

Rolls-Royce plc
Annual report 2014



Rolls-Royce

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

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

What's inside...

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FINANCIAL HIGHLIGHTS

How did we perform in 2014?

	2014	2013	Change
Order book £m	73,674	71,612	+3%
Underlying* revenue £m	14,588	15,505	-6%
Underlying* profit before tax £m	1,617	1,760	-8%
Reported revenue £m†	13,736	14,642	-6%
Reported profit before tax £m†	146	1,960	-96%
Net cash £m	666	1,939	-66%
Free cash flow £m	254	781	-67%

* Underlying explanation is in note 2 on page 67.

† 2013 re-presented to reflect Energy as a discontinued operation.

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

FORWARD-LOOKING STATEMENTS

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

GROUP AT A GLANCE

A HIGH-VALUE GLOBAL BUSINESS

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

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

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

GROUP



EMPLOYEES (YEAR AVERAGE)

54,100



ENGINEERS (YEAR END)

15,500



ORDER BOOK

£73.7bn



COUNTRIES

50+



INVESTED IN R&D

£1.2bn



PATENTS APPLIED FOR

600

UNDERLYING GROUP
REVENUE



■ Aerospace 61%
■ Land & Sea 39%

UNDERLYING GROUP
REVENUE

£14,588m

UNDERLYING GROUP
PROFIT BEFORE TAX

£1,617m

AEROSPACE

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

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

→ PAGES 22 TO 25
FOR MORE INFORMATION

CIVIL AEROSPACE

UNDERLYING
REVENUE MIX



■ OE revenue 48%
■ Services revenue 52%

UNDERLYING REVENUE

£6,837m

UNDERLYING PROFIT

£942m

DEFENCE AEROSPACE

UNDERLYING
REVENUE MIX



■ OE revenue 39%
■ Services revenue 61%

UNDERLYING REVENUE

£2,069m

UNDERLYING PROFIT

£366m

LAND & SEA

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

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

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

POWER SYSTEMS

UNDERLYING
REVENUE MIX



■ OE revenue 70%
■ Services revenue 30%

UNDERLYING REVENUE

£2,720m

UNDERLYING PROFIT

£253m

MARINE

UNDERLYING
REVENUE MIX



■ OE revenue 63%
■ Services revenue 37%

UNDERLYING REVENUE

£1,709m

UNDERLYING PROFIT

£138m

NUCLEAR

UNDERLYING
REVENUE MIX



■ OE revenue 37%
■ Services revenue 63%

UNDERLYING REVENUE

£684m

UNDERLYING PROFIT

£48m

ENERGY

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

UNDERLYING REVENUE

£724m

UNDERLYING PROFIT

£(3)m

→ PAGES 26 TO 31
FOR MORE INFORMATION

CHIEF EXECUTIVE'S REVIEW

Rolls-Royce is in business to deliver better power for a changing world.

The integrated power systems that we develop, build and maintain, address the increasing global demand for transport and energy.



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

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

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

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

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

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



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



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



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

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

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

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

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

BETTER POWER

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

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



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

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

CHIEF EXECUTIVE'S REVIEW

CONTINUED

INNOVATION

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



MORE INFORMATION
ON PAGES 10 AND 11

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

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

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

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

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

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

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

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

Improving performance in this way strengthens the relationship we have with

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

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

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

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

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

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

In November, we announced a restructuring programme in our Aerospace Division and central functions, which is expected to reduce headcount by 2,600. By the end of 2014, 545 people had left the business, with the majority of the reductions expected in 2015. This programme is expected to result in restructuring charges of around £120 million, of which £56 million was recognised in our 2014 results. We anticipate annualised cost benefits of around £80 million from 2016 onwards,

with £50 million in benefits expected in 2015. Our total Aerospace 2014 restructuring activities cost £164 million (of which £139 million was underlying).

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

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

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

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

OUR FIVE PRIORITIES FOR THE GROUP

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

FIX THE BASICS (THE 4Cs)

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

CULTURE

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

CIVIL WIDEBODY

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

CIVIL NARROWBODY

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

MEDIUM-SPEED RECIPROCATING ENGINES

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

CHIEF EXECUTIVE'S REVIEW

CONTINUED

TECHNOLOGY

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



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

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

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



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

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

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

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

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

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

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

For off-highway vehicles, MTU's latest Series 4000 engine has improved fuel consumption by 5%. For a typical application this can represent a saving of up to 100,000 litres of fuel and reduction of 350 tonnes of CO₂ emissions each year.

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

5%



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

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



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

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

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

This year we held our inaugural Trusted to Deliver Excellence Awards to recognise Rolls-Royce teams who have achieved outstanding results for their customers. The imagination, passion and ability to execute demonstrated by all the finalists is inspiring. You can read more about these awards on pages 32 to 33.

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

JOHN RISHTON
Chief Executive
12 February 2015



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

INNOVATION AND TECHNOLOGY

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

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

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

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

ENGINEERING STRENGTH

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

INNOVATION

We have a track record over many years of creating new products and services and we continue to strive to be leading edge in everything we do. Innovation cannot be left to chance. It needs to be encouraged, managed, selected and pulled through into products and services. Harnessing the total intellectual power of our people takes enthusiasm and effort. Our new Innovation Portal, Big Ideas Forums and Open Innovation challenge have been successful and each year we reward the most innovative ideas at our Sir Henry Royce Technology Awards. We look at innovation in terms of technology and services and also in the way we conduct engineering and manufacturing. This ensures that we continuously simplify and improve processes in order to be efficient and remove waste.

RESEARCH AND DEVELOPMENT

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

£1.2bn
R&D INVESTMENT



DEMONSTRATOR PROGRAMMES

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

* total as at end of 2014

OUR 'VISION' APPROACH

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

VISION 5

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

VISION 10

Vision 10 describes leading-edge, validated technologies for application in the 'medium term'. Most of these are at demonstration level today and will feature in the next generation of products. For example, the lean burn combustion system for aero gas turbines has been in development for some years and offers a 60% reduction in the pollutant NO_x and particulate matter (smoke) compared to year 2000 levels. It will reach flight test in 2015 and is supported by the European Clean Sky Programme.

VISION 20

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

MARKET OUTLOOK

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

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

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

Aerospace potential
for OE and services
over the next 20 years



US\$2,300bn[†]

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



£1,300bn[†]

[†] Rounded to the nearest 100bn

AEROSPACE DIVISION

CIVIL AEROSPACE

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

DEFENCE AEROSPACE

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

LAND & SEA DIVISION

POWER SYSTEMS

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

MARINE

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

NUCLEAR

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

STRATEGY

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

CUSTOMER



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

INNOVATION



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

PROFITABLE GROWTH



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

PEOPLE



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



SEE PAGES 34 TO 37 FOR MORE INFORMATION ON HOW SUSTAINABILITY PLAYS A PIVOTAL ROLE IN THE DELIVERY OF OUR STRATEGY

BUSINESS MODEL

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

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

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

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

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

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

CONNECT TECHNOLOGY TO CUSTOMER NEEDS

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



AEROSPACE

Gas turbines

Large & global

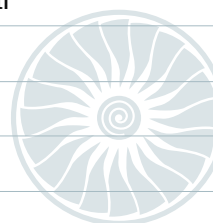
High

High

5-20 years

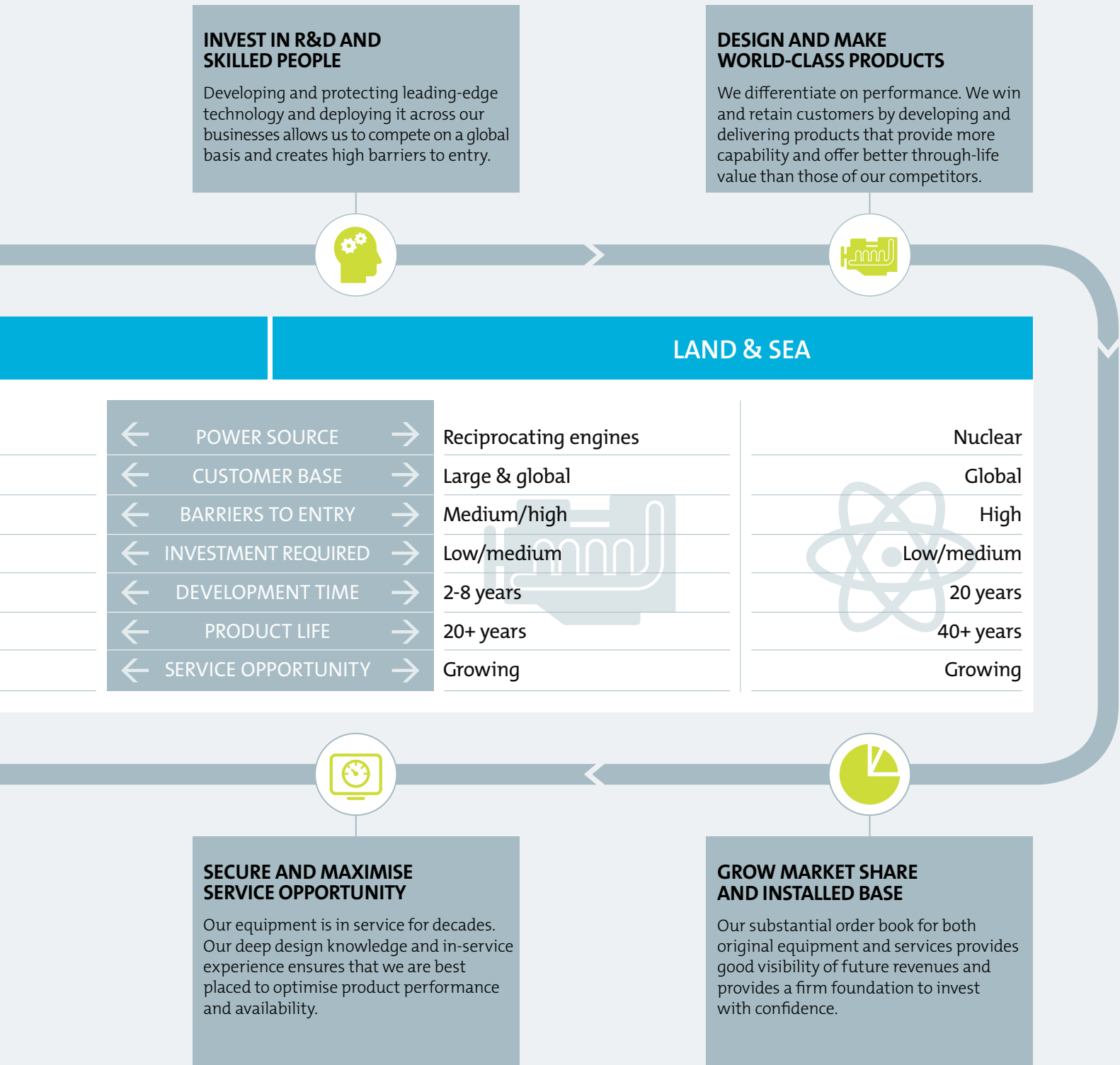
40+ years

Substantial and growing



ALLOCATE CAPITAL TO NEW GROWTH

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



CHIEF FINANCIAL OFFICER'S REVIEW

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

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

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

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

SUMMARY

	2014	2013	Change
Order book £m	73,674	71,612	+3%
Underlying* revenue £m	14,588	15,505	-6%
Underlying* profit before tax £m	1,617	1,759	-8%
Return on sales	11.5%	11.8%	-0.3pp
Reported revenue†	13,736	14,642	-6%
Reported profit before tax†	146	1,960	-93%
Net cash	666	1,939	-66%
Free cash flow £m	254	781	-67%

* Underlying explanation is in note 2 on page 67.

† 2013 re-presented to reflect Energy as a discontinued operation.

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

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

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

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

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

- maintaining a strong balance sheet that gives confidence to our customers and enables our business to invest in future programmes;

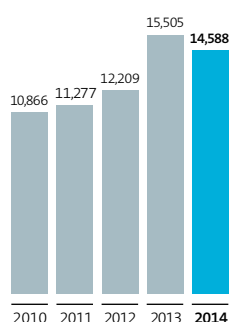
- continuing to refine our capital allocation processes and invest in R&D to develop the next generation of products; and
- managing risk prudently including hedging our foreign currency exposures to reduce volatility.

There's no doubt that the recent changes in oil and commodity prices, currencies and geopolitical strains have increased uncertainty. We therefore need to plan cautiously while accelerating our business improvement activity.

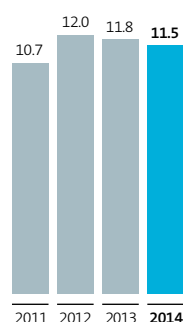
Looking ahead, our product portfolio transition will see rising deliveries of new civil engines that will significantly increase our installed base. We will also continue to grow our Land & Sea businesses. This and our investment in new technology and industrial transformation will constrain near-term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

➔ PAGES 52 TO 105
CONSOLIDATED FINANCIAL STATEMENTS

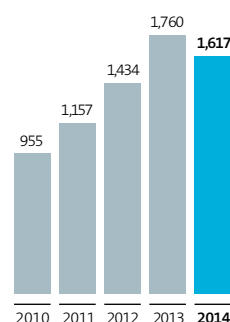
GROUP UNDERLYING
REVENUE (£m)



RETURN ON
SALES (%)



GROUP UNDERLYING
PROFIT BEFORE
TAXATION (£m)



FINANCIAL REVIEW

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

GROUP UNDERLYING INCOME STATEMENT

£ million	2014	2013	Change
Revenue	14,588	15,505	(917)
Profit before financing	1,678	1,832	(154)
Net financing	(61)	(72)	11
Profit before taxation	1,617	1,760	(143)
Taxation	(387)	(434)	47
Profit for the year	1,230	1,326	(96)
Gross R&D investment	1,249	1,118	131
Net R&D charge	755	624	131

SEGMENTAL ANALYSIS

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

GROUP UNDERLYING REVENUE

£14,588m

GROUP UNDERLYING PROFIT BEFORE TAXATION

£1,617m

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

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

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

→ PAGES 22 TO 31
FURTHER DISCUSSION OF TRADING IS INCLUDED
IN THE BUSINESS REVIEWS

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

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

→ PAGE 126
THE GROUP'S TAX PAYMENTS

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

REPORTED PROFIT BEFORE TAX

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

PROFIT BEFORE TAXATION

£ million	2014	2013
Underlying	1,617	1,760
Mark-to-market adjustments on derivatives	(1,254)	217
Movements on other financial instruments	(8)	8
Effect of acquisition accounting	(142)	(265)
Exceptional restructuring	(39)	—
Acquisitions and disposals	8	335
Post-retirement schemes	(29)	(90)
Other (including discontinued operations)	(7)	(5)
Reported (2013 restated to exclude discontinued operations)	146	1,960

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

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

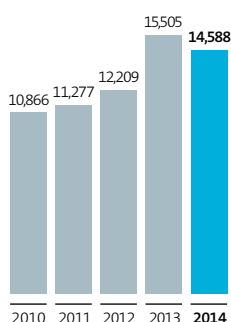
Costs associated with the substantial closure or exit of a site, facility or activity are classified as **exceptional restructuring** and excluded.

