriately. Action may be taken by further authorities against the Company or individuals. In addition, the Group could still be affected by actions from customers and customers' financiers. The Directors are not currently aware of any matters that are likely to lead to a material financial loss over and above the penalties imposed to date, but cannot anticipate all the possible actions that may be taken or their potential consequences.

26 Contingent liabilities continued

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, commitments made for future service demand in respect of maintenance, repair and overhaul, and 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 nil (2019: nil).

27 Related party transactions

	2020 £m	2019 £m
Sales of goods and services to joint ventures and associates ¹	3,760	3,776
Purchases of goods and services from joint ventures and associates ¹	(4,288)	(3,685)
Lease payments to joint ventures and associates	(226)	(210)
Guarantees of joint arrangements' and associates' borrowings	3	1
Guarantees of non-wholly owned subsidiaries' borrowings	3	3
Dividends received from joint ventures and associates	60	92
Other income received from joint ventures and associates	3	1

¹ Included at the exchange rate achieved on settled derivative contracts, consistent with note 2. At the average exchange rate, sales were £3,768m (2019: £4,485m) and purchases were £4,292m (2019: £4,442m).

Included in sales of goods and services to joint ventures and associates are sales of spare engines amounting to £102m (2019: £277m). Profit recognised in the year on such sales amounted to £91m (2019: £93m), including profit on current year sales and recognition of profit deferred on sales in previous years. On an underlying basis (at actual achieved rates on settled derivative transactions), the amounts were £90m (2019: £78m). Cash receipts relating to the sale of spare engines amounted to £193m (2019: £414m).

The aggregated balances with joint ventures are shown in notes 15 and 20. Transactions with Group pension schemes are shown in note 23.

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 (pages 64 to 66) and the members of the Executive Team (described on page 62). Remuneration for key management personnel is shown below:

	2020 £m	2019 £m
Salaries and short-term benefits	7	9
Post-retirement schemes	-	-
Share-based payments	1	5
	8	14

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 81 to 100. The charge for share-based payments above is based on when the award is charged to the income statement in accordance with IFRS 2 *Share-Based Payments*, rather than when the shares vest, which is the basis used in the Directors' Remuneration Report.

28 Acquisitions and disposals

Acquisitions

On 15 January 2020, the Group completed the acquisition of Qinous GmbH (increasing its shareholding from 24% to 100%) for a cash consideration of €15m, of which €10m was paid on completion. A further €2m is payable in September 2021 and €3m in September 2023. Under the sale agreement, the cash consideration may be adjusted up by €3m to €18m based on a revenue target being achieved by 31 December 2023. In accordance with IFRS 3 *Business Combinations* the pre-acquisition shareholding of 24% has been re-measured to fair value of €5m and a revaluation gain of €2m has been recognised in the income statement.

On the 7 March 2020, the Group signed an agreement to acquire 100% of the shares of Kinolt Group S.A., a Belgian company which designs and manufactures uninterruptible power supply systems. The transaction was completed on 1 July 2020 for net proceeds of €115m. The acquisition of Kinolt Group S.A. completes the Group's power supply product offering, accelerates its strategy of offering integrated solutions and enables the Group to strengthen its market position in safety critical applications with a leader in dynamic uninterruptible power supply. Fair values are determined on the basis of an assessment performed by an independent professional expert, using measurement techniques and estimation of future cash flows to assess the values of identifiable assets and liabilities at the date of acquisition. The total fair value of acquired identifiable assets and liabilities was €65m, primarily related to technology and customer relationships. Goodwill of €50m was recognised on acquisition in relation to workforce, future products, synergies and access to new customers and markets.

On 18 May 2020, the Group entered into an agreement to increase its shareholding in Reaction Engines Ltd from 2.0% to 10.1% for a cash consideration of £20m. The consideration is payable (and the associated shares acquired) in four instalments that will be made between July 2020 and January 2022. Reaction Engines is accounted for as an investment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

28 Acquisitions and disposals continued

On the 7 December 2020, the Group completed the acquisition of Servowatch Systems Limited (SSL) for a cash consideration of £5m. The acquisition will provide key technology within Power Systems for the Naval and Commercial Marine markets. The Group has performed a final assessment to determine the fair values of the identifiable assets and liabilities acquired in accordance with IFRS 3 and has identified intangible assets amounting to £5m and £(4)m of other assets and liabilities. Goodwill of £4m was recognised on acquisition in relation to workforce and synergies.

Recognised amounts of assets acquired and liabilities assumed

	Qinous £m	Kinolt £m	Servowatch £m	Total £m
Intangible assets	14	61	5	80
Property, plant and equipment	–	17	–	17
Right-of-use assets	–	1	–	1
Inventory	3	42	1	46
Trade receivables and other assets	1	17	1	19
Cash and cash equivalents	–	11	–	11
Trade and other payables	(5)	(47)	(5)	(57)
Provisions	–	(4)	–	(4)
Borrowings and lease liabilities	–	(24)	–	(24)
Deferred tax	(3)	(16)	(1)	(20)
Total identifiable assets and liabilities	10	58	1	69
Goodwill arising	7	46	4	57
Total consideration	17	104	5	126

Consideration satisfied by:

Existing shareholding	4	–	–	4
Cash	8	104	5	117
Deferred consideration	5	–	–	5
	17	104	5	126

Net cash outflow arising on acquisition:

Cash and cash equivalents	8	104	5	117
Less: Cash and cash equivalents acquired	–	(11)	–	(11)
	8	93	5	106

Identifiable intangible assets comprise:

Customer relationships	–	37	4	41
Technology assets	14	22	–	36
Development expenditure	–	2	1	3
	14	61	5	80

The gross contractual value of trade receivables acquired was £15m. At the acquisition dates, it was estimated that contractual cash flows of £1m would not be collected.

The acquisitions of Qinous and Kinolt contributed £5m and £50m to revenue respectively and Qinous contributed £(10)m to loss before tax (including amortisation of the acquisition accounting adjustments) for the period between the date of acquisition and the 31 December 2020. If the acquisitions had been completed on 1 January 2020, the contribution to the Group's revenues and loss before tax due to Qinous would have been £5m and £(10)m respectively and due to Kinolt would have been £68m and £(4)m respectively.

Transaction costs of £3m have been expensed during the year relating to the acquisitions of Qinous, Kinolt and Servowatch.

Disposals

On the 31 January 2020, the Group completed the sale of its North America Civil Nuclear (NACN) business to Westinghouse Electric Company LLC. for \$25m. The business was disclosed as a disposal group held for sale at 31 December 2019. In the 2019 financial statements, the Group reported an impairment charge of £25m as a result of the decision to classify NACN as a business held for sale. Upon the disposal of NACN on 31 January 2020, and in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the Group has recycled the cumulative currency translation reserve through the income statement in 2020. This has resulted in a cumulative currency translation loss of £7m.

On the 3 February 2020, the Group sold its Knowledge Management Systems (KMS) business to Valsoft Corp. for a cash consideration of \$3m. Upon the disposal of KMS, and in accordance with IAS 21 the Group has recycled the cumulative currency translation reserve through the income statement in 2020. This has resulted in a cumulative currency translation gain of £3m.

On the 7 May 2020, the Group sold Trigno Energy Srl (Trigno) to Pilkington Italia S.p.A. for a cash consideration of €6m. Upon the disposal of Trigno, and in accordance with IAS 21 the Group has recycled the cumulative currency translation reserve through the income statement in 2020. This has resulted in a cumulative currency translation gain of £1m.

28 Acquisitions and disposals continued

On the 17 May 2020, the Group signed an agreement to sell its 18% shareholding in Exostar LLC for an initial cash consideration of \$23m. The transaction was completed on 6 July 2020. Upon the disposal of Exostar, and in accordance with IAS 21 the Group has recycled the cumulative currency translation reserve through the income statement in 2020. This has resulted in a cumulative currency translation loss of £3m.

	NACN £m	KMS £m	Trigno £m	subsidiaries £m	Total Exostar (investment) £m	Total £m
Proceeds						
Cash consideration	19	2	4	25	18	43
Cash and cash equivalents disposed	(9)	(2)	(4)	(15)	–	(15)
Net cash consideration per cash flow statement	10	–	–	10	18	28
Less: Net (assets)/liabilities disposed	(4)	1	(2)	(5)	(6)	(11)
Profit/(loss) on disposal before disposal costs and continuing obligations	6	1	(2)	5	12	17
Cumulative currency translation (loss)/gain	(7)	3	1	(3)	(3)	(6)
Disposal costs	(1)	–	–	(1)	–	(1)
(Loss)/Profit before tax	(2)	4	(1)	1	9	10

Disposal completed in prior periods

On 1 June 2018, the Group sold its L'Orange business, part of Rolls-Royce Power Systems, to Woodward Inc. for €673m. Under the sale agreement, the cash consideration may be adjusted by up to +/-€44m, based on L'Orange aftermarket sales over the five-year period to 31 May 2023. This is reviewed at each reporting date over the adjustment period, based on actual sales. During the year, a liability of €29m has been recognised for amounts that are now expected to be payable in relation to the years 2020–2023 as a result of a reduction in aftermarket sales as a consequence of the impact of COVID-19. This €29m liability has been reflected as an adjustment to sales proceeds. Cash consideration has been adjusted by £5m which has been paid during the year.

Reconciliation of loss on acquisition & disposal of businesses per the income statement	£m
Profit on disposal of businesses	10
Gain on revaluation of Qinous	1
Adjustment to L'Orange sales proceeds	(25)
Loss on acquisition & disposal of businesses (income statement – non-underlying)	(14)

Businesses held for sale

On 28 February 2020, the Group announced the decision to carry out a strategic review of Bergen, our medium-speed gas and diesel engine business. Bergen formed part of the Power Systems business and from 2020 it has been reclassified as non-core following the announcement of the strategic review. On 1 February 2021, the Group signed an agreement for the sale of Bergen to TMH Group for a cash consideration of approximately €150m (subject to closing adjustments) which is expected to complete in the second half of 2021. Consequently, in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, Bergen has been classified as held for sale at 31 December 2020. As at 31 December 2020, Bergen had an additional £25m of cash which, as part of bank pooling arrangements, was held by another Group company and consequently is not included in the disposal group as the resulting intra-group balances are eliminated on consolidation. On completion, such cash will be included in the disposal group.

On 7 December 2020, the Group signed an agreement for the sale of Civil Nuclear Instrumentation & Control business to Framatome. Consequently, in accordance with IFRS 5, the business has been classified as held for sale at 31 December 2020 and its carrying value assessed against the anticipated proceeds and disposal costs.

The table below summarises the categories of assets and liabilities classified as held for sale:

	Bergen £m	Civil Nuclear £m	Total £m
Intangible assets	–	16	16
Property, plant and equipment	3	4	7
Right-of-use assets	2	7	9
Deferred tax assets	2	4	6
Cash and cash equivalents	25	26	51
Inventory	97	14	111
Trade receivables and other assets	50	38	88
Assets held for sale	179	109	288
Trade payables and other liabilities	(100)	(84)	(184)
Provisions for liabilities and charges	(11)	(7)	(18)
Borrowings and lease liabilities	(4)	(7)	(11)
Deferred tax liabilities	(2)	–	(2)
Post-retirement scheme deficits	–	(13)	(13)
Liabilities associated with assets held for sale	(117)	(111)	(228)
Net assets held for sale	62	(2)	60

During the year, the Group announced its intention to sell ITP Aero. At 31 December 2020, ITP Aero was not available for immediate sale in its present condition and therefore, in line with IFRS 5 has not been classified as a disposal group. The assets of ITP Aero have been assessed for impairment in accordance with IAS 36 on a value in use basis which assumes the value will be realised over the long-term.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

29 Derivation of summary funds flow statement

	2020		2019		Source
	£m	£m	£m	£m	
Underlying operating (loss)/profit (see note 2)		(1,972)		808	Note 2
Amortisation and impairment of intangible assets	902		372		Cash flow statement (CFS)
Depreciation and impairment of property, plant and equipment	821		532		CFS
Depreciation and impairment of right-of-use assets	732		411		CFS
Adjustment to residual value guarantees in lease liabilities	(102)		–		CFS
Impairment of joint ventures	24		–		Note 13
Reversal of non-underlying impairments of non-current assets	(1,293)		(84)		Reversal of underlying adjustment (note 2)
Acquisition accounting	(133)		(163)		Reversal of underlying adjustment (note 2)
Depreciation and amortisation		951		1,068	
Additions of intangible assets		(316)		(591)	CFS less exceptional restructuring (see below)
Purchases of property, plant and equipment		(579)		(747)	CFS
Lease payments (capital plus interest)		(379)		(319)	CFS (payments adjusted for foreign exchange (FX))
Decrease/(increase) in inventories		588		(43)	CFS
Movement in receivables/payables	(2,332)		(33)		CFS adjusted for the impact of exceptional programme charges and exceptional restructuring shown on the basis of the FX rate achieved on settled derivative contracts
Movement in contract balances (excluding Civil LTSA)	(276)		526		CFS adjusted for the impact of exceptional programme charges and FX and excluding Civil LTSA (shown separately below)
Underlying movement in Civil LTSA contract balances	479		754		Movement in Civil Aerospace LTSA balances within movement of contract balances in CFS less impact of FX
Revaluation of trading assets (excluding exceptional items)	(299)		265		Adjustment to reflect the impact of the FX contracts held on receivables/payables
Realised derivatives in financing	700		(266)		Realised cash flows on FX contracts not included in underlying operating profit less cash flows on settlement of excess derivative contracts
Movement on receivables/payables/contract balances		(1,728)		1,246	
Movement on provisions		(195)		(506)	CFS adjusted for the impact of exceptional programme charges and anticipated recoveries, exceptional restructuring and FX contracts held
Net interest received and paid		(75)		(73)	CFS
Fees paid on undrawn facilities		(97)		–	CFS
Cash flows on settlement of excess derivative contracts		(202)		–	CFS
Cash flows on financial instruments net of realised losses included in operating profit		(8)		(15)	Cash flows on other financial instruments (CFS) not allocated to lease payments or exceptional programme expenditure adjusted for the impact of FX not held for trading
Trent 1000 insurance	–		173		Included in movements in payables and provisions in CFS
Other	(102)		56		Principally disposals of non-current assets, joint venture trading and the effect of share-based payments
Trading cash flow		(4,114)		1,057	
Underlying operating profit charge in excess of contributions to defined benefit schemes	160		(9)		CFS excluding additional contribution of £35m shown below
Tax	(231)		(175)		CFS
Free cash flow		(4,185)		873	
Shareholder payments		(92)		(224)	CFS (includes dividends to NCI)
Proceeds of rights issue (net of expenses and rights taken by employee share trust)	1,972		–		CFS
Acquisition of businesses	(130)		(43)		CFS
Disposal of businesses		23		453	CFS
Exceptional restructuring costs	(323)		(216)		£268m related to severance costs and £55m capital expenditure (2019: £167m and £49m respectively)
DPA payments	(135)		(102)		CFS
Pension fund contribution	–		(35)		CFS
Difference in fair values of derivative contracts held for financing	(26)		(2)		CFS
Payments of lease principal less new leases and other non-cash adjustments to lease liabilities	311		123		CFS adjusted for the impact of FX
Foreign exchange	51		(98)		CFS less allocation to leases above
Other	(49)		(6)		Cash outflow on M&A spend and timing of cash flows on a prior period disposal. See below.
Change in net (debt)/funds		(2,583)		723	
Change in net (debt)/funds		(2,583)		723	
Non-cash lease impact		(311)		(123)	
Reclassification of other financial liabilities to borrowings		–		(79)	
Change in net (debt)/funds excluding lease liabilities		(2,894)		521	

29 Derivation of summary funds flow statement continued

The comparative information for the year ended 31 December 2019 has been re-presented to be on a comparable basis with the presentation adopted for the year ended 31 December 2020. There is no change to trading or group free cash flow. In summary: (i) cash flows on financial instruments net of realised losses included in operating profit previously included in other within trading cash flow, have been shown separately; (ii) differences in fair values of derivative contracts held for financing previously included in other below free cash flow have been shown separately; and (iii) foreign exchange transactions have been re-presented within line items to be consistent with presentation throughout the financial statements.

Free cash flow is a measure of financial performance of the Group's cash flow to see what is available for distribution among those stakeholders funding the Group (including debt holders and shareholders). Free cash flow is the movement in net debt from cash flows excluding: transactions with ordinary shareholders; M&A activity; financial penalties paid; exceptional restructuring payments; and the capital element of lease payments. The Board considers that free cash flow reflects cash generated from the Group's underlying trading.

The table below shows a reconciliation of free cash flow to the change in cash and cash equivalents presented in the condensed consolidated cash flow statement on page 109.

	2020		2019		Source
	£m	£m	£m	£m	
Change in cash and cash equivalents	(995)		(413)		CFS
Net cash flow from changes in borrowings and lease liabilities	(1,630)		1,385		CFS excluding repayment of debt acquired. See below.
Decrease in short-term investments	(6)		–		CFS
Movement in net (debt)/funds from cash flows	(2,631)		972		
Exclude: Capital element of lease repayments	(284)		(271)		CFS
Movement in net (debt)/funds from cash flows (excluding lease liabilities)	(2,915)		701		
Rights issue	(1,972)		–		CFS
Returns to shareholders	92		224		CFS
Acquisition of businesses	130		43		CFS including repayment of debt acquired
Disposal of businesses	(23)		(453)		CFS
Other acquisitions and disposals	12		1		£12m related to costs incurred on central M&A activity
Changes in group structure	119		(409)		
Payments of financial penalties	135		102		CFS
Exceptional restructuring costs	323		216		£268m related to severance costs and £55m capital expenditure (2019: £167m and £49m respectively)
Pension fund contribution	–		35		Additional contribution in connection with the pensioner buy-out (note 23)
Other	33		4		Timing of cash flows on a prior period disposal where the Group retains the responsibility for collecting cash before passing it on to the acquirer
Free cash flow	(4,185)		873		

COMPANY FINANCIAL STATEMENTS

Company balance sheet

At 31 December 2020

	Notes	2020 £m	2019 £m
ASSETS			
Investments – subsidiary undertakings	2	14,688	12,801
Trade receivables and other assets	3	–	1,870
Cash and cash equivalents		–	9
Current assets		–	1,879
TOTAL ASSETS		14,688	14,680
LIABILITIES			
Trade payables and other liabilities	4	(331)	(2,228)
Other financial liabilities	5	(28)	(31)
Current liabilities		(359)	(2,259)
NET ASSETS		14,329	12,421
EQUITY			
Called-up share capital	6	1,674	386
Share premium		1,012	319
Merger reserve		6,962	7,051
Capital redemption reserve		2,744	2,652
Other reserve		275	248
Retained earnings		1,662	1,765
TOTAL EQUITY		14,329	12,421

The Company has elected to take the exemption under section 408 of the Companies Act 2006 from presenting the parent company income statement. The loss for the Company for the year was £1m (2019: profit £1,498m).

The Financial Statements on pages 177 to 182 were approved by the Board on 11 March 2021 and signed on its behalf by:

Warren East Stephen Daintith
Chief Executive Chief Financial Officer

Company's registered number: 7524813

Company statement of changes in equity

For the year ended 31 December 2020

	Attributable to ordinary shareholders						
	Share capital £m	Share premium £m	Merger reserve ¹ £m	Capital redemption reserve £m	Other reserve ² £m	Retained earnings ³ £m	Total equity £m
At 1 January 2019	379	268	7,029	2,432	218	529	10,855
Profit for the year	–	–	–	–	–	1,498	1,498
Arising on issues of ordinary shares ⁵	7	51	244	–	–	–	302
Issue of C Shares	–	–	(222)	–	–	–	(222)
Redemption of C Shares	–	–	–	220	–	(220)	–
Share-based payments – direct to equity	–	–	–	–	30	(42)	(12)
At 1 January 2020	386	319	7,051	2,652	248	1,765	12,421
Loss for the year	–	–	–	–	–	(1)	(1)
Arising on issue of ordinary shares ⁵							
– Rights issue ⁴	1,288	693	–	–	–	(10)	1,971
Issue of C Shares	–	–	(89)	–	–	1	(88)
Redemption of C Shares	–	–	–	92	–	(92)	–
Ordinary shares purchased	–	–	–	–	–	(1)	(1)
Share-based payments – direct to equity	–	–	–	–	27	–	27
At 31 December 2020	1,674	1,012	6,962	2,744	275	1,662	14,329