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

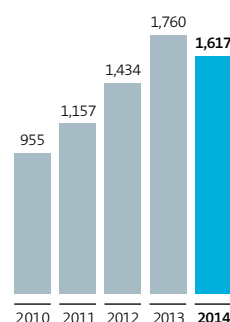
Net financing on **post-retirement schemes** is excluded from underlying profit and, in 2013, the cost of providing a discretionary increase to pensions was also excluded.

Appropriate tax rates are applied to these adjustments, the net effect of which was a £239 million reduction in the reported tax charge (2013 £54 million reduction). The adjustment includes a £64 million reduction in the value of recoverable advance corporation tax recognised. A reconciliation of the tax charge is included in note 5.

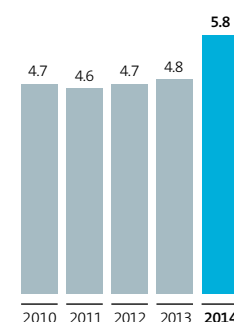
UNDERLYING REVENUE (£m)



UNDERLYING PROFIT BEFORE TAXATION (£m)



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



FINANCIAL REVIEW

CONTINUED

SUMMARY BALANCE SHEET

£ million	2014	Other changes	Energy disposal (note 25)	2013
Intangible assets	4,804	(77)	(106)	4,987
Property, plant and equipment	3,446	241	(187)	3,392
Joint ventures and associates	539	(6)	(56)	601
Net working capital	(712)	694	(393)	(1,013)
Net funds	666	(1,269)	(4)	1,939
Provisions	(807)	(108)	34	(733)
Net post-retirement scheme surpluses/(deficits)	555	1,348	–	(793)
Net financial assets and liabilities	(833)	(1,120)	–	287
Other net assets and liabilities	(827)	(294)	–	(533)
Net assets	6,831	(591)	(712)	8,134
Other items				
USD hedge book US\$ billion	25.6			24.7
TotalCare assets	2,492			1,901
TotalCare liabilities (2013 includes £245m not previously included)	(687)			(559)
Net TotalCare assets	1,805			1,342
Customer financing contingent commitments:				
Gross	388			356
Net	59			59

BALANCE SHEET

Intangible assets (note 8) represent long-term assets of the Group. These assets decreased by £77 million with additional development, contractual aftermarket rights, certification and software costs being more than offset by annual amortisation charges.

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain: reductions in assumed market share; programme timings; increases in unit cost assumptions; and adverse movements in discount rates. There have been no significant impairments in 2014.

Property, plant and equipment (note 9) increased by £241 million due to the ongoing development and refreshment of

facilities and tooling as the Group prepares for increased production volumes.

Investments in joint ventures and associates (note 10) remain stable as the share of retained profit was offset by dividends received.

Provisions (note 17) largely relate to warranties and guarantees provided to secure the sale of OE and services. The increase is largely a result of the recognition of restructuring costs.

Net post-retirement scheme surpluses/(deficits) (note 18) increased by £1,348 million, principally due to relative movements in the yield curves used to value the underlying assets and liabilities in accordance with IAS 19. In addition, the scheme rules on the largest UK scheme were amended during the year, resulting in the surplus being recognised (£544 million impact).

The Group's principal pension schemes adopt a low risk investment strategy that reduces volatility going forward and enables the funding position to remain stable: interest rate and inflation risks are largely hedged and the exposure to equities is around 8% of scheme assets.

Net financial assets and liabilities (note 16) include the fair value of derivatives and financial RSAs. The reduction primarily reflects foreign exchange derivatives (£1,137 million) due to the strengthening of the US dollar.

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

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

Customer financing facilitates the sale of OE and services by providing financing support to certain customers. Where such support is provided by the Group, it is almost exclusively to customers of the Civil aerospace business and takes the form of various types of credit and asset value guarantees. These exposures produce

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

contingent liabilities that are outlined in note 18. The contingent liabilities represent the maximum aggregate discounted gross and net exposure in respect of delivered aircraft, regardless of the point in time at which such exposures may arise.

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

FUNDS FLOW

Movement in working capital – the increase reflects the growth of the net TotalCare asset and an increase in amounts due from the parent company, offset by a reduction in the amount of customer deposits.

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

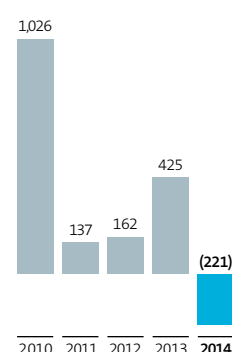
Pensions – contributions to defined benefit pension schemes in 2014 included £33 million to UK schemes to fund the discretionary increases agreed in 2013. The service cost included a past-service credit of £31 million – largely relating to restructuring (2013 past-service cost £71 million – largely relating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

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

Shareholder payments – the increase reflects the Power Systems dividend to Daimler (£14 million increase).

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

FREE CASH FLOW (£m)



SUMMARY FUNDS FLOW

£ million	2014	2013	Change
Opening net funds	1,939	1,316	
Closing net funds	666	1,939	
Change in net funds	(1,273)	623	
Underlying profit before tax	1,617	1,759	(142)
Depreciation and amortisation	600	608	(8)
Movement in net working capital	(985)	(265)	(720)
Expenditure on property, plant and equipment and intangible assets	(1,114)	(1,172)	58
Other	89	(231)	320
Trading cash flow	207	699	(492)
Contributions to defined benefit post-retirement schemes in excess of PBT charge	(152)	(36)	(116)
Tax	(276)	(238)	(38)
Free cash flow	(221)	425	(646)
Shareholder payments	(76)	(60)	(16)
Acquisitions and disposals	(965)	265	(1,230)
Net funds of businesses acquired	(30)	36	(66)
Foreign exchange	19	(43)	62
Change in net funds	(1,273)	623	
Average net funds	(38)	350	(388)

BUSINESS REVIEW – AEROSPACE

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

TONY WOOD
President – Aerospace

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

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

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

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

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

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

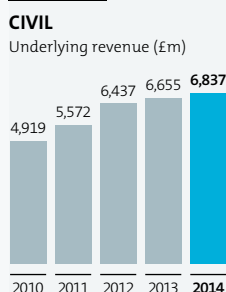
OVERVIEW

CIVIL AEROSPACE

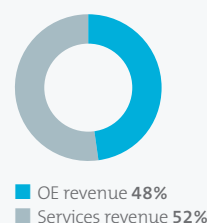
KEY HIGHLIGHTS

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

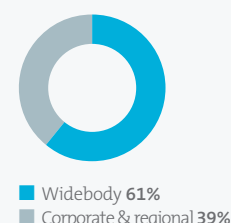
 **23,900** Employees



CIVIL UNDERLYING REVENUE MIX



CIVIL UNDERLYING REVENUE BY SECTOR

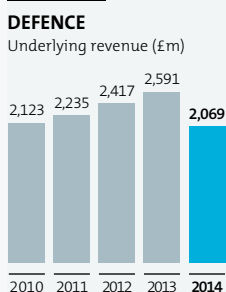


DEFENCE AEROSPACE

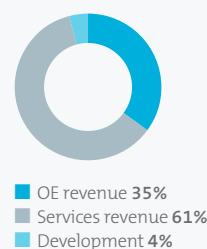
KEY HIGHLIGHTS

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

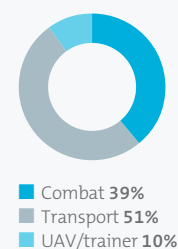
 **7,000** Employees



DEFENCE UNDERLYING REVENUE MIX



DEFENCE UNDERLYING REVENUE BY SECTOR



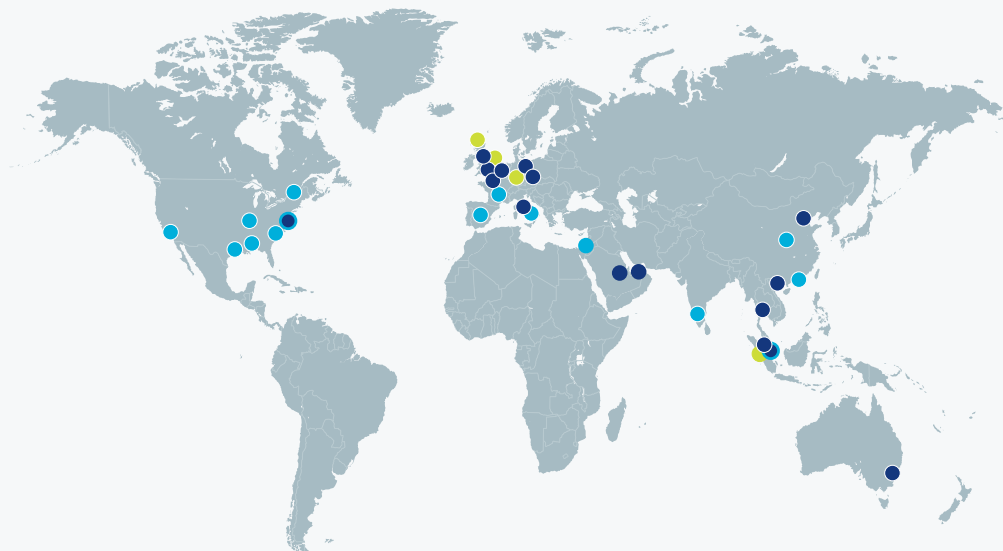
programmes, such as the Korean K-FX combat aircraft and the Anglo-French Future Combat Air System.

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

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

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

AEROSPACE LOCATIONS



Key

- Aerospace locations
- Corporate locations
- Aerospace and Corporate

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

CIVIL AEROSPACE

PERFORMANCE REVIEW

WHO WE ARE

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

FINANCIAL REVIEW

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

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

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

BUSINESS REVIEW – AEROSPACE

CONTINUED

CIVIL AEROSPACE – KEY FINANCIAL DATA

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

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

OUR YEAR

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

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

The latest version of the Trent 1000 entered into service in July, powering Boeing 787-9 Dreamliners for Air New Zealand and ANA. Work progressed on the Trent 1000-TEN which will be available from 2016 and will be capable of powering all variants of the Dreamliner.

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

25 Trent 7000-powered A330neos together with 25 Trent XWB-powered A350-900s.

1,500 Trent XWB engines have been ordered



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

We took significant steps in the development of our future engine programmes. In February, we announced two innovative new engine designs; the Advance turbofan and UltraFan which will feature a power gearbox. These will be available from 2020 and 2025 respectively. A new test bed for power gearboxes is to be built at our site in Dahlewitz, Germany, representing an investment of €65 million. An additional test bed for future extra-large engines of up to 150,000lbs thrust was also opened in Dahlewitz in November. We maintained our leading position in the business jet market. Our BR725 was selected to power Gulfstream's new ultra-long-range business jet, the G650ER. The year also saw the entry into service of the world's fastest civilian aircraft, the AE 3007C2-powered Citation X+.

To support operators of Rolls-Royce powered business jets we continued to expand our global network of authorised service centres. The number of engines powering corporate

aircraft covered by our CorporateCare® programme reached more than 1,600. The level of TotalCare coverage in the commercial transport installed engine base increased to 83% this year and 210 incremental corporate jets were signed up to our CorporateCare programme.

LOOKING AHEAD

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

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

DEFENCE AEROSPACE

PERFORMANCE REVIEW

WHO WE ARE

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

FINANCIAL REVIEW

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

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

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

OUR YEAR

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

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

We secured a major long-term agreement with Lockheed Martin worth up to US\$1 billion to supply up to 600 AE 2100 engines for the C-130J aircraft, in addition to over US\$200 million in support contracts for AE 2100 engines. Deliveries were made to Turkey, France, Germany and the UK of the TP400-powered Airbus A400M transport aircraft. The 100th TP400 production engine was delivered in November and in the same month, we announced an £18 million investment in facilities at Bristol to support this programme. 2014 saw good progress in

the tanker aircraft market where we are a shareholder in AirTanker which operates the A330 Multi Role Tanker Transport (MRTT) on behalf of the Royal Air Force. In 2014, the A330 MRTT was also selected by the defence forces of France and the Republic of Singapore.

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

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

In the unmanned aircraft market our stealthy, integrated, propulsion system successfully demonstrated its capability in the second round of flight trials of the UK's Taranis demonstrator. Our AE 3007 engine also powered the US Navy's Triton unmanned aerial system on its first trans-America flight. We were named a 'superior supplier' by both the US Navy

and US Defense Logistics Agency in 2014 and recognised by Northrop Grumman for our support of its Global Hawk unmanned aerial vehicle programme.