¹ The Company's merger reserve was created as a result of a High Court approved scheme of arrangement in 2011, when the Company became the holding company for the Rolls-Royce Group.² Other reserve represents the value of the share-based payments in respect of employees of subsidiary undertakings for which payment has not been received.³ The reserves, which are distributable to the Company's equity shareholders, are determined with reference to the Companies Act 2006 and requires judgement in determining the amount available for distribution. Further guidance is given in the Institute of Chartered Accountants in England and Wales technical release 02/17BL in relation to what profits can be treated as distributable. At 31 December 2020, all the Company's retained earnings are distributable, however, the available amount may be different at the point any future distributions are made.⁴ On 12 November 2020, the Company completed a rights issue to existing shareholders on the basis of ten ordinary shares for every three fully paid ordinary shares held. As a result, 6,436,601,676 ordinary shares with an aggregate nominal value of £1,288m were issued for cash consideration of £2,060m. Transaction costs of £79m were incurred and deducted from share premium.⁵ At 31 December 2020, 39,866,717 ordinary shares with a net book value of £89m (2019: 12,476,576 ordinary shares with a net book value of £108m) were held for the purpose of share-based payment plans and included in accumulated losses. During the year, 3,458,865 ordinary shares with a net book value of £29m (2019: 8,984,219 ordinary shares with a net book value of £82m) vested in share-based payment plans. During the year, the Company acquired 85,724 (2019: 118,831) of its ordinary shares via reinvestment of dividends received on its own shares and purchased 30,763,282 (2019: 1,673,143) of its ordinary shares through purchases on the London Stock Exchange. During the year, the Company issued no new ordinary shares (2019: 7,803,043) to the Group's share trust for its employee share-based payment plans with a net book value of nil (2019: £66m).

1 Accounting policies

Basis of accounting

Rolls-Royce Holdings plc (the Company) is a public company limited by shares incorporated and domiciled in England in the United Kingdom. These Financial Statements have been prepared in accordance with Financial Reporting Standard 101 *Reduced Disclosure Framework* on the historical cost basis.

These financial statements have been prepared on a going concern basis. Further details are given in the Going Concern Statement on pages 52 to 54. After due consideration the Directors consider that the Group has sufficient liquidity headroom to continue in operational existence for a period of at least eighteen months from the date of this report and there are no material uncertainties that may cast doubt on the Company's going concern status, accordingly they are satisfied that it is appropriate to adopt the going concern basis of accounting in preparing the Company Financial Statements.

In accordance with the Companies Act 2006 and EU regulations, the Company Financial Statements have been prepared in accordance with international accounting standards in conformity with the requirements of the Companies Act 2006 and international financial reporting standards adopted pursuant to Regulation (EC) No 1606/2002 as it applies in the EU.

In these Financial Statements the Company has applied the exemptions available under FRS 101 in respect of the following disclosures:

- a cash flow statement and related notes;
- comparative period reconciliations for share capital;
- the effects of new, but not yet effective accounting standards; and
- the requirements of IAS 24 *Related Party Transactions* and has, therefore, not disclosed transactions between the Company and its wholly-owned subsidiaries.

The accounting policies set out below have, unless otherwise stated, been applied consistently to all periods presented in these Financial Statements.

There were no changes to accounting standards that had a material impact on these Financial Statements.

The Company's Financial Statements are presented in sterling, which is the Company's functional currency.

As permitted by section 408 of the Companies Act 2006, a separate income statement 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.

Key areas of judgement and sources of estimation uncertainty

The carrying value of the investment in subsidiary undertakings is reviewed for impairment on an annual basis. The recoverable amount is determined based on value in use which requires the determination of appropriate assumptions (which are sources of estimation uncertainty) in relation to the cash flow forecasts (including the impact of climate change), the long-term growth rate to be applied and the risk-adjusted discount rate used to discount the estimated cash flows to present value.

Estimation uncertainty arises due to changing economic and market factors, most particularly as a result of the COVID-19 pandemic. The recoverable amount of the investments in Rolls-Royce Group Limited and Rolls-Royce plc of £14.7bn has been assessed for impairment based on a value in use calculation using cash flow projections from the Group's latest forecasts which have regard to the current market and the Group's views on the future achievable growth. Discount rates used reflect current market assessments of the time value of money and the rate of return a market participant would require. The rate used to discount the forecast cash flows reflect the individual businesses in the Group and is 9% post-tax. The Directors have determined that no impairment charge is required. An increase in the rate from 9% to 10% would cause the carrying amount of the Company's investment to equal its recoverable amount. This sensitivity does not assign value to the new programmes that the Company expects to bring to market as part of its sustainability initiatives.

Significant accounting policies

The Company's significant accounting policies are set out below. These accounting policies have been applied consistently to all periods presented in these Financial Statements.

Investments in subsidiary undertakings

Investments included in fixed assets are investments in subsidiary companies. These are held at historical cost and are considered for impairment annually by the Directors.

Trade receivables

Trade receivables are recognised initially at the transaction price. They are subsequently measured at amortised cost using the effective interest method, less provision for impairment. A provision for the impairment of trade receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivables. The Company applies the IFRS 9 *Financial Instruments* simplified approach to measuring expected credit losses which uses a lifetime expected loss allowance for all trade receivables.

Trade payables

Trade payables are recognised initially at the transaction price and subsequently measured at amortised cost using the effective interest method.

Equity

Ordinary shares are classified as equity. Equity instruments are measured at the fair value of the cash or other resources received or receivable, net of the direct costs of issuing the equity instruments.

1 Accounting policies continued

Share-based payments

As described in the Directors' Remuneration Report on pages 81 to 100, the Company grants awards of its own shares to employees of its subsidiary undertakings (see note 25 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 IFRS 2 *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 IAS 32 *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.

Costs of share issues

The cost of issuing ordinary shares are charged to the share premium account.

2 Investments – subsidiary undertakings

	£m
Cost:	
At 1 January 2020	12,801
Additions ¹	1,860
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	27
At 31 December 2020	14,688

¹ During the year, the Company made a capital injection of £1,860m to its subsidiary undertaking, Rolls-Royce Group Limited.

Details of the Company's subsidiary undertakings and joint venture and associates undertakings are listed on pages 183 and 189.

Assessment of carrying value of investments in subsidiary undertakings

The carrying value of the Company's investments in subsidiary undertakings has been tested for impairment in accordance with IAS 36 *Impairment of Assets*. The carrying value is compared to the asset's recoverable amount and has been assessed by reference to value in use. The value in use has been calculated based upon a discounted cash flow methodology using the most recent forecasts prepared by management of the Rolls-Royce Holdings plc group. These forecasts:

- are consistent with past experience and external sources on market conditions;
- cover the next five years for the Power Systems, Defence and Central businesses together with a terminal value. Cash flows are assumed to grow at 2.0% which is based on inflation forecasts by recognised bodies;
- utilise long-term cash flow forecasts for the Civil and ITP Aero businesses to reflect the best estimate of the impact and subsequent recovery from the COVID-19 pandemic, together with the estimated cash flows from its significant growth programmes such as the Trent XWB and Trent 7000. These forecasts extend to 2035 after which a negative growth rate is applied to reflect the remaining flows to the end of our current product portfolio;
- reflect estimation uncertainty through the use of a probability weighted downside scenario for the Civil business where the uncertainty is most significant. The assumptions are consistent with those set out in the Going Concern Statement on pages 52 to 54. The weighting applied is 75% to a base case and 25% to a downside scenario;
- include ongoing capital expenditure required to maintain the current programmes but excludes any growth from the new programmes that the Company expects to bring to market as part of its sustainability initiatives.

The key assumptions for the value in use calculation are assumed market share, programme timings, unit cost assumptions, discount rates and foreign exchange. Management estimates discount rates that reflect current market assessments of the time value of money and the rate of return a market participant would require. The rate used to discount the forecast cash flows reflects the individual businesses in the Group and is c.9% post-tax. As a result of this analysis, the Directors have determined that no impairment charge is required.

An increase in the post-tax discount rate from 9% to 10% would cause the carrying amount of the Company's investment to equal its recoverable amount. This sensitivity does not assign value to the new programmes that the Company expects to bring to market as part of its sustainability initiatives. As a stress test, the potential impact of the full downside scenario (referred to above) occurring has also been evaluated. It is estimated that this would result in an impairment of the investment in subsidiary undertakings of around £0.5bn.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

3 Trade and other receivables

	2020 £m	2019 £m
Amounts owed by subsidiary undertakings	–	1,870

In 2019, amounts owed by subsidiary undertakings related to dividends receivable from Rolls-Royce Group Limited. This balance was settled during the year.

4 Trade and other payables

	2020 £m	2019 £m
Amounts owed to subsidiary undertakings	331	2,228

Amounts owed to subsidiary undertakings are interest-free and repayable on demand.

5 Financial liabilities**C Shares**

Movements during the year were as follows:

	C Shares of 0.1p Millions	Nominal value £m
At 1 January 2020	30,608	31
Issued	88,825	89
Redeemed	(91,893)	(92)
At 31 December 2020	27,540	28

The rights attaching to C Shares are set out on page 208.

6 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
Issued and fully paid					
At 1 January 2020	1	–	–	1,931	386
Rights issue	–	–	–	6,437	1,288
At 31 December 2020	1	–	–	8,368	1,674

The rights attaching to each class of share are set out on page 208.

On 12 November 2020, the Company completed a rights issue to existing shareholders on the basis of ten ordinary shares for every three fully paid ordinary shares held. As a result, 6,436,601,676 ordinary shares with an aggregate nominal value of £1,288m were issued for a cash consideration of £2,060m. Transaction costs directly attributable to the rights issue of £79m were incurred and have been accounted for as a deduction from share premium.

In accordance with IAS 32, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 5.

7 Reconciliation of net assets between Rolls-Royce Holdings plc Group and Company

As at 31 December 2020, Rolls-Royce Holdings plc consolidated group had net liabilities of £4.9bn (2019: £3.4bn) compared to £14.3bn (2019: £12.4bn) of net assets of the Company. The Company is a holding company and does not trade in its own right. The Company was incorporated in 2011 and became the Rolls-Royce holding company through a Scheme of Arrangement. On becoming the Rolls-Royce holding company, the value of the Company's investment in subsidiaries was based on the market capitalisation of the Rolls-Royce group at that time. There was an increase in the investment as a result of a capital injection to Rolls-Royce Group Limited during the year. As set out in note 2, management has assessed the recoverable amount of the Company's investment in subsidiaries, which supports the carrying value of those investments. The Group's consolidated financial statements are prepared on a historical cost basis except where IFRS requires a valuation basis to be applied (see page 114 for further details). As different principles are applied in preparing the Company and consolidated group balance sheets there is a difference in the financial position reported. Examples of such differences include the following items that are in the Consolidated balance sheet but not reflected in the Company's balance sheet: liabilities of £8,922m as a result of adopting IFRS 15 in 2017; and financial liabilities of £2,871m arising from the recognition at fair value of foreign exchange derivatives held to manage exposure on the Group's future trading.