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

LOOKING AHEAD

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

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

DEFENCE – KEY FINANCIAL DATA

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

BUSINESS REVIEW – LAND & SEA

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

LAWRIE HAYNES
President – Land & Sea

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

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

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

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

OVERVIEW

POWER SYSTEMS

KEY HIGHLIGHTS

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



10,700 Employees

POWER SYSTEMS

Underlying revenue (£m)*



POWER SYSTEMS UNDERLYING REVENUE MIX



POWER SYSTEMS UNDERLYING REVENUE BY SECTOR



MARINE

KEY HIGHLIGHTS

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



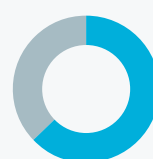
6,400 Employees

MARINE

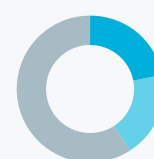
Underlying revenue (£m)*



MARINE UNDERLYING REVENUE MIX



MARINE UNDERLYING REVENUE BY SECTOR



NUCLEAR

KEY HIGHLIGHTS

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



3,900 Employees

NUCLEAR

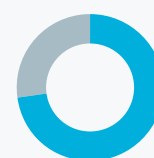
Underlying revenue (£m)*



NUCLEAR UNDERLYING REVENUE MIX



NUCLEAR UNDERLYING REVENUE BY SECTOR



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

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

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

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

At sea, our Naval business has done well despite continued pressure on defence budgets. Nuclear reactors designed and manufactured by us have been powering the Royal Navy's nuclear submarine fleet

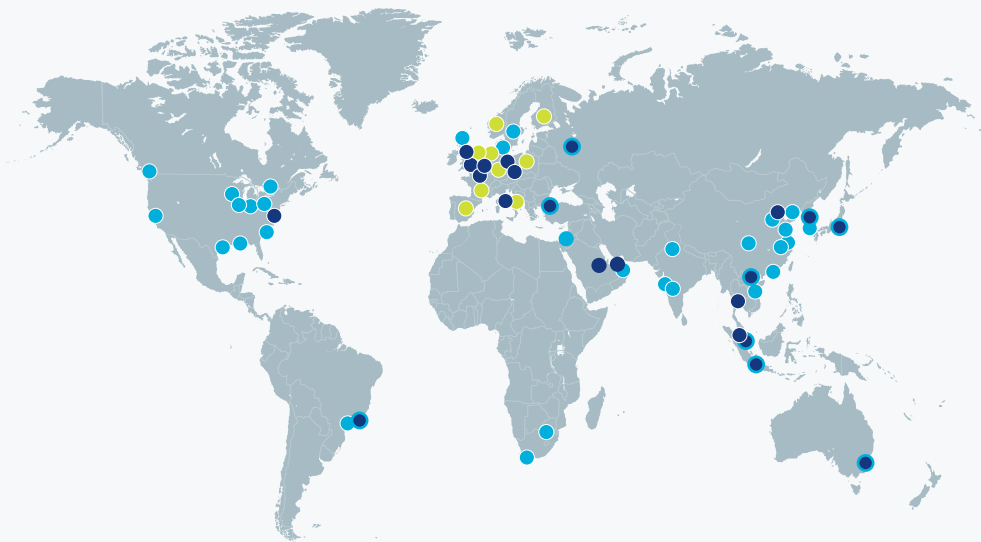
for the last 55 years and our engineers are currently designing the next generation for the fleet of the future.

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

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

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

LAND & SEA LOCATIONS



Key		
● Land & Sea locations	● Multiple Land & Sea locations:	
● Corporate locations	Finland 2	Netherlands 2
● Land & Sea and Corporate	France 2	Norway 8
	Germany 10	Poland 2
	Italy 2	Spain 2
		United Kingdom 4

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



BUSINESS REVIEW – LAND & SEA

CONTINUED

POWER SYSTEMS – KEY FINANCIAL DATA

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

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

POWER SYSTEMS

BUSINESS PERFORMANCE REVIEW

WHO WE ARE

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

FINANCIAL REVIEW

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

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

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

OUR YEAR

Slower growth in Eurozone countries and emerging economies presented challenges to our business in 2014. However, the

breadth of our portfolio presented opportunities for growth in some parts of the business.

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

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

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

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

Sales in the European construction, industrial and agriculture sectors were substantially lower in 2014 compared with

the high volumes ordered in 2013. Sharp falls in commodity prices led customers in the mining and oil & gas industries to delay or cancel orders for OE.

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

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

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

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

LOOKING AHEAD

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

MARINE

BUSINESS PERFORMANCE REVIEW

WHO WE ARE

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

MARINE – KEY FINANCIAL DATA

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

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

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

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

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

FINANCIAL REVIEW

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

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

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

OUR YEAR

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

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

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

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

We continue to focus on efficiency and cost reduction, addressing areas including our supply chain, operational footprint and indirect headcount. We have reduced the number of suppliers to Marine by almost

40% in the last four years (half of that in 2014) and reduced indirect headcount by more than 500 people over the past two years.

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

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

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

**A ship fit for a queen"**

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

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

BUSINESS REVIEW – LAND & SEA

CONTINUED

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

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

LOOKING AHEAD

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

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

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

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

We have begun to transform our business to improve our competitiveness in all areas and this programme will continue, again focusing on consolidation of manufacturing, our external supply chain and reducing our overhead costs. We will adapt to the market conditions in our biggest market sector, Offshore, which accounts for around two-thirds of our business, responding to the uncertainties caused by the significant decrease in oil prices over recent months.

NUCLEAR

BUSINESS PERFORMANCE REVIEW

WHO WE ARE

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

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

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

FINANCIAL REVIEW

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

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

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

OUR YEAR

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

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

Civil nuclear power is increasingly important to the energy policy of a growing number of countries and regions such as China, India, Middle Eastern countries and Central and Eastern Europe. Increased focus on low-

AT SEA

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

ON LAND

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

NUCLEAR – KEY FINANCIAL DATA

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

carbon electricity generation and security of energy supply, continued to drive demand for the upgrade, plant-life extension and replacement of nuclear capacity. More countries are considering adopting nuclear power for the first time, with governments seeking to develop a nuclear industrial and supply chain strategy designed to benefit local economies and capability (Turkey and Poland being examples).

For the UK civil nuclear new build programme, we continued to carry out early works to support developers and operators and we continue to recruit and develop capability in line with market growth projections for future years. The UK has one of the largest new build programmes in the western world with 11 reactors expected to be built by 2030. European Union Commission approval in 2014 of the investment contract for the first new reactor to be built at Hinkley Point C in Somerset was a significant milestone.

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

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

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

LOOKING AHEAD

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

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

ENERGY BUSINESS**PERFORMANCE REVIEW**

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

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

ENERGY – KEY FINANCIAL DATA

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

OUR PEOPLE

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

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

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

CELEBRATING SUCCESS: AWARD WINNERS' STORIES

SIMPLE TOUCH SCREEN TO HELP MARINE CUSTOMERS

MARINE
ÅLESUND, NORWAY

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

100% RIGHT-FIRST-TIME DISC PRODUCTION

SUPPLY CHAIN
WASHINGTON, UK

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

CHALLENGING CONVENTIONAL THINKING

ENGINEERING AND TECHNOLOGY
UK AND GERMANY

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

STANDING IN OUR CUSTOMERS' SHOES

CIVIL SMALL & MEDIUM ENGINES
MONTREAL, CANADA

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

IMPROVED TURBINE BLADE QUALITY AT LESS COST

SUPPLY CHAIN
ROTHERHAM, UK

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

MONITORING THRUSTERS AT SEA TO PLAN MAINTENANCE

ENGINEERING AND TECHNOLOGY
UK AND FINLAND

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

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

SAVING CUSTOMERS MONTHS OF TIME IN COMMISSIONING

NUCLEAR
DERBY, UK

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



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

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

SUSTAINABILITY

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

OUR APPROACH

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

BETTER POWER

HELPING OUR CUSTOMERS DO MORE, USING LESS

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

IMPROVING ENVIRONMENTAL PERFORMANCE

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

PRODUCT SAFETY

Our products are often deployed in mission critical environments. We are committed to delivering products and services that achieve the highest standards of product safety. We have a consistent approach to safety across the Group and systematically pursue proactive opportunities for improvement.

BETTER FUTURE

COMMITTED TO INNOVATION, POWERING BETTER, CLEANER ECONOMIC GROWTH

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

OUR PEOPLE

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

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

A diverse workforce will help ensure our continued success as a global business and contribute towards a better future.

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

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

EMPLOYEE INVOLVEMENT

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

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

EARLY CAREER DEVELOPMENT PROGRAMMES

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

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

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

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

HUMAN RIGHTS

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

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

EMPLOYEE WELLBEING

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

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

COMMUNITIES

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

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

GLOBAL PARTNERSHIPS

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

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

BETTER BUSINESS

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

ETHICS

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

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

HEALTH, SAFETY AND ENVIRONMENT

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

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

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

* The TRI rate excludes Power Systems, and has been adjusted to reflect the disposal of our Energy gas turbines and compressor business in December 2014. Entities that were part of the Energy business that were not part of the disposal have been included. See note at the bottom of page 36.

ACCELERATING PROGRESS

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

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

Our 2014 sustainability performance and targets are detailed overleaf.

2014 PERFORMANCE

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

CUSTOMER 	INNOVATION 	PROFITABLE GROWTH 
BETTER POWER	BETTER FUTURE	BETTER BUSINESS
In the air Our new Trent 7000 engine will deliver a 10% improvement in specific fuel consumption and halve the noise energy output compared to the current engine on the A330. Announced this year, our Advance and UltraFan next generation designs will offer at least 20-25% better fuel burn and CO₂ emissions than first generation Trent engines. 	Over 1,000 employee STEM ambassadors globally 	A Global Code of Conduct issued to all employees in 21 different languages 
On land Our MTU technology installed on Deutsche Bahn's diesel Coradia Lint 54 and 81-type trains reduces particulate emissions by 90% and contributes to reducing fuel consumption and CO₂ emissions. Our nuclear technology is installed in over 200 reactors across 20 countries worldwide, making a significant contribution to low-carbon electricity generation. 	Supporting a global network of 31 University Technology Centres, engaging over 700 academics in fundamental research into cutting edge technologies 	Reduced year-on-year energy consumption normalised by revenue by 16% since 2010 
At sea Our innovative ship design and propulsion systems and pioneering use of new cleaner fuel solutions are reducing emissions for our customers. Our Environship design reduces CO₂ by up to 40% compared to conventional diesel powered vessels and received the Heyerdahl Award this year. 	Recruited 354 graduates and 357 apprentices 	Invested £4 million in energy efficiency improvement projects
7,900 customers supported with our product learning solutions	£10.6 million invested in supporting communities, a 31% increase since 2013 	565 ktCO₂e absolute total GHG emissions from our operations* 
Hosted almost 14,000 visitors at our Customer Training Centres	40,000 employees directly accessed our learning system, completing 250,000 individual courses	Total reportable injury (TRI) rate of 0.37 per 100 employees 
	In 2014 we invested £1.2 billion in gross R&D and filed for 600 patents 	Occupational illness occurrence rate of 0.05 per 100 employees 
		Our health and safety performance continues to improve with a 45% reduction in TRI rate since 2010 
		Supported suppliers to complete 2,500 individual courses

MEMBER OF
Dow Jones Sustainability Indices
In Collaboration with RobecoSAM 

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



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

* Regulatory GHG emissions data detailed on page 49.

 Limited assurance engagement undertaken by KMPG LLP, using the assurance standards ISAE 3000 and ISAE 3410, over the GHG and TRI data as highlighted. More information detailed on page 49.
 We are in the process of integrating our Power Systems business into our HS&E management system. Energy, GHG, TRI and occupational illness data from Power Systems is excluded for 2014. The figures presented have been adjusted to reflect the disposal of our Energy gas turbine and compressor business in December 2014. Entities that were part of the Energy business that were not part of the disposal have been included.

TARGETS

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

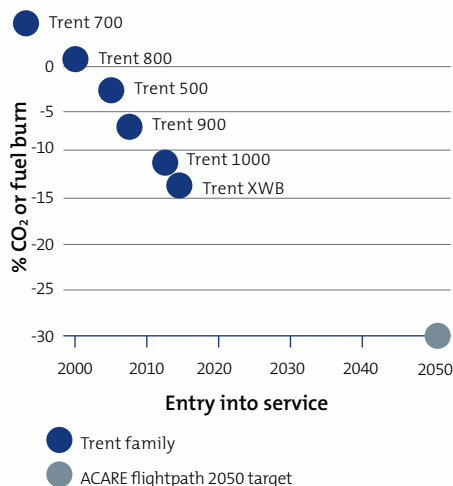
CUSTOMER



BETTER POWER

ACARE Flightpath 2050 goals

The Advisory Council for Aviation Research and Innovation in Europe (ACARE) has set challenging goals for aviation to meet by 2050. These include reducing aircraft CO₂ emissions by 75% (per passenger kilometre); reducing noise by 65%; and reducing oxides of nitrogen (NO_x) by 90%, all relative to a typical new aircraft produced in 2000.



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

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

INNOVATION



BETTER FUTURE

Reach

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



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



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



PROFITABLE GROWTH



BETTER BUSINESS

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

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



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



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



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

Zero waste to landfill by 2020**

All suppliers aligned to our own ambitions

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

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

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

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



Discover more online
www.rolls-royce.com/sustainability

* Provided by Towers Watson

** Excluding hazardous waste, incineration with energy recovery only.

KEY PERFORMANCE INDICATORS

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

Financial performance indicators are shown below. Non-financial performance indicators are shown in the Sustainability section on pages 34 to 37.

CUSTOMER

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

INNOVATION



NET R&D EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE

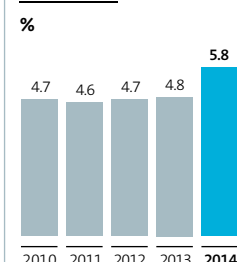
5.8%

WHY WE MEASURE IT

This measure reflects the need to generate current returns as well as to invest for the future. We measure R&D as the self-funded expenditure before both amounts capitalised in the year and amortisation of previously-capitalised balances. We expect to spend approximately 5% of underlying revenues on R&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.

HOW WE HAVE PERFORMED

The increase reflects increased investment due to the phasing of major new programmes.

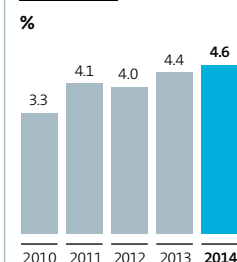


CAPITAL EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE

4.6%

To deliver on its commitments to customers, the Group invests significant amounts in its infrastructure. All proposed investments are subject to rigorous review to ensure that they are consistent with forecast activity and will provide value for money. We measure annual capital expenditure as the cost of property, plant and equipment acquired during the period and, over the medium term, expect a proportion of around 4%.

The level of expenditure reflects the ongoing investment in facilities and tooling as the Group prepares for increased production volumes.



PROFITABLE GROWTH



UNDERLYING PROFIT BEFORE FINANCING

-8%

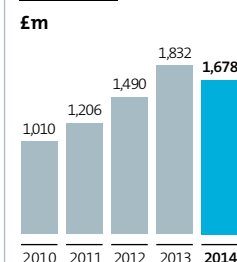
-5% excluding FX

WHY WE MEASURE IT

We measure underlying profit before financing on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements. In particular: (a) revenues and costs denominated in US dollars and euros are presented on the basis of the exchange rates achieved during the year; (b) similar adjustments are made in respect of commodity derivatives; and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis.

HOW WE HAVE PERFORMED

The reduction reflects FX changes, restructuring costs, a one-off product rectification charge and higher R&D, partially offset by benefits on TotalCare contracts and lower bonus costs.



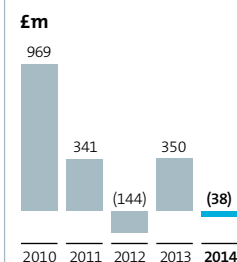
AVERAGE CASH/DEBT

-£38m

We measure average cash based on the weekly balance of net funds/debt. These balances are reported at prevailing exchange rates and in recent periods, year-on-year movements in average cash balances reflect the significant acquisitions and disposals which have taken place, most notably RRPS in 2011, IAE restructuring in 2012, the purchase of the remaining 50% of RRPS and the disposal of our Energy gas turbines and compressor business in 2014. The impact on average cash balances will depend on when these transactions took place during the year.

The reduction reflects the impact of the purchase of the remaining 50% of Power Systems in August.

The sale of the Energy business in December had a minimal impact.

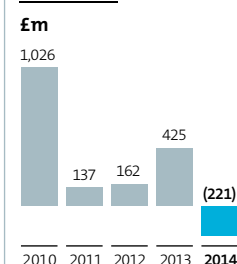


FREE CASH FLOW

£254m

In a business requiring significant investment, we monitor cash flow to ensure that profitability is converted into cash generation, both for future investment and as a return to shareholders. We measure free cash flow as the movement in net funds/debt during the year, before movements arising from payments to shareholders, acquisitions and disposals and FX.

The reduction mainly reflects lower profits and movements in customer deposits and movements in balances with the parent company.



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

PRINCIPAL RISKS

Managing our risks to deliver better power for a changing world

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

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

RISK GOVERNANCE

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

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

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

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

OUR RISK MANAGEMENT ACTIVITIES

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

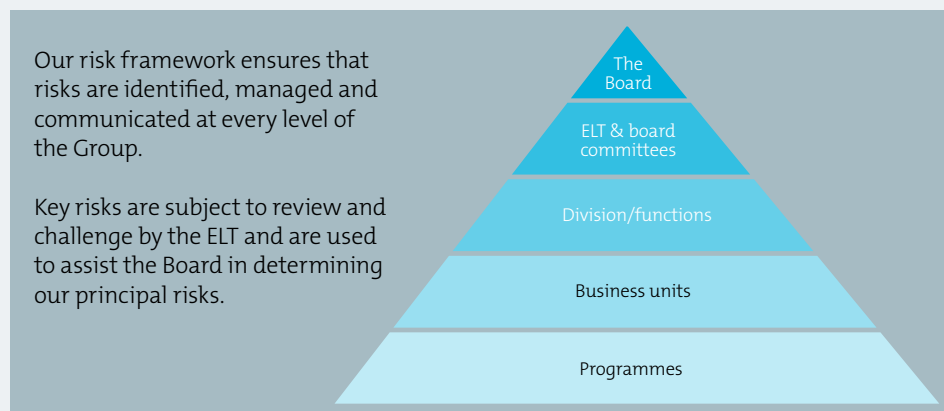
is designed to identify and manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss. Our risk management process is a key element of the Group's internal control system and will develop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

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

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

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

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



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

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

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

PRINCIPAL RISKS

During the year, the ELT, Board and the committees of the Rolls-Royce Holdings plc Board focused on the principal risks and the actions being taken to manage them. This involved: discussing changes to the

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

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

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
PRODUCT FAILURE Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.  	• Operating a safety first culture • Applying our engineering design and validation process from initial design, through production and into service • The Safety and Ethics Committee reviewing the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards • Operating a safety management system (SMS), governed by the product safety review board, and subject to continual improvement based on experience and industry best practice. Product safety training is an integral part of our SMS • Improving our supply chain quality • Crisis management team chaired by the Director – Engineering and Technology or General Counsel as appropriate This principal risk is subject to review by the Safety and Ethics Committee
BUSINESS CONTINUITY Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, financial insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results. 	• Continuing investment in adequate capacity, and modern equipment and facilities (see Aerospace Business review on page 23) • Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and our people skills • Selecting and developing stronger suppliers • Developing dual sources or dual capability • Developing and testing incident management and business continuity plans • Crisis management team chaired by Director – Engineering and Technology or General Counsel as appropriate • Customer excellence centres providing improved response to supply chain disruption This principal risk is subject to review by the Audit Committee



PRINCIPAL RISKS

CONTINUED

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
COMPETITOR ACTION The presence of large, financially strong competitors in the majority of our markets means that the Group is susceptible to significant price pressure for original equipment or services even where our markets are mature or the competitors are few. Our main competitors have access to significant government funding programmes as well as the ability to invest heavily in technology and industrial capability. 	• Accessing and developing key technologies and service offerings which differentiate us competitively (see Innovation and Technology on page 11) • Focusing on being responsive to our customers and improving the quality, delivery and reliability of our products and services • Partnering with others effectively • Driving down cost and improving margins (see Chief Executive's review on page 6 and Chief Financial Officer's review on pages 16 and 17) • Protecting credit lines • Investing in innovation, manufacturing and production, and continuing governance of technology programmes • Understanding our competitors This principal risk is subject to review by the Board
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. For example: explicit trade protectionism, differing tax or regulatory regimes, potential for conflict, or broader political issues. 	• Where possible, locating our domestic facilities and supply chain in countries with a low level of political risk and/or ensuring that we maintain dual capability • Diversifying global operations to avoid excessive concentration of risks in particular areas • The international network of Rolls-Royce and its business units proactively monitoring local situations • Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base (see Chief Executive's review on pages 5 and 6 and business model on pages 14 and 15) • Proactively influencing regulation where it affects us (see Sustainability on page 35) This principal risk is subject to review by the Board
MAJOR PROGRAMME DELIVERY Failure to deliver a major programme on time, within budget to specification or technical performance falling significantly short of customer expectations, or not delivering the planned business benefits, would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation. 	• Major programmes are subject to Board approval (see Additional financial information on page 126) • Reviewing major programmes at levels and frequencies appropriate to their performance against key financial and non-financial deliverables and potential risks throughout the programme's life cycle (see Additional financial information on page 126) • Conducting technical audits at pre-defined points and performed by a team that is independent from the programme • Requiring programmes to address the actions arising from reviews and audits and monitoring and controlling progress through to closure • Applying knowledge management principles to provide benefit to current and future programmes This principal risk is subject to review by the Board

STRATEGIC PRIORITIES



Customer



Innovation



Profitable growth

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
COMPLIANCE Non-compliance by the Group with legislation or other regulatory requirements in the heavily regulated environment in which it operates (for example: export controls, use of controlled chemicals and substances, and anti-bribery and corruption legislation) compromising the ability to conduct business in certain jurisdictions and exposing the Group to potential reputational damage, financial penalties, debarment from government contracts for a period of time, and/or suspension of export privileges or export credit financing, any of which could have a material adverse effect. 	• Taking an uncompromising approach to compliance • Operating an extensive compliance programme. This programme and the Global Code of Conduct are disseminated throughout the Group and are updated and reinforced from time-to-time to ensure their continued relevance, and to ensure that they are complied with both in spirit and to the letter. The Global Code of Conduct and the Group's compliance programme are supported by appropriate training • A legal and compliance team is in place to manage our compliance programme and any ongoing regulatory investigations • Lord Gold has reviewed the Group's current compliance procedures and the Group has continued to implement an improvement plan • Implementing a comprehensive REACH compliance programme. This includes establishing appropriate data systems and processes, working with our suppliers, customers and trade associations and conducting research on alternative materials This principal risk is subject to review by the Safety and Ethics Committee
MARKET SHOCK The Group is exposed to a number of market risks, some of which are of a macro-economic nature. For example, oil price or foreign currency exchange rates, and some which are more specific to the Group, such as liquidity and credit risks, reduction in air travel or disruption to other customer operations. Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness. This would affect operational results or the outcomes of financial transactions. 	• Maintaining a strong balance sheet, through healthy cash balances and a continuing low level of debt • Providing financial flexibility by maintaining high levels of liquidity and an investment grade 'A' credit rating (see Additional financial information on page 127) • Sustaining a balanced portfolio through earning revenue both from the sale of original equipment and aftermarket services, providing a broad product range and addressing diverse markets that have differing business cycles • Deciding where and what currencies to source in, and where and how much credit risk is extended or taken. The Group has a number of treasury policies that are designed to hedge residual risks using financial derivatives (foreign exchange, interest rate and commodity price risk – see Additional financial information on page 126 and note 16) This principal risk is subject to review by the Audit Committee
IT VULNERABILITY Breach of IT security causing controlled or critical data to be lost, made inaccessible, corrupted or accessed by unauthorised users impacting the Group's operations or reputation. 	• Establishing 'defence in depth' through deployment of multiple layers of software protection and processes including web gateways, filtering, firewalls, intrusion, and advanced persistent threat detectors and integrated reporting • Running security and network operations centres • Actively sharing IT Security information through industry, government and security forums This principal risk is subject to review by the Audit Committee

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

PAMELA COLES
Company Secretary

BOARD OF DIRECTORS

IAN DAVIS CHAIRMAN

Appointed to the Board March 2013 and as Chairman May 2013

Key areas of experience: Finance, government and overseas experience

Other current appointments:

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

Previous relevant experience:

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

JOHN RISHTON CHIEF EXECUTIVE

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

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

Other current appointments:

- Unilever NV and Unilever plc, non-executive director

Previous relevant experience:

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

LEWIS BOOTH CBE

SENIOR INDEPENDENT DIRECTOR

Appointed to the Board May 2011

Key areas of experience: Finance, industrial and overseas experience

Other current appointments:

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

Previous relevant experience:

- Ford Motor Company, senior positions in Europe, Asia, Africa and US, 1978 – 2009
 - Ford Motor Company, executive vice president and CFO 2008 – 2012
- He was awarded a CBE in 2012 for services to the UK automotive and manufacturing industries

DAME HELEN ALEXANDER

NON-EXECUTIVE DIRECTOR

Appointed to the Board September 2007

Key areas of experience: Media, business and finance

Other current appointments:

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

Previous relevant experience:

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

RUTH CAIRNIE NON-EXECUTIVE DIRECTOR

Appointed to the Board September 2014

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

Other current appointments:

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

Previous relevant experience:

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

SIR FRANK CHAPMAN NON-EXECUTIVE DIRECTOR

Appointed to the Board November 2011

Key areas of experience: Engineering and industrial

Other current appointments:

- Golar LNG Limited, chairman

Previous relevant experience:

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

WARREN EAST CBE NON-EXECUTIVE DIRECTOR

Appointed to the Board January 2014

Key areas of experience: Technology and engineering

Other current appointments:

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

Previous relevant experience:

- ARM Holdings plc, chief executive 2001 – 2013
 - ARM Holdings plc, various senior appointments 1994 – 2001
- He was awarded a CBE in 2014 for services to the technology industry

LEE HSIEN YANG NON-EXECUTIVE DIRECTOR

Appointed to the Board January 2014

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

Other current appointments:

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

Previous relevant experience:

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

JOHN MCADAM NON-EXECUTIVE DIRECTOR

Appointed to the Board February 2008

Key areas of experience: Retail and industrial

Other current appointments:

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

Previous relevant experience:

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

JOHN NEILL CBE NON-EXECUTIVE DIRECTOR

Appointed to the Board November 2008

Key areas of experience: Engineering, industrial and finance

Other current appointments:

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

Previous relevant experience:

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

JASMIN STAIBLIN NON-EXECUTIVE DIRECTOR

Appointed to the Board May 2012

Key areas of experience: Technology, engineering and overseas experience

Other current appointments:

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

Previous relevant experience:

- ABB Switzerland Ltd, CEO until 2012

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

Appointed to the Board January 1998

Key areas of experience: Sales, marketing and airline operations

Other current appointments:

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

Previous relevant experience:

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

DAVID SMITH CHIEF FINANCIAL OFFICER

Appointed to the Board November 2014

Key areas of experience: Finance

Other current appointments:

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

Previous relevant experience:

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

COLIN P SMITH CBE DIRECTOR – ENGINEERING AND TECHNOLOGY

Appointed to the Board July 2005

Key areas of experience: Engineering

Other current appointments:

- Council for Science and Technology, member

Previous relevant experience:

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

PAMELA COLES COMPANY SECRETARY

Appointed Company Secretary in October 2014

Key areas of experience: Corporate governance and company law

Previous relevant experience:

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

The names of the directors who held office during the year are set out above, with the exception of Iain Conn who retired on 1 May 2014, and Mark Morris who left the Company on 4 November 2014.