8 Contingent liabilities & commitments

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 2020, these guarantees amounted to £10,522m (2019: £5,585m) of which total drawn amounted to **£5,022m** (2019: £3,085m).

9 Other information

Employees

The Company had no employees in 2020 (2019: none).

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.

Emoluments of Directors

The remuneration of the Directors of the Company is shown below, further information is in the Directors' Remuneration Report on pages 81 to 100.

	2020			2019		
	Highest paid director £000	Other directors £000	Total £000	Highest paid director £000	Other directors £000	Total £000
Remuneration	1,110	1,946	3,056	2,080	2,754	4,834
Gains made on share options	530	318	848	1,079	714	1,793
	1,640	2,264	3,904	3,159	3,468	6,627

No Director accrued any retirement benefits in the year (2019: none).

SUBSIDIARIES

SUBSIDIARIES

As at 31 December 2020, the companies listed below and on the following pages are indirectly held by Rolls-Royce Holdings plc except Rolls-Royce Group Limited which is 100% directly owned by Rolls-Royce Holdings plc. The financial year end of each company is 31 December unless otherwise indicated.

Company name	Address	Class of shares	% of class held
Aeromaritime America, Inc.	M&H Agent Services, Inc., 1850 North Central Avenue, Suite 2100, Phoenix, Arizona 85004, United States	Common	100
Aeromaritime Mediterranean Limited	7 Industrial Estate, Hal Far, Birzebbuga, BBG 3000, Malta	Ordinary	100
Aerospace Transmission Technologies GmbH**	Adelheidstrasse 40, D-88046, Friedrichshafen, Germany	Capital Stock	50
Amalgamated Power Engineering Limited *	Derby ¹	Deferred	100
		Ordinary	100
Bergen Engines AS	Hordvikneset 125, N-5108, Hordvik, Bergen 1201, Norway	Ordinary	100
Bergen Engines Bangladesh Private Limited	Green Grandeur, 6th Floor, Plot no.58 E, Kamal Ataturk Avenue Banani, C/A Dhaka, 1213, Bangladesh	Ordinary	100
Bergen Engines BV	Werfdijk 2, 3195HV Pernis, Rotterdam, Netherlands	Ordinary	100
Bergen Engines Denmark A/S	Østre Havnepromenade 34 9000 Ålborg, Denmark	Ordinary	100
Bergen Engines India Private Limited ³	52-b, 2nd Floor, Okhla Industrial Estate, Phase III, New Delhi 110020, India	Ordinary	100
Bergen Engines Limited	Derby ¹	Ordinary	100
Bergen Engines PropertyCo AS	Hordvikneset 125, N-5108, Hordvik, Bergen 1201, Norway	Ordinary	100
Bergen Engines S.L.	Calle Dinamarca s/n (esquina Calle Alemania), Polígono Industrial de Constanti, 43120 Constanti, Tarragona, Spain	Social Participation	100
Bergen Engines S.r.l.	Via Castel Morrone 13, 16161, Genoa, Italy	Social Capital	100
Bristol Siddeley Engines Limited *	Derby ¹	Ordinary	100
Brown Brothers & Company Limited *	Taxiway, Hillend Industrial Estate, Dalgety Bay, Dunfermline, Fife, KY11 9JT, Scotland	Ordinary	100
C.A. Parsons & Company Limited *	Derby ¹	Ordinary	100
Derby Specialist Fabrications Limited *	Derby ¹	Ordinary	100
Europea Microfusioni Aerospaziali S.p.A.	Zona Industriale AS1, 83040 Morra de Sanctis, Avellino, Italy	Ordinary	100
Heaton Power Limited *	Derby ¹	Ordinary	100
Industria de Tuberías Aeronáuticas México S.A. de C.V.	Acceso IV, No.6B, Zona Industrial Benito Juárez, Querétaro, 76120, Mexico	Class A	100
Industria de Tuberías Aeronáuticas S.A.U.	Pabellón Industrial, Torrelarrgoiti, Parcela 5H, Naves 7 a 10, Zamudia, Vizcaya, Spain	Ordinary	100
Industria de Turbo Propulsores S.A.	Parque Technológico Edificio 300, 48170 Zamudio, Vizcaya, Spain	Ordinary	100
ITP Engines UK Limited	The Whittle Estate, Cambridge Road, Whetstone, Leicester, LE8 6LH, England	Ordinary	100
ITP Externals India Private Ltd	Plot 60/A, IDA Gandhi Nagar, Hyderabad, 500037, India	Ordinary	100
ITP Externals S.L.U.	Pabellón Industrial, Polígono Ugaldeguren I, PIILA, Pab 1-2 Zamudio, Vizcaya, Spain	Ordinary	100
ITP Ingeniería y Fabricación S.A. de C.V.	Acceso IV, No.6D, Zona Industrial Benito Juárez, Querétaro, 76120, Mexico	Class A Class B	100 100
ITP México Fabricación S.A. de C.V.	Acceso IV, No.6, Zona Industrial Benito Juárez, Querétaro, 76120, Mexico	Class A	100
ITP México S.A. de C.V.	Acceso IV, No.6, Zona Industrial Benito Juárez, Querétaro, 76120, Mexico	Fixed capital B Variable capital B	100 100
ITP Next Generation Turbines S.L.U.	Parque Technológico Edificio 300, 48170 Zamudio, Vizcaya, Spain	Ordinary	100
John Thompson Cochran Limited *	Taxiway, Hillend Industrial Estate, Dalgety Bay, Dunfermline, Fife, KY11 9JT, Scotland	6% Cumulative Preference Ordinary	100 100

* Dormant entity.

**Though the interest held is 50%, the Company controls the entity (see note 1 to the consolidated Financial Statements) and, as a result, consolidates the entity and records a non-controlling interest.

¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.

² Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808, United States.

³ Reporting year end is 31 March.

SUBSIDIARIES

Company name	Address	Class of shares	% of class held
Kamewa Holding AB * (in liquidation)	Box 1010, S-68129, Kristinehamn, Sweden	Ordinary	100
Karl Maybach-Hilfe GmbH	Maybachplatz 1, 88045, Friedrichshafen, Germany	Capital Stock	100
Kinolt FZE	Warehouse Number FZLIU10BD09, Liu 10, BD09 Jafza South Jebel Ali Free Zone, PO Box 263346, Dubai, United Arab Emirates	Ordinary	100
Kinolt GmbH	Konrad-Zuse-Str. 3, 47877, Willich	Ordinary	100
Kinolt Group SA	Rue de l'Avenir 61, 4460, Grace-Hollogne, Belgium	Ordinary	100
Kinolt Guc Kaynakları Sistemleri San. Ve Tic A.A.	Kazim Ozalp Mah. Kuleli, Sok. No:83/5 Cankaya-Ankara, Turkey	Ordinary	100
Kinolt Hong Kong Limited	20th Floor, Euro-Trade Centre, 21-23 Des Vouex Road Central, Hong Kong	Ordinary	100
Kinolt Immo SA	Rue de l'Avenir 61, 4460, Grace-Hollogne, Belgium	Ordinary	100
Kinolt Immobilien SA	Rue de l'Avenir 61, 4460, Grace-Hollogne, Belgium	Ordinary	100
Kinolt LLC **	REGUS Service Office, Office No. 1034, Shoumoukh Tower, 10th Floor, Tower B, C-Ring Road, Al Sadd, PO Box 207207, Doha, Qatar	Ordinary	49
Kinolt LLC	Electrozavodskaya str, 33, bld.5, floor 4, room VII, office 12, Moscow, 107076, Russia	Ordinary	100
Kinolt Pte. Limited	1 Kaki Bukit View Techview #05-03/04, 415941, Singapore	Ordinary	100
Kinolt SA	Rue de l'Avenir 61, 4460, Grace-Hollogne, Belgium	Ordinary	100
Kinolt SAS	Tour Opus 2, La Defense 9, 77 Esplanade du General du Gaulle, 92914 Paris La Defense Cedex, France	Ordinary	100
Kinolt Sistemas de UPS Limitada	Alameda dos Maracatins 780-2502, Indianapolis 04089-001, Sao Paulo, Brazil	Ordinary	100
Kinolt Sistemas de UPS SpA	Bucarest No 17 Oficina, No 33, Previdencia, Santiago, Chile	Ordinary	100
Kinolt UK Limited	101/102 Cirencester Business Park, Love Lane, Cirencester, GL7 1XD, United Kingdom	Ordinary	100
Kinolt USA Inc.	Corporation Trust Center, 1209 Orange Street, Wilmington, County of New Castle, Delaware, USA	Common Stock	100
LC Nuclear Limited	Derby ¹	Ordinary	100
MTU Africa (Proprietary) Limited	36 Marconi Street, Montague Gardens, Cape Town, 7441, South Africa	Capital Stock	100
MTU America Inc.	Wilmington ²	Ordinary	100
MTU Asia PTE Limited	10 Tukang Innovation Drive, Singapore 618302	Ordinary	100
MTU Benelux B.V.	Merwedestraat 86, 3313 CS, Dordrecht, Netherlands	Ordinary	100
MTU China Company Limited	Room 1803 18/F Ascendas Plaza, No.333 Tian Yao Qiao Road, Xuhai Distrcit, Shanghai, 200030, China	Ordinary	100
MTU do Brasil Limitada	Via Anhanguera, KM 29203, 05276-000 Sao Paulo – SP, Brazil	Ordinary	100
MTU Engineering (Suzhou) Company Limited	9 Long Yun Road, Suzhou Industrial Park, Suzhou 215024, Jiang Su, China	Ordinary	100
MTU France S.A.S.	Immeuble Colorado, 8/10 rue de Rosa Luxembourg-Parc des Bellevues 95610, Erangy-sur-Oise, France	Ordinary	100
MTU Friedrichshafen GmbH	Maybachplatz 1, 88045, Friedrichshafen, Germany	Capital Stock	100
MTU Hong Kong Limited	Room 1006, 10/F, Hang Seng Tsimshatsui Building, 18 Carnarvon Road, Tsimshatsui, Kowloon, Hong Kong	Ordinary	100
MTU Ibérica Propulsión y Energia S.L.	Calle Copérnico 26-28, 28823 Coslada, Madrid, Spain	Ordinary	100
MTU India Private Limited ³	6th Floor, RMZ Galleria, S/Y No. 144 Bengaluru, Bangalore, Karnataka 560,064, India	Ordinary	100
MTU Israel Limited	4 Ha'Alon Street, South Building, Third Floor, 4059300 Kfar Neter, Israel	Ordinary	100
MTU Italia S.r.l.	Via Aurelia Nord, 328, 19021 Arcola (SP), Italy	Capital Stock	100
MTU Japan Co. Limited	Resorttrust Building 4-14-3, Nishitennma Kita-ku, Osaka 530-0047, Japan	Ordinary	100
MTU Korea Limited	22nd Floor, Olive Tower, 41 Sejongdaero 9 gil, Junggu, 100-737 Seoul, Republic of Korea	Ordinary	100
MTU Middle East FZE	S3B5SR06, Jebel Ali Free Zone, South P.O. Box 61141, Dubai, United Arab Emirates	Ordinary	100
MTU Motor Türbin Sanayi ve Ticaret. A.Ş.	Hatira Sokak, No. 5, Ömerli Mahellesi, 34555 Arnavutköy, Istanbul, Turkey	Ordinary	100
MTU Onsite Energy GmbH	Dasinger Strasse 11, 86165, Augsburg, Germany	Capital Stock	100
MTU Onsite Energy Systems GmbH	Rotthofer Strasse 8, 94099 Ruhstorf a.d. Rott, Germany	Capital Stock	100
MTU Polska Sp. z o.o.	Ul. Śląska, Nr 9. Raum, Ort: Stargard Szczeciński, Plz: 73-110, Poland	Ordinary	100

* Dormant entity.

**Though the interest held is 49%, the Company controls the entity (see note 1 to the consolidated Financial Statements) and, as a result, consolidates the entity and records a non-controlling interest.

¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.

² Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808, United States.

³ Reporting year end is 31 March.

SUBSIDIARIES

Company name	Address	Class of shares	% of class held
MTU Reman Technologies GmbH	Friedrich-List-Strasse 8, 39122 Magdeburg, Germany	Capital Stock	100
MTU Rus Limited Liability Company	Shabolovka Street 2, 119049, Moscow, Russian Federation	Ordinary	100
MTU South Africa (Proprietary) Limited	36 Marconi Street, Montague Gardens, Cape Town, 7441, South Africa	Ordinary	100
MTU UK Limited	Derby ¹	Ordinary	100
NEI International Combustion Limited *	Derby ¹	Ordinary	100
NEI Mining Equipment Limited *	Derby ¹	Ordinary	100
NEI Nuclear Systems Limited *	Derby ¹	Ordinary	100
NEI Parsons Limited *	Derby ¹	Ordinary	100
NEI Peebles Limited *	Derby ¹	Ordinary	100
NEI Power Projects Limited *	Derby ¹	Ordinary	100
Nightingale Insurance Limited	Maison Trinity, Trinity Square, St. Peter Port, GY1 4AT, Guernsey	Ordinary	100
No-Break Power Limited *	101/102 Cirencester Business Park, Love Lane, Cirencester, GL7 1XD, United Kingdom	Ordinary	100
Power Jets (Research and Development) Limited *	The Whittle Estate, Cambridge Road, Whetstone, Leicester, LE8 6LH, England	Ordinary	100
Powerfield Limited	Derby ¹	Ordinary	100
Precision Casting Bilbao S.A.U.	Calle El Barracón 1, Baracaldo, Vizcaya, 48910, Spain	Ordinary	100
PT MTU Indonesia	Secure Building Blok B, Jl. Raya Protokol Halim, Perdanakusuma, Jakarta, 13610, Indonesia	Ordinary	100
PT Rolls-Royce	Secure Building Blok B, Jl. Raya Protokol Halim, Perdanakusuma, Jakarta, 13610, Indonesia	Ordinary	100
Rolls-Royce (Ireland) Unlimited Company *	Ulster International Finance, 1st Floor IFSC House, IFSC, Dublin 1, Ireland	Ordinary	100
Rolls-Royce (Thailand) Limited	4, 4.5 Level 12, Suite 1299, Rajdamri Road, Pathumwan, Bangkok, 10330, Thailand	Ordinary	100
Rolls-Royce Aero Engine Services Limited *	Derby ¹	Ordinary	100
Rolls-Royce Australia Pty Limited	Level 1, 60 Martin Place, Sydney NSW 2000, Australia	Ordinary	100
Rolls-Royce Australia Services Pty Limited	Level 1, 60 Martin Place, Sydney NSW 2000, Australia	Ordinary	100
Rolls-Royce Brasil Limitada	Rua drive Cincinato Braga No. 47, Planalto District, São Bernardo do Campo, SP, 09890-900, Brazil	Quotas	100
Rolls-Royce Canada Limited	9500 Côte de Liesse, Lachine, Québec H8T 1A2, Canada	Common Stock	100
Rolls-Royce Chile SpA	Alcantra 200 office 601, Piso 6, C.O. 7550159 Las Condes, Santiago, Chile	Ordinary	100
Rolls-Royce China Holding Limited	305-306 Indigo Building 1, 20 Jiuxianqiao Road, Beijing, 100016, China	Registered Capital	100
Rolls-Royce Civil Nuclear S.A.S.	23 chemin du Vieux Chêne, 38240, Meylan, France	Ordinary	100
Rolls-Royce Commercial Aero Engines Limited *	Derby ¹	Ordinary	100
Rolls-Royce Control Systems Holdings Co	Wilmington ²	Common Stock	100
Rolls-Royce Controls and Data Services (NZ) Limited	c/o Deloitte, 80 Queen Street, Auckland Central, Auckland 1010, New Zealand	Ordinary	100
Rolls-Royce Controls and Data Services (UK) Limited	Derby ¹	Ordinary	100
Rolls-Royce Controls and Data Services Limited *	Derby ¹	Ordinary	100
Rolls-Royce Corporation	Wilmington ²	Common Stock	100
Rolls-Royce Crosspointe LLC	Wilmington ²	Partnership (no equity)	100
Rolls-Royce Defense Products and Solutions, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce Defense Services, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce Deutschland Ltd & Co KG	Eschenweg 11, 15827 Blankenfelde-Mahlow, Germany	Capital Stock	100
Rolls-Royce Electrical Norway AS	Jarleveien 8A, 7041, Trondheim 500, Norway	Ordinary	100
Rolls-Royce Energy Angola, Limitada *	Rua Rei Katayavalá, Edificio Rei Katayavalá, Entrada B, Piso 8, Luanda, Angola	Quota	100
Rolls-Royce Energy Systems Inc.	Wilmington ²	Common Stock	100
Rolls-Royce Engine Services Holdings Co.	Wilmington ²	Common Stock	100
Rolls-Royce Engine Services Limitada Inc. (in liquidation)	Bldg. 06 Berthaphil Compound, Jose Abad Santos Avenue, Clark Special Economic Zone, Clark, Pampanga, Philippines	Capital Stock	100

* Dormant entity.

¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.² Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808, United States.

SUBSIDIARIES

Company name	Address	Class of shares	% of class held
Rolls-Royce Erste Beteiligungs GmbH	Eschenweg 11, 15827 Blankenfelde-Mahlow, Germany	Capital Stock	100
Rolls-Royce Finance Company Limited	Derby ¹	Deferred Ordinary	100
Rolls-Royce Finance Holdings Co.	Wilmington ²	Common Stock	100
Rolls-Royce Fuel Cell Systems Limited	Derby ¹	Ordinary	100
Rolls-Royce General Partner Limited *	Derby ¹	Ordinary	100
Rolls-Royce General Partner (Ireland) Limited	29 Earlshot Terrace, Dublin 2, Ireland	Ordinary	100
Rolls-Royce Group Limited	Kings Place, 90 York Way, London, N1 9FX, England	Ordinary	100
		Ordinary A	100
Rolls-Royce High Temperature Composites, Inc.	Corporation Service Company, 2710 Gateway Oaks Drive, Suite 150N, Sacramento, California 95833, United States	Ordinary	100
Rolls-Royce Holdings Canada Inc.	9500 Côte de Liesse, Lachine, Québec H8T 1A2, Canada	Common C	100
Rolls-Royce Hungary Kft	Gizella U. 51-57, 1143 Budapest, Hungary	Cash shares	100
Rolls-Royce India Limited * ³	Derby ¹	Ordinary	100
Rolls-Royce India Private Limited ³	Birla Tower West, 2nd Floor 25, Barakhamba Road, New Delhi, 110001, India	Equity	100
Rolls-Royce Industrial & Marine Power Limited *	Derby ¹	Ordinary	100
Rolls-Royce Industrial Power (India) Limited * ³	Derby ¹	Ordinary	100
Rolls-Royce Industrial Power Engineering (Overseas Projects) Limited	Derby ¹	Ordinary	100
Rolls-Royce Industries Limited	Derby ¹	Ordinary	100
Rolls-Royce International Limited	Derby ¹	Ordinary	100
Rolls-Royce International s.r.o.	Pobřežní 620/3, Postal code 186 00, Karlin – Prague 8, Czech Republic	Ordinary	100
Rolls-Royce Japan Co., Limited	31st Floor, Kasumigaseki Building, 3-2-5 Kasumigaseki, Chiyoda-Ku, Tokyo, 100-6031, Japan	Ordinary	100
Rolls-Royce Leasing Limited	Derby ¹	Ordinary	100
Rolls-Royce Malaysia Sdn. Bhd.	C-2-3A TTDI Plaza, Jalan Wan Kadir 3, Taman Tun Dr Ismail, 6000 Kuala Lumpur, Malaysia	Ordinary	100
Rolls-Royce Marine North America, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce Mexico Administration S. de R.L. de C.V.	Boulevard Adolfo Ruiz Cortinez 3642-403, Fracc Costa de Oro, Verzcrus CP 94299 6, Mexico	Ordinary	100
Rolls-Royce Mexico S. de R.L. de C.V.	Boulevard Adolfo Ruiz Cortinez 3642-403, Fracc Costa de Oro, Verzcrus CP 94299 6, Mexico	Ordinary	100
Rolls-Royce Military Aero Engines Limited * ³	Derby ¹	Ordinary	100
Rolls-Royce New Zealand Limited	c/o Deloitte, 80 Queen Street, Auckland Central, Auckland 1010, New Zealand	Ordinary	100
Rolls-Royce North America (USA) Holdings Co.	Wilmington ²	Common Stock	100
Rolls-Royce North America Holdings, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce North America, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce North America Ventures, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce North American Technologies, Inc.	Wilmington ²	Common Stock	100
Rolls-Royce Oman LLC	Bait Al Reem, Business Office #131, Building No 81, Way No 3409, Block No 234, Al Thaqafa Street, Al Khuwair, PO Box 20, Postal Code 103, Oman	Ordinary	100
Rolls-Royce Operations (India) Private Limited	Birla Tower West, 2nd Floor, 25 Barakhamba Road, New Delhi, 110001, India	Ordinary	100
Rolls-Royce Overseas Holdings Limited	Derby ¹	Ordinary	100
		Ordinary A	100
Rolls-Royce Overseas Investments Limited	Derby ¹	Ordinary	100
Rolls-Royce Placements Limited	Derby ¹	Ordinary	100
Rolls-Royce plc	Kings Place, 90 York Way, London, N1 9FX, England	Ordinary	100
Rolls-Royce Power Engineering plc	Derby ¹	Ordinary	100
Rolls-Royce Power Systems AG	Maybachplatz 1, 88045, Friedrichshafen, Germany	Ordinary	100
Rolls-Royce Retirement Savings Trust Limited * ³	Derby ¹	Ordinary	100
Rolls-Royce Saudi Arabia Limited	PO Box 88545, Riyadh, 11672, Saudi Arabia	Cash shares	100