At 31 December 2014, all the directors were also directors of Rolls-Royce Holdings plc, the ultimate parent company. As directors of the ultimate parent company, there is no requirement to disclose their remuneration or their interests in the shares of Rolls-Royce group companies in this Directors' Report, as they are included in the Annual Report of Rolls-Royce Holdings plc.

INTERNAL CONTROL AND RISK MANAGEMENT

THE BOARD'S RESPONSIBILITY FOR INTERNAL CONTROL AND RISK MANAGEMENT

The directors are responsible for the Group's system of internal control and for maintaining and reviewing its effectiveness from both a financial and an operational perspective. The Group's risk management process is a key element of the internal control system. This system of internal control is designed to identify and manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss. The Group's system of internal controls is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss.

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

The structure of the Group was changed in 2014 to bring greater organisational and management coherence to the work of our main two Divisions, Aerospace and Land & Sea. Through this change we are aiming to encourage better coordination across the different activities, secure benefits from greater integration and reinforce accountabilities. Each of the Divisions is described in more detail on pages 22 to 31. As part of the ongoing work looking at governance across the Group, we will continue to review our processes and structures within the Divisions and as we integrate Power Systems. We are further strengthening governance at divisional level through our sector audit committees.

Also, as part of the ongoing review, the Board is considering how internal controls and the risk management framework are operating in practice (as outlined on pages 40 to 43). We view this as fundamental to understanding and discussing the main challenges to the business, both strategic and operational. The Executive Leadership Team will continue to review all principal and emerging risks. Each identified principal risk will also be considered by the Board who will allocate certain risks to the most appropriate board committee of Rolls-Royce Holdings plc. Those committees will then report back to the Board with their views on how those risks are being managed and controlled.

The Audit Committee will continue to review all principal risks and the overall internal controls and risk management framework as part of its year-end activities. This will remain an area of focus in 2015.

FINANCIAL REPORTING

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

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

THE AUDIT COMMITTEE

The key objective is assist the Board in ensuring the integrity of its financial statements. In addressing the key objective, the committee reviewed financial statements with both management and the external auditor, concentrating on:

FINANCIAL REPORTING

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

INTERNAL CONTROL AND INTERNAL AUDIT

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

EXTERNAL AUDIT

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

As described in the business model on pages 14 and 15, the development of gas turbine engines for use in civil aircraft applications involves large upfront investments, which may be shared with suppliers, and which are expected to be recovered over long periods from the sale of original equipment; and subsequently the aftermarket from the sale of spare parts and engine maintenance work. Much of the aftermarket repair and overhaul is provided through long-term service agreements. Given this long exposure, which may extend to for decades from the initial concept, the amount of revenue and profit recognised during any period requires a significant number of accounting judgements and estimates. Consequently, one of the committee's primary responsibilities is to ensure that the bases for these judgements and estimates are robust.

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

From 2015 onwards, as a result of a broad ranging review of the risk governance approach, the overall assessment will combine oversight of principal risk management undertaken by each board committee or the Board. In this way we aim to make sure that the Board's oversight of risks and risk management is rigorous in its coverage and depth, making sure that principal risks are assessed in detail and that one committee has an integrated review of how the internal control framework is operating.

In line with this, during 2014, the committee carried out an assessment of financial controls, primarily based on a self-assessment of these controls by each of the businesses. A priority for 2015 is to standardise and, where necessary, enhance the Group's financial internal control framework, against which this assessment is made.

This will create greater consistency, particularly in the Group's small operations, and reinforce ownership and accountability for effective internal control throughout the organisation.

THE ROLLS-ROYCE HOLDINGS PLC ETHICS COMMITTEE AND THE REFERRAL TO THE SERIOUS FRAUD OFFICE

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

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

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

SHARE CAPITAL

Throughout 2014, the Company's authorised share capital was £400 million, comprising 2,000,000,000 ordinary shares of 20p. On 31 December 2013, there were 1,630,996,508 ordinary shares in issue.

Each member has one vote for each ordinary share held. Holders of ordinary shares are entitled to receive the Company's Annual Report; attend and speak at general meetings of the Company; to appoint one or more proxies or, if they are corporations, corporate representatives; and to exercise voting rights.

The ordinary shares are not listed.

OTHER STATUTORY INFORMATION

DISCLOSURES IN THE STRATEGIC REPORT

The Board has taken advantage of section 414C(11) of the Companies Act 2006 to include disclosures in the Strategic Report on:

	page(s)
• disabled people and employee involvement	34
• the future development, performance and position of the Group	1 to 43
• the financial position of the Group	16 to 31
• R&D activities	10 and 11
• the principal risks and uncertainties	40 to 43

POLITICAL DONATIONS

The Group's policy is not to make political donations and therefore did not donate any money to any political party during the year.

However, it is possible that certain activities undertaken by the Group may unintentionally fall within the broad scope of the provisions contained in the Companies Act 2006 (the Act).

During the year, expenses incurred by Rolls-Royce North America Inc. in providing administrative support for the Rolls-Royce North America Political Action Committee (RRNAPAC) was US\$52,690 (2013: US\$69,430). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act.

The PAC is independent of the Group and independent of any political party. The PAC funds are contributed voluntarily by employees and the Company cannot affect how they are applied, although under US Law, the business expenses are paid by the Company. Such contributions do not require authorisation by shareholders under the Companies Act 2006 and therefore do not count towards the limits for political donations and expenditure.

GREENHOUSE GAS EMISSIONS

Our greenhouse gas emissions reporting excludes data from our Power Systems business for 2013 and 2014, as detailed on page 36. In 2014, our total greenhouse gas (GHG) emissions from our facilities, processes, and product test and development was 565 kilotonnes carbon dioxide equivalent (ktCO₂e). This represents an increase of 2% compared with 554 ktCO₂e in 2013 (see table below).

Total GHG emissions (ktCO ₂ e)	2010	2011	2012	2013	2014*
Direct emissions – facilities, processes, product test and development (Scope 1)	221	218	219	241	231
Indirect emissions – facilities, processes, product test and development (Scope 2)	349	327	313	313	334
Total for facilities, processes, product test and development	570	545	532	554	565
Direct emissions – power generation to grid (Scope 1)				153	155
Indirect emissions – power generation to grid (Scope 2)				12	14
Total for facilities, processes, product test and development, and power generation to grid				719	734
Normalised (by revenue) emissions ration for facilities, processes, product test and development (ktCO₂e/£m)	0.058	0.056	0.049	0.048	0.047

* We engaged KPMG LLP to undertake a limited assurance engagement, reporting to Rolls-Royce Holdings plc, using the assurance standards ISAE 3000 and ISAE 3410 over the GHG and TRI data that have been highlighted in this report with ☒ and as set out on page 36 of this report and in the table above. Their full statement, as well as our methodology for reporting and the criteria used as set out in our Basis of Reporting document, is available on our website at www.rolls-royce.com/sustainability. The level of assurance provided for a limited assurance engagement is substantially lower than a reasonable assurance agreement. In order to reach their opinion they performed a range of procedures over the GHG and TRI data including: evaluating the work performed and conclusions reached by the Rolls-Royce Internal Audit team; agreeing a selection of the data to the corresponding source documentation; and reviewing the data collation and validation processes at the head office level, including formulae used and manual calculations performed. A summary of the work they performed is included within their assurance opinion. Non-financial performance information, greenhouse gas quantification in particular, is subject to more inherent limitations than financial information. It is important to read the energy, GHG and TRI data in the context of the full limited assurance statement provided by KPMG LLP and the reporting criteria as set out in the Rolls-Royce Basis of Reporting document.

The figures in the table do not include emissions associated with our Power Systems business. We are in the process of integrating our Power Systems business into our HS&E management system. The figures presented have been adjusted to reflect the disposal of our Energy gas turbine and compressor business in December 2014.

Entities that were part of the Energy business that were not part of the disposal have been included.

Power generation relates to the operation of commercial gas-fired power stations and the figures have been adjusted to include emissions associated with Trigno Energy S.r.l. We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) as of 31 December 2014 data gathered to fulfil our requirements under the Carbon Reduction Commitment (CRC)

Energy Efficiency scheme, the UK Government's GHG reporting guidance and DEFRA's emissions factors for company reporting for 2014 as the basis of our methodology.

Through our active participation in the International Aerospace Environment Group we have helped to introduce new guidance on greenhouse gas emissions reporting in June to enable consistent communications and reporting for aerospace industry companies. The Guidance is a voluntary consensus standard designed to supplement the World Resources Institute's (WRI) GHG Protocol. It earned the WRI 'Built on GHG Protocol' mark after public comment consultation.

BRANCHES

We are a global company and our activities and interests are operated through subsidiaries, branches of subsidiaries, joint ventures and associates which are subject to the laws and regulations of many different jurisdictions. Our principal subsidiaries and joint ventures are listed on page 123 and 124.

POST BALANCE SHEET EVENTS

There have been no events affecting the Group since 31 December 2014 which need to be reflected in the 2014 financial statements.

FINANCIAL INSTRUMENTS

Details of the Group's financial instruments are set out in note 16 to the Financial Statements.

RELATED PARTY TRANSACTIONS

Related party transactions are set out in note 23 to the Financial Statements.

MANAGEMENT REPORT

The Strategic Report and the Directors' Report together are the management report for the purposes of the Disclosure and Transparency Rules 4.1.8R.

DIRECTORS' REPORT AND FINANCIAL STATEMENTS

RESPONSIBILITY STATEMENTS

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

The directors, as listed on pages 44 and 45, are responsible for preparing the Annual Report and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRS as adopted by the EU and applicable law and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of their profit or loss for that period.

In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent and Group's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

RESPONSIBILITY STATEMENTS UNDER THE DISCLOSURE AND TRANSPARENCY RULES

Each of the persons who is a director at the date of approval of this report confirms that to the best of his or her knowledge:

- i) each of the Group and parent company financial statements, prepared in accordance with IFRS and UK Accounting Standards respectively, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and
- ii) the Strategic Report on pages 1 to 43 and Directors' Report on pages 44 to 50 includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

GOING CONCERN

As described on page 127, the Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds and notes. At 31 December 2014, the Group had borrowing facilities of £3.5 billion and total liquidity of £4.1 billion, including: cash and cash equivalents of £2.9 billion and undrawn facilities of £1.3 billion. £67 million of the facilities mature in 2015.

The Group's forecasts and projections, taking into account reasonably possible changes in trading performance, show that the Group has sufficient financial resources. The directors have reasonable expectation that the Company and the Group are well placed to manage their business risks and to continue in operational existence for the foreseeable future, despite the current uncertain global economic outlook.

Accordingly, the directors continue to adopt the going concern basis in preparing the consolidated financial statements.

DISCLOSURE OF INFORMATION TO AUDITORS

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

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

This confirmation is given, and should be interpreted, in accordance with the provisions of Section 418 of the Companies Act 2006.

By order of the Board

PAMELA COLES
Company Secretary
12 February 2015

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3 Intangible assets	111	15 Movements in capital and reserves	120
4 Tangible assets	112	16 Operating lease annual commitments	120
5 Investments	112	17 Share-based payments	120
6 Stocks	113	18 Contingent liabilities	122
7 Debtors	113	19 Related party transactions	122
		20 Ultimate holding company	122

CONSOLIDATED INCOME STATEMENT

For the year ended 31 December 2014

	Notes	2014 £m	Re-presented* 2013 £m
Continuing operations			
Revenue	2	13,736	14,642
Cost of sales		(10,533)	(11,482)
Gross profit		3,203	3,160
Other operating income	3	10	65
Commercial and administrative costs		(1,124)	(1,236)
Research and development costs	3	(793)	(658)
Share of results of joint ventures and associates	10	94	149
Operating profit		1,390	1,480
Profit on acquisition/reclassification of joint ventures		2	119
Profit on disposal of businesses	24	6	216
Profit before financing and taxation	2	1,398	1,815
Financing income	4	32	327
Financing costs	4	(1,284)	(182)
Net financing		(1,252)	145
Profit before taxation		146	1,960
Taxation	5	(151)	(377)
Profit for the year from continuing operations		(5)	1,583
Discontinued operations			
Profit for the year from ordinary activities	2	4	56
Profit on disposal	24	138	—
Profit for the year from discontinued operations		142	56
Profit for the year		137	1,639
Attributable to:			
Ordinary shareholders		148	1,627
Non-controlling interests		(11)	12
Profit for the year		137	1,639

* Re-presented to reflect the Energy business as a discontinued operation. The relevant notes have also been re-presented.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2014

	Notes	2014 £m	2013 £m
Profit for the year		137	1,639
Other comprehensive income			
Items that will not be reclassified to profit or loss			
Movements in post-retirement schemes	18	1,192	48
Related tax movements	5	(431)	10
		761	58
Items that may be reclassified to profit or loss			
Foreign exchange translation differences on foreign operations		(158)	(64)
Reclassified to income statement on disposal of businesses		(29)	—
Share of other comprehensive income of joint ventures and associates	10	(13)	(6)
Related tax movements	5	(2)	1
		(202)	(69)
Total comprehensive income for the year		696	1,628
Attributable to:			
Ordinary shareholders		729	1,617
Non-controlling interests		(33)	11
Total comprehensive income for the year		696	1,628