* Dormant entity.

¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.

² Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808, United States.

³ Reporting year end is 31 March.

SUBSIDIARIES

Company name	Address	Class of shares	% of class held
Rolls-Royce Singapore Pte. Limited	6 Shenton Way, #33-00 OUE, Downtown Singapore 068809, Singapore	Ordinary	100
Rolls-Royce Solutions Berlin GmbH	Villa Rathenau, Wilhelmminenstrasse 75, 12459 Berlin, Germany	Preference A Preference	100 100
Rolls-Royce Sp z.o.o.	Opolska 100 31-323, Krakow, Poland	Ordinary	100
Rolls-Royce Submarines Limited	Atlantic House, Raynesway, Derby, DE21 7BE, Derbyshire, England	Ordinary	100
Rolls-Royce Technical Support Sarl	Centreda I, Avenue Didier Daurat, 31700 Blagnac, Toulouse, France	Ordinary	100
Rolls-Royce Total Care Services Limited	Derby ¹	Ordinary	100
Rolls-Royce Turkey Power Solutions Industry and Trade Limited	Levazim Mahellesi, Koru Sokagi, Zorlu Center, No. 2 Teras Evler T2 D:204, Zincirlikuyu, Besiktas, Istanbul 34340, Turkey	Cash shares	100
Rolls-Royce UK Pension Fund Trustees Limited *	Derby ¹	Ordinary	100
Rolls-Royce Zweite Beteiligungs GmbH	Eschenweg 11, 15827 Blankenfelde-Mahlow, Germany	Capital Stock	100
Ross Ceramics Limited	Derby ¹	Ordinary	100
Servowatch Systems Limited	Endeavour House, Benbridge Industrial Estate, Holloway Road, Heybridge, Maldon, Essex, CM9 4ER, United Kingdom	Ordinary	100
Sharing in Growth UK Limited **	Derby ¹	Limited by guarantee	100
Spare IPG 20 Limited *	Derby ¹	Ordinary	100
Spare IPG 21 Limited *	Derby ¹	Ordinary	100
Spare IPG 24 Limited *	Derby ¹	Ordinary	100
Spare IPG 27 Limited *	Taxiway Hillend Industrial Estate, Dalgety Bay, Dunfermline, Fife, KY11 9JT, Scotland	Ordinary 7% Cumulative Preference	100 100
Spare IPG 32 Limited *	Derby ¹	7.25% Cumulative Preference Ordinary	100
Spare IPG 4 Limited *	Derby ¹	Ordinary	100
The Bushing Company Limited *	Derby ¹	Ordinary	100
Timec 1487 Limited *	Derby ¹	Ordinary	100
Trigno Energy S.R.L.	Zona Industriale, San Salvo, 66050, Italy	Ordinary	100
Turbine Surface Technologies Limited **	Derby ¹	Ordinary A Ordinary B	Nil 100
Turborreactores S.A. de C.V.	Acceso IV, No.6C, Zona Industrial Benito Juárez, Querétaro, 76120, Mexico	Class A Class B	100 100
Vessel Lifter, Inc. *	Corporation Service Company, 1201 Hays Street, Tallahassee, Florida 32301, United States	Common Stock	100
Vinters Defence Systems Limited *	Derby ¹	Ordinary	100
Vinters Engineering Limited	Derby ¹	Ordinary	100
Vinters International Limited	Derby ¹	Ordinary	100
Vinters Limited	Derby ¹	Ordinary	100
Vinters-Armstrongs (Engineers) Limited *	Derby ¹	Ordinary	100
Vinters-Armstrongs Limited *	Derby ¹	Ordinary B	100
Yocova PTE. Ltd.	6 Shenton Way, #33-00 OUE, Downtown Singapore 068809, Singapore	Ordinary	100

* Dormant entity.

**The entity is not included in the consolidation as Rolls-Royce plc does not have a beneficial interest in the net assets of the entity.

¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.³ Reporting year end is 31 March.

JOINT VENTURES AND ASSOCIATES

Company name	Address	Class of shares	% of class held	Group interest held %
Aero Gearbox International SAS **	18 Boulevard Louis Sequin, 92700 Colombes, France	Ordinary	50	50
Airtanker Holdings Limited	Airtanker Hub, RAF Brize Norton, Carterton, Oxfordshire, OX18 3LX, England	Ordinary	23	23
Airtanker Services Limited	Airtanker Hub, RAF Brize Norton, Carterton, Oxfordshire, OX18 3LX, England	Ordinary	23.5	23.5
Alpha Leasing (US) (No.2) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Leasing (US) (No.4) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Leasing (US) (No.5) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Leasing (US) (No.6) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Leasing (US) (No.7) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Leasing (US) (No.8) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Leasing (US) LLC	Wilmington ²	Partnership (no equity held)	–	50
Alpha Partners Leasing Limited	1 Brewer's Green, London, SW1H 0RH, England	Ordinary A	100	50
CFMS Limited	43 Queen Street, Bristol, BS1 4QP, England	Limited by guarantee	–	50
Clarke Chapman Portia Port Services Limited	Maritime Centre, Port of Liverpool, Liverpool, L21 1LA, England	Ordinary A	100	50
Consorcio Español para el Desarrollo Industrial del Helicóptero de Ataque Tigre, A.I.E.	Avda. de Aragón 404, 28022 Madrid, Spain	Partnership (no equity held)	–	50
Consorcio Español para el Desarrollo Industrial del Programa Eurofighter, A.I.E.	Paseo de John Lennon, s/n, edificio T22, 2 ^a planta, Getafe, Madrid, Spain	Partnership (no equity held)	–	50
Egypt Aero Management Services (in liquidation)	EgyptAir Engine Workshop, Cairo International Airport, Cairo, Egypt	Ordinary	50	50
EPI Europrop International GmbH	Dachauer Strasse 655, 80995, Munich, Germany	Capital Stock	44	44
Eurojet Turbo GmbH	Lilienthalstrasse 2b, 85399 Halbergmoos, Germany	Capital Stock	46	46
Force MTU Power Systems Private Limited	Mumbai Pune Road, Akurdi, Pune, Maharashtra 411035, India	Capital Stock	49	49
Genistics Holdings Limited	Derby ¹	Ordinary A	100	50
Global Aerospace Centre for Icing and Environmental Research Inc. **	1000 Marie-Victorin Boulevard, Longueuil Québec J4G 1A1, Canada	Ordinary	50	50
Hong Kong Aero Engine Services Limited	33rd Floor, One Pacific Place, 88 Queensway, Hong Kong	Ordinary	50	50
International Aerospace Manufacturing Private Limited ** ³	Survey No. 3 Kemppapura Village, Varthur Hobli, Bangalore, KA 560037, India	Ordinary	50	50
Light Helicopter Turbine Engine Company (unincorporated partnership)	Suite 119, 9238 Madison Boulevard, Madison, Alabama 35758, United States	Partnership (no equity held)	–	50
MEST Co., Limited	97 Bukjeonggongdan 2-gil, Yangsan-si, Gyeongsangnam-do, 50571, Republic of Korea	Normal	46.8	46.8

** These entities are accounted for as joint operations (see note 1 to the consolidated Financial Statements).

¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.

² Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808, United States.

³ Reporting year end is 31 March.