CONSOLIDATED BALANCE SHEET

At 31 December 2014

	Notes	2014 £m	2013 £m
ASSETS			
Non-current assets			
Intangible assets	8	4,804	4,987
Property, plant and equipment	9	3,446	3,392
Investments – joint ventures and associates	10	539	601
Investments – other	10	31	27
Other financial assets	16	107	674
Deferred tax assets	5	369	316
Post-retirement scheme surpluses	18	1,740	248
		11,036	10,245
Current assets			
Inventories	11	2,768	3,319
Trade and other receivables	12	6,820	5,940
Taxation recoverable		19	16
Other financial assets	16	22	74
Short-term investments		7	321
Cash and cash equivalents	13	2,862	3,990
Assets held for sale		1	6
		12,499	13,666
Total assets		23,535	23,911
LIABILITIES			
Current liabilities			
Borrowings	14	(68)	(207)
Other financial liabilities	16	(187)	(102)
Trade and other payables	15	(7,680)	(7,936)
Current tax liabilities		(184)	(204)
Provisions for liabilities and charges	17	(433)	(348)
		(8,552)	(8,797)
Non-current liabilities			
Borrowings	14	(2,193)	(2,164)
Other financial liabilities	16	(717)	(360)
Trade and other payables	15	(2,445)	(2,138)
Non-current tax liabilities		(10)	(10)
Deferred tax liabilities	5	(1,228)	(882)
Provisions for liabilities and charges	17	(374)	(385)
Post-retirement scheme deficits	18	(1,185)	(1,041)
		(8,152)	(6,980)
Total liabilities		(16,704)	(15,777)
Net assets		6,831	8,134
EQUITY			
Equity attributable to ordinary shareholders			
Called-up share capital	19	326	326
Share premium account		631	631
Cash flow hedging reserve		(81)	(68)
Other reserves		75	247
Retained earnings		5,875	6,300
		6,826	7,436
Non-controlling interests	10	5	698
Total equity		6,831	8,134

The financial statements on pages 52 to 105 were approved by the Board on 12 February 2015 and signed on its behalf by:

JOHN RISHTON Chief Executive

DAVID SMITH Chief Financial Officer

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2014

	Notes	2014 £m	2013 £m
Reconciliation of cash flows from operating activities			
Operating profit from continuing operations		1,390	1,480
Operating (loss)/profit from discontinued operations		(1)	56
Operating profit		1,389	1,536
(Profit)/loss on disposal of property, plant and equipment		(3)	7
Share of results of joint ventures and associates	10	(94)	(160)
Dividends received from joint ventures and associates	10	73	99
Return of capital from joint ventures		3	—
Gain on consolidation of previously non-consolidated subsidiary		(3)	—
Amortisation and impairment of intangible assets	8	367	428
Depreciation and impairment of property, plant and equipment	9	375	372
Increase/(decrease) in provisions		129	(17)
Decrease in inventories		166	119
Increase in trade and other receivables		(1,341)	(834)
Increase in trade and other payables		202	349
Cash flows on other financial assets and liabilities held for operating purposes		(30)	9
Net defined benefit post-retirement cost recognised in profit before financing		170	279
Cash funding of defined benefit post retirement schemes		(322)	(315)
Share-based payments	20	21	79
Net cash inflow from operating activities before taxation		1,102	1,951
Taxation paid		(276)	(238)
Net cash inflow from operating activities		826	1,713
Cash flows from investing activities			
Additions of unlisted investments		(11)	(1)
Disposals of unlisted investments		—	1
Additions of intangible assets		(477)	(503)
Purchases of property, plant and equipment		(648)	(669)
Government grants received		11	21
Disposals of property, plant and equipment		65	7
Acquisitions of businesses	24	(3)	(37)
Acquisition of non-controlling interest		(1,937)	—
Reclassification of joint ventures to subsidiaries	24	—	245
Acquisition of preference shares in subsidiary		—	(34)
Disposals of discontinued operation	24	1,027	—
Disposals of other businesses		24	273
Investments in joint ventures and associates		(17)	(43)
Net cash outflow from investing activities		(1,966)	(740)
Cash flows from financing activities			
Repayment of loans		(233)	(133)
Proceeds from increase in loans and finance leases		49	1,013
Net cash flow from decrease in borrowings and finance leases		(184)	880
Interest received		18	15
Interest paid		(63)	(58)
Decrease/(increase) in short-term investments		313	(313)
Dividend paid to non-controlling interest		(76)	(60)
Net cash (outflow)/inflow from financing activities		8	464
Change in cash and cash equivalents		(1,133)	1,437
Cash and cash equivalents at 1 January		3,987	2,584
Exchange gains/(losses) on cash and cash equivalents		8	(34)
Cash and cash equivalents at 31 December		2,862	3,987

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2014

	2014 £m	2013 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Change in cash and cash equivalents	(1,133)	1,437
Cash flow from decrease/(increase) in borrowings and finance leases	184	(880)
Cash flow from (decrease)/increase in short-term investments	(313)	313
Change in net funds resulting from cash flows	(1,262)	870
Net funds (excluding cash and cash equivalents) of businesses acquired	(30)	(204)
Exchange gains/(losses) on net funds	19	(43)
Fair value adjustments	(59)	105
Movement in net funds	(1,332)	728
Net funds at 1 January excluding the fair value of swaps	1,940	1,212
Net funds at 31 December excluding the fair value of swaps	608	1,940
Fair value of swaps hedging fixed rate borrowings	58	(1)
Net funds at 31 December	666	1,939

The movement in net funds (defined by the Group as including the items shown below) is as follows:

	At 1 January 2014 £m	Funds flow £m	Net funds of businesses acquired £m	Exchange differences £m	Fair value adjustments £m	Reclassifications £m	At 31 December 2014 £m
Cash at bank and in hand	982	(228)		(15)	—	—	739
Money market funds	1,157	(470)		5	—	—	692
Short-term deposits	1,851	(438)		18	—	—	1,431
Overdrafts	(3)	3		—	—	—	—
Cash and cash equivalents	3,987	(1,133)		8	—	—	2,862
Short-term investments	321	(313)	—	(1)	—	—	7
Current borrowings excluding overdrafts	(204)	229	(30)	—	(2)	(60)	(67)
Non-current borrowings	(2,163)	(3)	—	14	(57)	60	(2,149)
Finance leases	(1)	(42)	—	(2)	—	—	(45)
Net funds excluding fair value of swaps	1,940	(1,262)	(30)	19	(59)	—	608
Fair value of swaps hedging fixed rate borrowings	(1)				59		58
Net funds	1,939	(1,262)	(30)	19	—	—	666

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the year ended 31 December 2014

	Notes	Attributable to ordinary shareholders					Non-controlling interests (NCI) £m	Total equity £m
		Share capital £m	Share premium £m	Cash flow hedging reserve ¹ £m	Translation Reserve £m	Retained earnings £m	Total £m	
At 1 January 2013		326	631	(63)	310	5,449	6,653	6,716
Profit for the year		—	—	—	—	1,627	1,627	1,639
Foreign exchange translation differences on foreign operations		—	—	—	(63)	—	(63)	(64)
Movement on post-retirement schemes	18	—	—	—	—	48	48	48
Share of other comprehensive income of joint ventures and associates	10	—	—	(5)	(1)	—	(6)	(6)
Related tax movements	5	—	—	—	1	10	11	11
Total comprehensive income for the year		—	—	(5)	(63)	1,685	1,617	1,628
Dividend paid						(900)	(900)	(900)
Share-based payments – direct to equity ²		—	—	—	—	53	53	53
Reclassification of Rolls-Royce Power Systems AG ³		—	—	—	—	—	669	669
Transactions with NCI		—	—	—	—	—	(45)	(45)
Related tax movements	5	—	—	—	—	13	13	13
Other changes in equity in the year		—	—	—	—	(834)	(834)	(210)
At 1 January 2014		326	631	(68)	247	6,300	7,436	8,134
Profit for the year		—	—	—	—	148	148	137
Foreign exchange translation differences on foreign operations		—	—	—	(141)	—	(141)	(158)
Reclassified to income statement on disposal of businesses		—	—	—	(29)	—	(29)	(29)
Movement on post-retirement schemes		—	—	—	—	1,199	1,199	1,192
Share of other comprehensive income of joint ventures and associates	10	—	—	(13)	—	—	(13)	(13)
Related tax movements	5	—	—	—	(2)	(433)	(435)	(433)
Total comprehensive income for the year		—	—	(13)	(172)	914	729	696
Share-based payments – direct to equity ²		—	—	—	—	18	18	18
Purchase of NCI's remaining interest in subsidiary ⁴		—	—	—	—	(1,353)	(1,353)	(1,937)
Transactions with NCI		—	—	—	—	—	(76)	(76)
Related tax movements	5	—	—	—	—	(4)	(4)	(4)
Other changes in equity in the year		—	—	—	—	(1,339)	(1,339)	(1,999)
At 31 December 2014		326	631	(81)	75	5,875	6,826	6,831

¹ See accounting policies note 1.

² Share-based payments – direct to equity is the net of the credit to equity in respect of the share-based payment charge to the income statement and the actual cost of shares vesting, excluding those vesting from own shares.

³ On 1 January 2013, the Group exercised rights that resulted in Rolls-Royce Power Systems AG (RRPS formerly Tognum AG) being classified as a subsidiary and consolidated.

⁴ On 26 August 2014, the Group purchased the remaining 50% of Rolls-Power Systems Holding GmbH from Daimler AG for £1,937m.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES

THE COMPANY

The consolidated financial statements of Rolls-Royce plc (the 'Company') for the year ended 31 December 2014 consist of the consolidation of the financial statements of the Company and its subsidiaries (together referred to as the 'Group') and include the Group's interest in jointly controlled and associated entities.

BASIS OF PREPARATION AND STATEMENT OF COMPLIANCE

In accordance with European Union (EU) regulations, these financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), as adopted for use in the EU effective at 31 December 2014 (Adopted IFRS).

The Company has elected to prepare its parent company financial statements under UK Generally Accepted Accounting Practices. These are set out on pages 106 to 122 and the accounting policies in respect of Company financial statements are set out on page 108.

These consolidated financial statements have been prepared on the historical cost basis except where Adopted IFRS requires the revaluation of financial instruments to fair value and certain other assets and liabilities on an alternative basis – most significantly post-retirement scheme obligations are valued on the basis required by IAS 19 *Employee Benefits* – and on a going concern basis as described on page 50.

The consolidated financial statements are presented in sterling which is the Company's functional currency.

The preparation of financial statements in conformity with Adopted IFRS requires management to make judgements and estimates that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

KEY AREAS OF JUDGEMENT

INTRODUCTION

The Group generates a significant portion of its revenues and profit on aftermarket arrangements arising from the installed original equipment (OE) fleet. As a consequence, the Group will often agree contractual prices for OE deliveries that take into account the anticipated aftermarket arrangements. Accounting policies reflect this aspect of the business model, in particular the policies for the recognition of contractual aftermarket rights and the linkage of OE and aftermarket arrangements.

When a civil large engine is sold, the economic benefits received usually far exceed the cash receivable under the contract, due to the rights to valuable aftermarket spare parts business. However, because the value of this right cannot be estimated with enough precision, accounting standards require that the revenue recognised in the accounts on sale of the engine is restricted to a total amount that results in a break even position. The amount of the revenue recognised in excess of cash receivable is recognised as an intangible asset, which is called a 'contractual aftermarket right' (previously referred to as a 'recoverable engine cost'; this change has been made to reflect better the nature of the asset).

There is only one circumstance where accounting standards require the recognition of more of the value of the aftermarket rights when an engine is sold. This occurs where a long-term aftermarket contract (generally a TotalCare agreement — TCA) and an engine sale contract have been negotiated together. In this circumstance, the part of the aftermarket rights covered by the TCA can be valued much more precisely and is recognised at the time of the engine sale through accounting for the engine sale and TCA as a single contract. Nevertheless, the accounting profit recognised is still less than the economic benefits on the sale as there will be other valuable aftermarket rights (for instance for the period beyond the TCA term or for the sale of parts which are outside the scope of the TCA) which cannot be recognised.

The Group enters into arrangements with long-term suppliers to share the risks and rewards of major programmes – risk and revenue sharing arrangements (RRSAs). The accounting policy for these arrangements has been chosen, consistent with Adopted IFRS, to reflect their commercial effect.

The key judgements in determining these accounting policies are described below.

CONTRACTUAL AFTERMARKET RIGHTS (CARs)

On delivery of Civil aerospace engines, the Group has contractual rights to supply aftermarket parts to the customers and its intellectual rights, warranty arrangements and, where relevant, statutory airworthiness or other regulatory requirements provide reasonable control over this supply. The directors consider that these rights meet the definition of an intangible asset in IAS 38 *Intangible Assets*. However, the directors do not consider that it is possible to determine a reliable fair value for this intangible asset. Accordingly, an intangible asset (CAR) is only recognised on the occasions where the contractual price of the engine is below the cost of manufacture and then only to the extent of this deficit, as this amount is reliably measureable. An equal amount of revenue is recognised at the same point. Where a long-term aftermarket contract is linked to the OE contract (see below), the contractual price of the engine (including amounts allocated from the aftermarket contract) is above its cost of manufacture; consequently no CAR is recognised.

MEASURE OF PERFORMANCE ON LONG-TERM AFTERMARKET CONTRACTS

A large proportion of the Group's activities relate to long-term aftermarket contracts, in particular TotalCare and similar arrangements in the Aerospace segment. Under these contracts, the Group's primary obligation is to maintain customers' equipment in an operational condition and achieves this by undertaking various activities, such as engine monitoring, line maintenance and repair and overhaul, over

1 ACCOUNTING POLICIES CONTINUED

the period of the contract. In general, the directors consider that the stage of performance of the contract should be by reference to the obligation to maintain an operational fleet and that this is best measured by the operation of the fleet. Accordingly, stage of performance is measured by reference to flying hours of each fleet under contract.