JOINT VENTURES AND ASSOCIATES

Company name	Address	Class of shares	% of class held	Group interest held %
Metlase Limited	Unipart House, Garsington Road, Cowley, Oxford, OX4 2PG, England	Ordinary B	100	20
MTU Power Systems Sdn. Bhd.	Level 10 Menara LGB, 1 Jalan Wan Kadir Taman Tun Dr Ismail 60000 Kuala Lumpur, Malaysia	Ordinary A	100	49
MTU Turbomeca Rolls-Royce GmbH	Am Söldnermoos 17, 85399 Hallbergmoos, Germany	Capital Stock	33.3	33.3
MTU Turbomeca Rolls-Royce ITP GmbH	Am Söldnermoos 17, 85399 Hallbergmoos, Germany	Capital Stock	50	50
MTU Yuchai Power Company Limited	No 7 Danan Road, Yuzhou, Yulin, Guangxi, China, 537005, China	Capital Stock	50	50
N3 Engine Overhaul Services GmbH & Co KG	Gerhard-Höltje-Strasse 1, D-99310, Arnstadt, Germany	Capital Stock	50	50
N3 Engine Overhaul Services Verwaltungsgesellschaft Mbh	Gerhard-Höltje-Strasse 1, D-99310, Arnstadt, Germany	Capital Stock	50	50
Rolls Laval Heat Exchangers Limited *	Derby ¹	Ordinary	50	50
Rolls-Royce & Partners Finance (US) (No 2) LLC	Wilmington ²	Partnership (no equity held)	-	50
Rolls-Royce & Partners Finance (US) LLC	Wilmington ²	Partnership (no equity held)	-	50
SAFYRR Propulsion Limited	Derby ¹	B Shares	100	50
Shanxi North MTU Diesel Co. Limited	No.97 Daqing West Road, Datong City, Shanxi Province, China	Ordinary	49	49
Singapore Aero Engine Services Private Limited	11 Calshot Road, 509932, Singapore	Ordinary	50	50
Taec Ucak Motor Sanayi AS	Buyukdere Caddesi, Prof. Ahmet Kemal Aru, Sokagi Kaleseramik, Binasi Levent No. 4, Besiktas, Istanbul, Turkey	Cash Shares	49	49
Techjet Aerofoils Limited **	Tefen Industrial Zone, PO Box 16, 24959, Israel	Ordinary A Ordinary B	50 50	50
Texas Aero Engine Services LLC	The Corporation Trust Company, 1209, Orange Street, Wilmington, Delaware 19801, United States	Partnership (no equity held)	-	50
TRT Limited	Derby ¹	Ordinary B	100	49.9
UK Nuclear Restoration Limited *	Booths Park, Chelford Road, Knutsford, Cheshire, WA16 8QZ, England	Ordinary	20	20
Xian XR Aero Components Co., Limited **	Xujiawan, Beijiao, Po Box 13, Xian 710021, Shaanxi, China	Ordinary	49	49

^{*} Dormant company.^{**} These entities are accounted for as joint operations (see note 1 to the consolidated Financial Statements).¹ Moor Lane, Derby, Derbyshire, DE24 8BJ, England.² Corporation Service Company, 251 Little Falls Drive, Wilmington, Delaware 19808, United States.

INDEPENDENT AUDITORS' REPORT

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

Report on the audit of the financial statements

Opinion

In our opinion:

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

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

Our opinion is consistent with our reporting to the Audit Committee

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

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

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

Basis for opinion

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

Independence

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

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

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

Our audit approach

Overview

Audit scope

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

INDEPENDENT AUDITORS' REPORT

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

Key audit matters

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

Materiality

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

The scope of our audit

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

Capability of the audit in detecting irregularities, including fraud

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

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

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

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

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

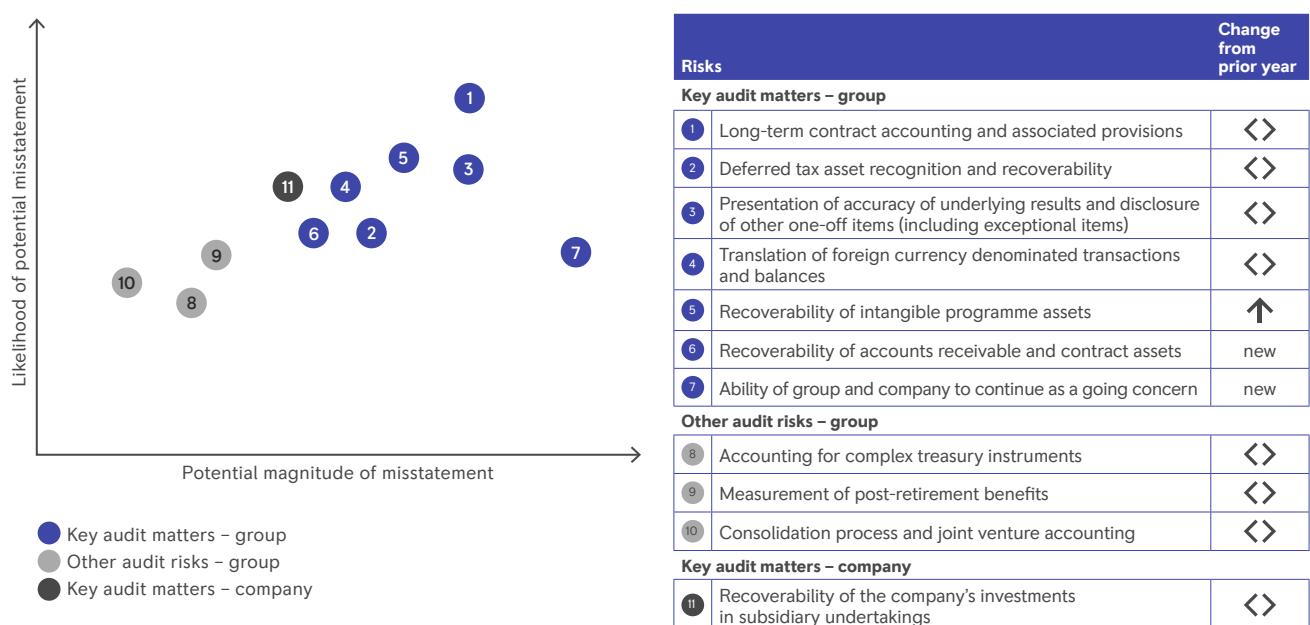
Key audit matters

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

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

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

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



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

INDEPENDENT AUDITORS' REPORT

Key audit matter

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

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

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

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

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

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

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

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

How our audit addressed the key audit matter

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

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

INDEPENDENT AUDITORS' REPORT

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

INDEPENDENT AUDITORS' REPORT

Key audit matter

Translation of foreign-currency denominated transactions and balances

(relevant to the Consolidated Financial Statements)

Page 119 (note 1 to the Consolidated Financial Statements – Accounting policies – Foreign currency translation)

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

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

How our audit addressed the key audit matter

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

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

There are no material uncorrected exceptions from our audit work.

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

(relevant to the Consolidated Financial Statements)

Page 114 (note 1 to the Consolidated Financial Statements – Accounting policies – Presentation of underlying results), page 126 (Note 2 to the Consolidated Financial Statements – Segmental analysis) and page 175 (note 29 to the Consolidated Financial Statements – Derivation of summary of funds flow statement)

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

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

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

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

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

INDEPENDENT AUDITORS' REPORT

Key audit matter

How our audit addressed the key audit matter

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

INDEPENDENT AUDITORS' REPORT

Key audit matter

Recoverability of intangible programme assets

(relevant to the Consolidated Financial Statements)

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

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

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

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

How our audit addressed the key audit matter

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

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

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

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

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

Ability of the group and company to continue as a going concern

(relevant to the Consolidated and Company Financial Statements)

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

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

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

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

INDEPENDENT AUDITORS' REPORT

Key audit matter	How our audit addressed the key audit matter
<p>Ability of the group to continue as a going concern continued</p> <p>There is on-going and significant uncertainty over the shape and speed of potential recovery and the impact of new variants of the COVID-19 virus. The group's free cash flow forecasts for 2021 and 2022 have been significantly downgraded as a result by analysts. Given this uncertainty management has modelled a base and downside liquidity headroom position for its going concern assessment. The group's debt facilities do not contain financial covenants. The Directors have concluded that there is sufficient liquidity available for at least the 18 month period of its going concern assessment to September 2022.</p> <p>As the going concern assessment is dependent on management's future cash flow forecasts there is significant judgement involved in determining these and concluding that there is not a material uncertainty.</p>	
<p>Recoverability of the company's investments in subsidiary undertakings (relevant to the Company Financial Statements)</p> <p><i>Page 180 (note 2 to the Company Financial Statements – Investments – Subsidiary Undertakings)</i></p> <p>Investments in subsidiaries of £14,688m (2019: £12,801m) are accounted for at cost less provision for impairment in the Company balance sheet at 31 December 2020. The increase in the year principally relates to a capital injection to the company's subsidiary, Rolls-Royce Group Limited.</p> <p>Investments are tested for impairment if impairment indicators exist. If such indicators exist, the recoverable amounts of the investments in subsidiaries are estimated in order to determine the extent of the impairment loss, if any. Any such impairment loss is recognised in the income statement.</p> <p>Management has identified the impact of COVID-19 on future cash flows of the group as an indicator of potential impairment. In addition, the carrying value significantly exceeded the market capitalisation of the group at 31 December 2020. These necessitated an impairment assessment to be performed, for which management engaged a third party expert.</p> <p>Judgement is required in this area, particularly in assessing: (1) whether an event has occurred that may indicate that the related asset values may not be recoverable; (2) whether the carrying value of an asset can be supported by the recoverable value, being the higher of fair value less cost of disposal or the net present value of future cash flows which are estimated based on the continued use of the asset in the business; and (3) key assumptions to be applied in preparing cash flow projections including whether these cash flow projections are discounted using an appropriate rate. Changing the assumptions selected by management to determine the level of any impairment, including the discount rates or the growth rate assumptions in the cash flow projections, could materially affect the recoverable value determined by the impairment test and as a result affect the company's financial condition and results.</p>	<p>We evaluated management's determination of whether any indicators of impairment existed by comparing the carrying value of investments in subsidiary undertakings to the market capitalisation of the group at 31 December 2020 and post year-end and by comparing the performance of the group in the year to previous budgets and agreed that an impairment assessment is necessary.</p> <p>The recoverable value of the group was determined from the discounted future cash flows of the group. We have tested the reasonableness of the key assumptions used, including revenue, profit and cash flow growth rates, terminal growth rates and the discount rate that management has applied. We tested that the underlying assumptions were consistent with other forecasts such as those used to assess the recoverability of the deferred tax asset. We also assessed whether management's probability weighted cash flow forecasts appropriately reflects the estimation uncertainty over the group's forecast cash flows especially within Civil Aerospace.</p> <p>Deploying our valuations experts, we assessed the methodology applied by management's expert as well as certain key assumptions such as the discount rate. We also considered other estimates of the group's valuation such as third party analyst reports and considered the potential reasons why the market capitalisation of the group was lower than the carrying value and valuation produced by management's expert.</p> <p>We performed our own independent sensitivity analysis to understand if reasonable possible changes in management's assumptions would result in an impairment.</p> <p>As a result of our work, we did not identify any material impairment and consider the carrying value of the investments in subsidiary undertakings to be supportable in the context of the Company Financial Statements taken as a whole. We have assessed the disclosures provided, including the sensitivity disclosures and consider them to be appropriate given the estimation uncertainty inherent in the analysis.</p>

INDEPENDENT AUDITORS' REPORT

Key audit matter

How our audit addressed the key audit matter

Impact of the COVID-19 pandemic*(relevant to the Consolidated and Company Financial Statements)*

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

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

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

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

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

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

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

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

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

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

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

How we tailored the audit scope

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

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

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

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

INDEPENDENT AUDITORS' REPORT

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

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

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

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

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

Materiality

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

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

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

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

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

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

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

Conclusions relating to going concern

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

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

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

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

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

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

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

Reporting on other information

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

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

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

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

INDEPENDENT AUDITORS' REPORT

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

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

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

Directors' Remuneration

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

Corporate governance statement

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

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

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

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

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

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

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

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of the Directors' responsibilities in respect of the Financial Statements, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the group's and the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or the company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

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

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

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

Use of this report

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

Other required reporting

Companies Act 2006 exception reporting

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

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

We have no exceptions to report arising from this responsibility.

Appointment

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

Ian Chambers (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
11 March 2021

SUSTAINABILITY ASSURANCE STATEMENT

Independent Limited Assurance Statement

To the stakeholders of Rolls-Royce Holdings plc

Introduction and objectives of work

Bureau Veritas UK Limited (Bureau Veritas) has been engaged by Rolls-Royce Holdings plc (Rolls-Royce) to provide limited assurance over selected sustainability performance indicators for inclusion in its 2020 Annual Report and website. This Assurance Statement applies to the related information included within the scope of work described below.

Scope of work

The scope of our work was limited to assurance over the following information included within Rolls-Royce's 2020 Annual Report ('the Report') for the period 1st of January to the 31st of December 2020 (the 'Selected Information'):

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

Reporting criteria

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

Limitations and exclusions

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

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

This limited assurance engagement relies on a risk based selected sample of sustainability data and the associated limitations that this entails. The scope of a limited assurance engagement is substantially less than for reasonable assurance both in terms of the risk assessment procedures and in performing the procedures to address the identified risks. This independent statement should not be relied upon to detect all errors, omissions or misstatements that may exist.

Responsibilities

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

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

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

Assessment Standard

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

Summary of work performed

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

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

Conclusion

On the basis of our methodology and the activities described above, nothing has come to our attention to indicate that the Selected Information has not been properly prepared, in all material respects, in accordance with the Reporting Criteria.

Statement of Independence, Integrity and Competence

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

Bureau Veritas operates a certified Quality Management System which complies with the requirements of ISO 9001:2015, and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

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

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



Bureau Veritas UK Limited
London
03 March 2021

¹ Certificate of Registration can be provided on request

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

GREENHOUSE GAS EMISSIONS

GREENHOUSE GAS EMISSIONS

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

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

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

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

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

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

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

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

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Foreign exchange

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

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

The Group's global corporate income tax contribution

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

In common with most multinational groups, the total of all profits in respect of which corporate income tax is paid is not the same as the consolidated loss before tax reported on page 106. The main reasons for this are:

- (i) the consolidated income statement is prepared under IFRS, whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;
- (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 level of tax paid in each country is impacted by the above. In most cases, (i) and (ii) are only a matter of timing and therefore tax will be paid in an earlier or later year. As a result they only have a negligible impact on the Group's underlying tax rate. The underlying tax rate can be found on page 20. This is due to deferred tax accounting, details of which can be found in note 5 to the Consolidated Financial Statements. The impact of (iii) will often be permanent depending on the relevant tax law. Further information on the tax position of the Group can be found as follows:

- Audit Committee Report (page 77) – The group tax director gave a presentation to the Audit Committee during the year which covered various matters including tax risks and how they are managed and key sources of estimation uncertainty (in particular the recognition of deferred tax assets and provisions for uncertain tax positions);
- note 1 to the Consolidated Financial Statements (page 114) – Details of key areas of uncertainty and accounting policies for tax; and

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

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

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

Investments and capital expenditure

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

The Group has a portfolio of projects at different stages of their lifecycles. All of our major investments and projects are assessed using a range of financial metrics, including discounted cash flow and return on investment.

Financial risk management

The Board has established a structured approach to financial risk management. The Financial risk committee (Frc) is accountable for managing, reporting and mitigating the Group's financial risks and exposures. These risks include the Group's principal counterparty, currency, interest rate, commodity price, liquidity and credit rating risks outlined in more depth in note 21. The Frc is chaired by the Chief Financial Officer or group controller. The Group has a comprehensive financial risk policy that advocates the use of financial instruments to manage and hedge business operations risks that arise from movements in financial, commodities, credit or money markets. The Group's policy is not to engage in speculative financial transactions. The Frc sits quarterly to review and assess the key risks and agree any mitigating actions required.

Capital structure

£m	2020	2019
Total equity	(4,875)	(3,354)
Cash flow hedges	94	96
Group capital	(4,781)	(3,258)
Net funds (excluding lease liabilities)	(1,533)	1,361

Operations are funded through various shareholders' funds, bank borrowings, bonds and notes. The capital structure of the Group reflects the judgement of the Board as to the appropriate balance of funding required. Funding is secured by the Group's continued access to the global debt markets. Borrowings are funded in various currencies using derivatives where appropriate to achieve a required

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currency and interest rate profile. The Board's objective is to retain sufficient financial investments and undrawn facilities to ensure that the Group can both meet its medium-term operational commitments and cope with unforeseen obligations and opportunities.

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

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

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

The maturity profile of the borrowing facilities is regularly reviewed to ensure that refinancing levels are manageable in the context of the business and market conditions. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating. The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This debt is further outlined in note 12.

Credit rating

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

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

Accounting

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

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

Additional commentary on key performance indicators

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

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

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

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

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

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

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

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

DIRECTORS' REPORT

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Board of Directors

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

Directors' indemnities

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

Share price

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

* Share price adjusted to reflect the rights issue.

Share capital

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

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

The ordinary shares are listed on the London Stock Exchange.

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

Share class rights

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

Ordinary shares

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

C Shares

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

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

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

Special Share

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

DIRECTORS' REPORT

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

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

Shareholder agreements and consent requirements

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

Authority to issue shares

At the 2020 AGM, authority was given to the Directors to allot new C Shares up to a nominal value of £500m as an alternative to a cash dividend.

In addition, an ordinary resolution was passed authorising the Directors to allot new ordinary shares up to a nominal value of £128,733,021 equivalent to one-third of the issued share capital of the Company. This resolution also authorised the Directors to allot up to two-thirds of the total issued share capital of the Company, but only in the case of a rights issue.

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

These authorities are valid until the 2021 AGM or 30 June 2021, whichever is earlier, and the Directors propose to renew each of them at the 2021 AGM. The Board believes that these authorities will allow the Company to retain flexibility to respond to circumstances and opportunities as they arise.

Rights issue

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

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

Authority to purchase own shares

At the 2020 AGM, the Company was authorised by shareholders to purchase up to 193,099,531 of its own ordinary shares representing 10% of its issued ordinary share capital.

The authority for the Company to purchase its own shares expires at the conclusion of the 2021 AGM or 30 June 2021, whichever is the earlier. A resolution to renew the authority will be proposed at the 2021 meeting.

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

Deadlines for exercising voting rights

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

Voting rights for employee share plan shares

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

Major shareholdings

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

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

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

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

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

Changes to the Articles of Association

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

Change of control

Contracts and joint venture agreements

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

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At 31 December 2020, these facilities were 26% drawn (2019: less than 2%).

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

Employee share plans

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

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

Political donations

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

which might not be thought of as political expenditure in the usual sense, could be captured. Activities of this nature would not be thought of as political donations in the ordinary sense of those words. The resolution to be proposed at the 2021 AGM, authorising political donations and expenditure, is to ensure that the Group does not commit any technical breach of the Act.

During the year, expenses incurred by Rolls-Royce North America, Inc. in providing administrative support for the Rolls-Royce North America political action committee (PAC) was US\$68,100 (2019: US\$81,866). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act.

The PAC is independent of the Group and independent of any political party. The PAC funds are contributed voluntarily by employees and the Group cannot affect how they are applied, although under US law, the business expenses are paid by the employee's company. Such contributions do not count towards the limits for political donations and expenditure for which shareholder approval will be sought at this year's AGM to renew the authority given at the 2020 AGM.

Disclosures in the Strategic Report

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

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

Information required by UK Listing Rule (LR) 9.8.4

There are no disclosures to be made under LR 9.8.4.

Management report

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

By order of the Board

Pamela Coles

Company Secretary

11 March 2021

SHAREHOLDER INFORMATION

Managing your shareholding

Your shareholding is managed by Computershare Investor Services plc (the Registrar). When making contact with the Registrar please quote your Shareholder Reference Number (SRN). This is a 10-digit number prefixed with the letter 'C' that can be found on the right-hand side of your share certificate or in any other shareholder correspondence.

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

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

Payments to shareholders

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

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

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

Share dealing

The Registrar offers shareholders an internet dealing service at www.computershare.co.uk and a telephone dealing service (+44 (0)370 703 0084). Real-time dealing is available during market hours, 8.00am to 4.30pm, Monday to Friday excluding bank holidays. Orders can still be placed outside of market hours. The fee for internet dealing is 1% of the transaction value subject to a minimum fee of £30. The fee for telephone dealing is 1% of the transaction value plus £50. Stamp duty of 0.5% is payable on all purchases. This service is only available to shareholders resident in certain jurisdictions. Before you can trade you must register to use the service. Other share dealing facilities are available but you should always use a firm regulated by the FCA (see www.fca.org.uk/register).

Your share certificate

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

American Depository Receipts (ADR)

ADR holders should contact the depositary, JP Morgan, by calling +1 (800) 990 1135 (toll free within the US) or +1 (651) 453 2128 (outside the US) or via www.adr.com/contact/jpmorgan.

Warning to shareholders – investment scams

We are aware that some of our shareholders have received unsolicited telephone calls or correspondence, offering to buy or sell their shares at very favourable terms. The callers can be very persuasive and extremely persistent and often have professional websites and telephone numbers to support their activities.

These callers will sometimes imply a connection to Rolls-Royce and provide incorrect or misleading information. This type of call should be treated as an investment scam – the safest thing to do is hang up.

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

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

Visit Rolls-Royce online

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

Communication preferences

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

Analysis of ordinary shareholders at 31 December 2020

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

GLOSSARY

GLOSSARY

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

Trade marks

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