LINKAGE OF ORIGINAL AND LONG-TERM AFTERMARKET CONTRACTS

Where the key terms of a long-term aftermarket contract are substantively agreed (eg in a term sheet) at the same time as an OE contract with the operator, the directors consider these to be linked for accounting purposes and they are treated as a single contract, as this best reflects the overall commercial effect. Where the OE contract is not with the operator, eg where it is with an OE manufacturer or a lessor, the contracts are not linked as they were not negotiated on a unified basis.

RISK AND REVENUE SHARING ARRANGEMENTS (RRSAs)

RRSAs with key suppliers (workshare partners) are a feature of our Civil aerospace business. Under these contractual arrangements the key commercial objectives are that: (i) during the development phase the workshare partner shares in the risks of developing an engine by performing its own development work, providing development parts and paying a non-refundable cash entry fee; and (ii) during the production phase it supplies components in return for a share of the programme revenues as a 'life of type' supplier (ie as long as the engine remains in service). The share of development costs borne by the workshare partner and of the revenues it receives reflect the partner's proportionate cost of providing its production parts compared to the overall manufacturing cost of the engine. The share is based on a jointly agreed forecast at the commencement of the arrangement.

These arrangements are complex and have features that could be indicative of: a collaboration agreement, including sharing of risk and cost in a development programme; a long-term supply agreement; sharing of intellectual property; or a combination of these. In summary, and as described below, the directors' view is that the development and production phases of the contract should be considered separately in accounting for the RRSA, which results in the entry fee being matched against the non-recurring costs incurred by the Group.

Having considered the features above, the directors considered that there is no directly applicable IFRS to determine an accounting policy for the recognition of entry fees of this nature in the income statement. Consequently, in developing an accounting treatment for such entry fees that best reflects the commercial objectives of the contractual arrangement, the directors have analysed these features in the context of relevant accounting pronouncements (including those of other standard setters where these do not conflict with IFRS) and have weighed the importance of each feature in faithfully representing the overall commercial effect. The most important considerations that need to be balanced are: the transfer of development risk; the workshare partner receiving little standalone value from the payment of the entry fee; and the overall effect being collaboration between the parties which falls short of being a joint venture as the Group controls the programme. Also important in the analysis is the fact that, whilst the Group and the workshare partner share risks and rewards through the life of the contract, these risks and rewards are very different during the development and production phases.

In this context, the entry fee might be considered to represent: an amount paid as an equalisation of development costs; a payment to secure a long-term supply arrangement; a purchase of intellectual property; or some combination thereof. The accounting under these different scenarios could include: recognition of the entry fee to match the associated costs in the income statement; being spread over the life of the programme as a reduction in the cost of supply during production; or being spread over the time period of the access to the intellectual property by the workshare partner.

The directors consider that the most important features of the arrangement are the risk sharing and that the entry fee represents a contribution to the development costs that the Group incurs in excess of its proportionate programme share. The key judgements taken in reaching this view are: the entry fee is determined by the parties on that basis and the contract specifies that, in the event that a derivative engine is to be developed, additional entry fees will also be calculated on this basis; the workshare partners describe the entry fee in this way; although the workshare partner receives little stand-alone value from paying the entry fee, the entry fee together with its own development activities represent its aggregate investment in the collaboration; the amount of the entry fee does not include any amount in excess of that necessary to equalise forecast development costs; the Group is not 'on risk' for the full development costs it incurs but for that amount less the entry fees received; and, as far as can be determined, this appears to be common industry accounting for arrangements of this type, under both Adopted IFRS and US accounting standards (which the directors do not believe conflicts with IFRS in this regard).

The resulting accounting policy (described on page 62) represents the commercial effect of the contractual arrangements in that the Group recognises only those development costs to which it is exposed (and thus reflects the significant transfer of development risk to the workshare partner) and the costs of supply of parts during the production phase is measured at the workshare partner's share of programme revenues (which we consider to be a commercial fair value). The directors do not consider that accounting which would result in entry fees only being recognised in the production phase would appropriately reflect the sharing of development risk. Accordingly, the directors believe that the policy adopted best reflects the commercial objectives of the arrangements, the nature of the relationship with the workshare partner and is in accordance with Adopted IFRS.

As described in the 2013 Annual Report, an alternative view is that the RRSA contract cannot be divided into separate development and production phases, as the fees and development components received by the Group during the development phase are exchanged for the obligation to pay the supplier a predetermined share of any sales receipts during the production phase. On this basis the entry fees received would be deferred in their entirety and recognised over the period of production. The size of the difference between the two

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES CONTINUED

approaches is monitored and is not currently expected to become material in the foreseeable future. The impact of the different approaches on profit before tax and net assets, which is not considered to be material, is as follows:

	2014			2013		
	Reported profit before tax £m	Underlying profit before tax £m	Net assets £m	Reported profit before tax £m	Underlying profit before tax £m	Net assets £m
Adopted policy	146	1,617	6,831	1,960	1,760	8,134
Difference	(30) ¹	(30)	(402)	(37)	(37)	(383) ²
Alternative policy	116	1,587	6,429	1,923	1,723	7,751

¹ If the alternative policy were adopted, the difference would be included in profit before financing, which would change from £1,398 as reported to £1,368m.

² The 2013 adjustment includes a consequential adjustment to transactions with joint ventures, which was not reflected in the 2013 Annual Report.

INTERNALLY GENERATED DEVELOPMENT COSTS

IAS 38 requires that internally generated development costs should only be recognised if strict criteria are met, in particular relating to technical feasibility and generation of future economic benefits. The directors consider that, due to the complex nature of new equipment programmes, these criteria are not met until relatively late in the programme – Civil aerospace programmes represent around half of development costs recognised; for these, the criteria are generally satisfied around the time of the initial engine certification.

CUSTOMER FINANCING CONTINGENT LIABILITIES

The Group has contingent liabilities in respect of financing support provided to customers. In order to assess whether a provision should be recognised, judgement as to the likelihood of these crystallising is required. This judgement is based on an assessment on the knowledge of the customers' fleet plans, the underlying value of the security provided and, where appropriate, the customers' creditworthiness.

KEY SOURCES OF ESTIMATION UNCERTAINTY

In applying the accounting policies, estimates are made in many areas; the actual outcome may differ from that calculated. The key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are set out below. The estimation of the relevant assets and liabilities involves the combination of a number of assumptions. Sensitivities are disclosed in the relevant notes where this is appropriate and practicable.

FORECASTS AND DISCOUNT RATES

The carrying values of a number of items on the balance sheet are dependent on the estimates of future cash flows arising from the Group's operations, in particular:

- The assessment of whether the goodwill and other intangible assets (carrying value at 31 December 2014 **£1,658 million**, 31 December 2013 £1,864 million) arising on the consolidation of RRPS is impaired is dependent of the present value of the future cash flows expected to be generated by the business.
- The assessment as to whether there are any indications of impairment of development, participation, certification and contractual aftermarket rights recognised as intangible assets (carrying values at 31 December 2014 **£2,533 million**, 31 December 2013 £2,499 million) is dependent on estimates of cash flows generated by the relevant assets and the discount rate used to calculate a present value. These estimates include the performance of long-term contractual arrangements as described below, as well as estimates for future market share, pricing and unit cost for uncontracted business. The risk of impairment is generally higher for newer programmes and, for customer specific intangible assets (CARs), for launch customers.

ASSESSMENT OF LONG-TERM CONTRACTUAL ARRANGEMENTS

The Group has long-term contracts that fall into different accounting periods and which can extend over significant periods – the most significant of these are long-term service arrangements in the Civil aerospace business. The estimated revenues and costs are inherently imprecise and significant estimates are required to assess: engine flying hours, time on wing and other operating parameters; the pattern of future maintenance activity and the costs to be incurred; and life cycle cost improvements over the term of the contracts. The estimates take account of the inherent uncertainties and the risk of non-recovery of any resulting contract balances.

POST-RETIREMENT BENEFITS

The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19. The accounting valuation, which is based on assumptions determined with independent actuarial advice, resulted in a net surplus of **£555 million** before deferred taxation being recognised on the balance sheet at 31 December 2014 (31 December 2013 net deficit £793 million). The size of the net surplus/deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 18.

1 ACCOUNTING POLICIES CONTINUED

PROVISIONS

As described in the accounting policy on page 65, the Group measures provisions (carrying value at 31 December 2014 **£807 million**, 31 December 2013 **£733 million**) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates take account of information available and different possible outcomes.

TAXATION

The tax payable on profits is determined based on tax laws and regulations that apply in each of the numerous jurisdictions in which the Group operates. Where the precise impact of these laws and regulations is unclear then reasonable estimates may be used to determine the tax charge included in the financial statements.

SIGNIFICANT ACCOUNTING POLICIES

The Group's significant accounting policies are set out below. These accounting policies have been applied consistently to all periods presented in these consolidated financial statements and by all Group entities.

BASIS OF CONSOLIDATION

The Group consolidated financial statements include the financial statements of the Company and its subsidiary undertakings together with the Group's share of the results of joint arrangements and associates made up to 31 December. In line with common practice in Germany, a small number of immaterial subsidiaries of Rolls-Royce Power Systems are not consolidated and are carried at cost in other investments. If such subsidiaries become material, they are consolidated. The difference between the net assets recognised and the investment cost eliminated is recognised in other operating income.

A subsidiary is an entity controlled by the Company. Control exists when the Company has power over an entity, exposure to variable returns from its involvement with an entity and the ability to use its power over an entity so as to affect the Company's returns.

A joint arrangement is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. Joint arrangements may be either joint ventures or joint operations; all the Group's joint arrangements have been classified as joint ventures. An associate is an entity, being neither a subsidiary nor a joint arrangement, in which the Group holds a long-term interest and where the Group has a significant influence. The results of joint ventures and associates are accounted for using the equity method of accounting.

Any subsidiary undertakings, joint ventures or associates sold or acquired during the year are included up to, or from, the dates of change of control. Transactions with non-controlling interests are recorded directly in equity.

All intra-group transactions, balances, income and expenses are eliminated on consolidation. Adjustments are made to eliminate the profit or loss arising on transactions with joint ventures and associates to the extent of the Group's interest in the entity.

REVENUE RECOGNITION

Revenues comprise sales to outside customers after discounts, excluding value added taxes.

Sales of products (both original equipment and spare parts) are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured – this is generally on delivery. On occasion, the Group may participate in the financing of OE, most commonly by the provision of guarantees as described in note 17. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing when the significant risks and rewards of ownership have been transferred to the customer. As described on page 58, a sale of OE at a contractual price below its cost of manufacture is considered to give rise to revenue to the extent that an intangible asset, (contractual aftermarket right), is recognised at the same time.

Sales of services are recognised by reference to the stage of completion based on services performed to date. As described on page 58, the assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on: flying hours or equivalent for long-term aftermarket arrangements where the service is provided on a continuous basis; costs incurred to the extent these relate to services performed up to the reporting date; or achievement of contractual milestones where relevant.

As described on page 59, **sales of products and services** are treated as though they are a single contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single transaction with an overall profit margin. The total revenue is allocated between the two components such that the total agreed discount to list prices is allocated to revenue for each of the two components pro rata, based on list prices. The revenue is then recognised for each component on this basis as the products are delivered and services provided, as described above. Where the contractual price of the OE component is below the revenue allocated from the combined arrangement, this will give rise to an asset included in 'amounts recoverable on contracts'. This asset reduces as services are provided, increases as costs are incurred, and reduces to zero by the end of the contract. Where the balance is a liability, it is recognised in 'accruals and deferred income'.

Provided that the outcome of construction contracts can be assessed with reasonable certainty, the revenues and costs on such contracts are recognised based on stage of completion and the overall contract profitability. Full provision is made for any estimated losses to completion of contracts, having regard to the overall substance of the arrangements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES CONTINUED

Progress payments received, when greater than recorded revenue, are deducted from the value of work in progress except to the extent that payments on account exceed the value of work in progress on any contract where the excess is included in accruals and deferred income within trade and other payables. The amount by which recorded revenue of long-term contracts is in excess of payments on account is classified as amounts recoverable on contracts and is separately disclosed within trade and other receivables.

TOTALCARE ARRANGEMENTS

As described above, these are accounted for on a stage of completion basis, with the stage of completion based on the proportion of flying hours completed compared to the total estimated under the contract. In making the assessment of future revenues, costs and the level of profit recognised the Group takes account of: (i) the forecast utilisation of the engines by the operator; (ii) the forecast costs to maintain the engines in accordance with the contractual requirements – the principal variables being the time between shop visits and the cost of each shop visit; and (iii) the recoverability of any contract asset arising. The Group benchmarks the forecast costs against previous programmes, recognising that the reliability of the forecasts will improve as operational experience of the engine increases. To the extent that actual costs differ from forecast costs or that forecast costs change, the cumulative impact is recognised in the period. An allowance is made against contract assets arising, based on both the customer's creditworthiness and an assessment of the importance of the particular engine fleet to the customer. Again, changes in this allowance are recognised in the period.

RISK AND REVENUE SHARING ARRANGEMENTS (RRSAs)

As described on page 59, the Group enters into arrangements with certain workshare partners under which these suppliers: (i) contribute to the forecast costs of developing an engine by performing their own development work, providing development parts and paying a non-refundable cash entry fee; and (ii) supply components for the production phase for which they receive consideration, which is an agreed proportion of the total programme revenues. Both the suppliers' contributions to the forecast non-recurring development costs and their consideration are determined by reference to their proportionate forecast scopes of supply relative to that of the engine overall. Once the forecast costs and the scopes of supply have been agreed at the inception of the contract, each party is then accountable for its own incurred costs. No accounting entries are recorded when the suppliers undertake development work or when development components are supplied. Cash sums received are recognised in the income statement, as a reduction in research and development costs incurred, to match the expensing of the Group's related costs – where the cash sums are received in advance of the related costs being expensed or where the related costs are capitalised as intangible assets, the recognition of the cash received is deferred (in accruals and deferred income) to match the recognition of the related expense or the amortisation of the related intangible asset respectively. The payments to suppliers of their shares of the programme revenues for their production components are charged to cost of sales as programme revenues arise.

The Group has arrangements with partners who do not undertake development work or supply parts. Such arrangements are considered to be financial instruments as defined by IAS 32 *Financial Instruments: Presentation* and are accounted for using the amortised cost method.

GOVERNMENT INVESTMENT

Where a government or similar body has previously invested in a development programme, the Group treats payments to that body as royalty payments, which are matched to related sales.

GOVERNMENT GRANTS

Government grants are recognised in the income statement so as to match them with the related expenses that they are intended to compensate. Where grants are received in advance of the related expenses, they are included in the balance sheet as deferred income. Non-monetary grants are recognised at fair value.

INTEREST

Interest receivable/payable is credited/charged to the income statement using the effective interest method. Where borrowing costs are attributable to the acquisition, construction or production of a qualifying asset, such costs are capitalised as part of the specific asset.

TAXATION

The tax charge/credit on the profit or loss for the year comprises current and deferred tax:

- Current tax is the expected tax payable for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.
- Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and the amounts used for taxation purposes and is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled.

Tax is charged or credited in the income statement or other comprehensive income (OCI) as appropriate, except when it relates to items credited or charged directly to equity in which case the tax is also dealt with in equity.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax is not recognised on taxable temporary differences arising on the initial recognition of goodwill or

1 ACCOUNTING POLICIES CONTINUED

for temporary differences arising from the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit.

Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be utilised.

Accruals for tax contingencies require management to make judgements and estimates of exposures in relation to tax audit issues. Tax benefits are not recognised unless the tax positions will probably be sustained. Once considered to be probable, management reviews each material tax benefit to assess whether a provision should be taken against full recognition of that benefit on the basis of potential settlement through negotiation and/or litigation. All provisions are included in current liabilities. Any liability relating to interest on tax liabilities is provided for in the tax charge.

FOREIGN CURRENCY TRANSLATION

Transactions denominated in currencies other than the functional currency of the transacting Group undertaking are translated into the functional currency at the exchange rates ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the rate ruling at the year end. Exchange differences arising on foreign exchange transactions and the retranslation of assets and liabilities into functional currencies at the rate ruling at the year-end are taken into account in determining profit before taxation.

The trading results of Group undertakings are translated into sterling at the average exchange rates for the year. The assets and liabilities of overseas undertakings, including goodwill and fair value adjustments arising on acquisition, are translated at the exchange rates ruling at the year end. Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are recognised in OCI. The cumulative amount of exchange adjustments were, on transition to IFRS in 2004, deemed to be nil.

FINANCIAL INSTRUMENTS

IAS 39 *Financial Instruments: Recognition and Measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different. The Group has classified its financial instruments as follows:

- short-term investments are generally classified as **available for sale**;
- short-term deposits (principally comprising funds held with banks and other financial institutions), trade receivables and short-term investments not designated as available for sale are classified as **loans and receivables**;
- borrowings, trade payables and financial RRSAs are classified as **other liabilities**; and
- derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as **fair value through profit or loss**.

Financial instruments are recognised at the contract date and initially measured at fair value. Their subsequent measurement depends on their classification:

- **Available for sale assets** are held at fair value. Changes in fair value arising from changes in exchange rates are included in the income statement. All other changes in fair value are taken to equity. On disposal, the accumulated changes in value recorded in equity are included in the gain or loss recorded in the income statement.
- **Loans and receivables** and **other liabilities** are held at amortised cost and not revalued (except for changes in exchange rates and forecast contractual cash flows, which are included in the income statement) unless they are included in a fair value hedge accounting relationship. Where such a hedging relationship exists, the instruments are revalued in respect of the risk being hedged, with the change in value included in the income statement.
- **Fair value through profit or loss** items are held at fair value. Changes in fair value are included in the income statement unless the instrument is included in a cash flow hedge. If the instruments are included in an effective cash flow hedging relationship, changes in value are taken to equity. When the hedged forecast transaction occurs, amounts previously recorded in equity are recognised in the income statement.

Financial instruments are derecognised on expiry or when all contractual rights and obligations are transferred.

HEDGE ACCOUNTING

The Group does not generally apply hedge accounting in respect of forward foreign exchange contracts or commodity swaps held to manage the cash flow exposures of forecast transactions denominated in foreign currencies or in commodities respectively.

The Group applies hedge accounting in respect of transactions entered into to manage the fair value and cash flow exposures of its borrowings. Forward foreign exchange contracts are held to manage the fair value exposures of borrowings denominated in foreign currencies and are designated as fair value hedges. Interest rate swaps are held to manage the interest rate exposures and are designated as fair value or cash flow hedges of fixed and floating rate borrowings respectively.

Changes in the fair values of derivatives designated as fair value hedges and changes in fair value of the related hedged item are recognised directly in the income statement.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES CONTINUED

Changes in the fair values of derivatives that are designated as cash flow hedges and are effective are recognised directly in equity. Any ineffectiveness in the hedging relationships is included in the income statement. The amounts deferred in equity are recognised in the income statement to match the recognition of the hedged item.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, exercised, or no longer qualifies for hedge accounting. At that time, for cash flow hedges and if the forecast transaction remains probable, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss previously recognised in equity is transferred to the income statement.

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in equity. The ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in the translation reserve will be recycled to profit when the foreign operation is sold.

BUSINESS COMBINATIONS AND GOODWILL

On the acquisition of a business, fair values are attributed to the identifiable assets and liabilities and contingent liabilities unless the fair value cannot be measured reliably, in which case the value is subsumed into goodwill. Where fair values of acquired contingent liabilities cannot be measured reliably, the assumed contingent liability is not recognised but is disclosed in the same manner as other contingent liabilities.

Goodwill recognised represents the excess of the fair value of the purchase consideration over the fair value to the Group of the net of the identifiable assets acquired and the liabilities assumed. On transition to IFRS on 1 January 2004, business combinations were not retrospectively adjusted to comply with Adopted IFRS and goodwill was recognised based on the carrying value under the previous accounting policies. Goodwill in respect of the acquisition of a subsidiary is recognised as an intangible asset. Goodwill arising on the acquisition of joint ventures and associates is included in the carrying value of the investment.

CERTIFICATION COSTS AND PARTICIPATION FEES

Costs incurred in respect of meeting regulatory certification requirements for new civil aero-engine/aircraft combinations including payments made to airframe manufacturers for this and participation fees are carried forward in intangible assets to the extent that they can be recovered out of future sales and are charged to the income statement over the programme life, up to a maximum of 15 years from the entry into service of the product.

RESEARCH AND DEVELOPMENT

In accordance with IAS 38 *Intangible Assets*, expenditure incurred on research and development is distinguished as relating either to a research phase or to a development phase.

All research phase expenditure is charged to the income statement. Development expenditure is capitalised as an internally generated intangible asset only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits. As described on page 60, the Group considers that it is not possible to distinguish reliably between research and development activities until relatively late in the programme.

Expenditure capitalised is amortised over its useful economic life, up to a maximum of 15 years from the entry into service of the product.

CONTRACTUAL AFTERMARKET RIGHTS

As described under key judgements on page 58, the Group may sell OE to customers at a price below its cost, on the basis that it also receives valuable aftermarket rights. Such a sale is considered to give rise to an intangible asset which is recognised, in accordance with IAS 38, at the same time as the revenue at an amount equal to the cash deficit and is amortised on a straight-line basis over the period that highly probable aftermarket sales are expected to be earned.

CUSTOMER RELATIONSHIPS

The fair value of customer relationships recognised as a result of a business combination relate to the acquired company's established relationships with its existing customers that result in repeat purchases and customer loyalty. Amortisation occurs on a straight-line basis over its useful economic life, up to a maximum of 15 years.

SOFTWARE

The cost of acquiring software that is not specific to an item of property, plant and equipment is classified as an intangible asset and amortised over its useful economic life, up to a maximum of five years.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment assets are stated at cost less accumulated depreciation and any provision for impairment in value.

1 ACCOUNTING POLICIES CONTINUED

Depreciation is provided on a straight-line basis to write off the cost, less the estimated residual value, of property, plant and equipment over their estimated useful lives. No depreciation is provided on assets in the course of construction. Estimated useful lives are as follows:

- i) land and buildings, as advised by the Group's professional advisers:
 - a) freehold buildings – five to 45 years (average 25 years)
 - b) leasehold buildings – lower of adviser's estimates or period of lease
 - c) no depreciation is provided on freehold land
- ii) plant and equipment – five to 25 years (average 13 years)
- iii) aircraft and engines – five to 20 years (average 14 years).

OPERATING LEASES

Payments made and rentals received under operating lease arrangements are charged/credited to the income statement on a straight-line basis.

IMPAIRMENT OF NON-CURRENT ASSETS

Impairment of non-current assets is considered in accordance with IAS 36 *Impairment of Assets*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the cash-generating unit to which the asset belongs. Goodwill and intangible assets not yet available for use are tested for impairment annually. Other intangible assets, property, plant and equipment and investments are assessed for any indications of impairment annually. If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense. The recoverable amount is the higher of value in use or fair value less costs to sell, if this is readily available. The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset.

INVENTORIES

Inventories and work in progress are valued at the lower of cost and net realisable value on a first-in, first-out basis. Cost comprises direct materials and, where applicable, direct labour costs and those overheads, including depreciation of property, plant and equipment, that have been incurred in bringing the inventories to their present location and condition. Net realisable value represents the estimated selling prices less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents includes cash at bank and in hand, investments in money-market funds and short-term deposits with a maturity of three months or less on inception. The Group considers overdrafts (repayable on demand) to be an integral part of its cash management activities and these are included in cash and cash equivalents for the purposes of the cash flow statement.

PROVISIONS

Provisions are recognised when the Group has a present obligation as a result of a past event, and it is probable that the Group will be required to settle that obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

POST-RETIREMENT BENEFITS

Pensions and similar benefits (principally healthcare) are accounted for under IAS 19 *Employee Benefits*.

For defined benefit plans, obligations are measured at discounted present value, using a discount rate derived from high quality corporate bonds denominated in the currency of the plan, whilst plan assets are recorded at fair value. Surpluses in schemes are recognised as assets only if they represent economic benefits available to the Group in the future. A liability is recognised to the extent that the minimum funding requirements in respect of past service will give rise to an unrecognisable surplus.

The service and financing costs of such plans are recognised separately in the income statement:

- current service costs are spread systematically over the lives of employees;
- past-service costs are recognised immediately; and
- financing costs are recognised in the periods in which they arise.

Actuarial gains and losses and movements in unrecognised surpluses and minimum funding liabilities are recognised immediately in OCI.

Payments to defined contribution schemes are charged as an expense as they fall due.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES CONTINUED

options that will vest, except where additional shares vest as a result of the Total Shareholder Return (TSR) performance condition in the Performance Share Plan (PSP).

Cash-settled share options (grants in the International ShareSave plan) are measured at fair value at the balance sheet date. The Group recognises a liability at the balance sheet date based on these fair values, taking into account the estimated number of options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

See note 21 for a further description of the share-based payment plans.

SALES FINANCING SUPPORT

In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers. These arrangements fall into two categories: credit-based guarantees and asset-value guarantees. In accordance with the requirements of IAS 39 and IFRS 4 *Insurance Contracts*, credit-based guarantees are treated as insurance contracts. The Group considers asset-value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts. As described on page [•], the directors consider the likelihood of crystallisation in assessing whether provision is required for any contingent liabilities.

The Group's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio, and are reported on a discounted basis.

REVISIONS TO ADOPTED IFRS IN 2014

With effect from 1 January 2014, the Group has adopted IFRS 10 *Consolidated Financial statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*. The principal potential effect was that certain entities previously classified as joint ventures might be classified as joint operations, requiring the Group's share of the individual assets and liabilities of these entities to be included in the financial statements rather than the equity accounting method previously applied. The Group has reviewed its material joint ventures and has concluded that none are to be classified as joint operations under the requirements of IFRS 11. Disclosures required by IFRS 12 are included in note 10.

REVISIONS TO IFRS NOT APPLICABLE IN 2014

Standards and interpretations issued by the IASB are only applicable if endorsed by the EU.

Once endorsed, IFRS 9 *Financial Instruments* will simplify the classification of financial assets for measurement purposes, but is not anticipated to have a significant impact on the financial statements.

IFRS 15 *Revenue from contracts with customers* (effective for the year ending 31 December 2017, not yet endorsed by the EU) provides a single, principles-based five-step model to be applied to all sales contracts, based on the transfer of control of goods and services to customers. It replaces the separate models for goods, services and construction contracts currently included in IAS 11 *Construction Contracts* and IAS 18 *Revenue*. Given the nature of the Group's long-term contracts, it is likely that the adoption of IFRS 15 will require significant judgement.

Based on an initial assessment, IFRS 15 may have a significant impact on the timing of recognition of revenue on individual long-term contracts, although this impact is likely to be significantly reduced at a Group level when all long-term contracts (with different start and end dates) are combined. The Group will continue to assess the impact during 2015.

The Group does not consider that any other standards, amendments or interpretations issued by the IASB, but not yet applicable, will have a significant impact on the financial statements.

2 SEGMENTAL ANALYSIS

The analysis by Division (business segment) is presented in accordance with IFRS 8 *Operating segments*, on the basis of those segments whose operating results are regularly reviewed by the Board (the Chief Operating Decision Maker as defined by IFRS 8), as follows:

AEROSPACE DIVISION:

- Civil – development, manufacture, marketing and sales of commercial aero engines and aftermarket services.
- Defence – development, manufacture, marketing and sales of military aero engines and aftermarket services.

LAND & SEA DIVISION:

- Power Systems – development, manufacture, marketing and sales of diesel engines and power systems.
- Marine – development, manufacture, marketing and sales of marine-power propulsion systems and aftermarket services.
- Nuclear & Energy – development, manufacture, marketing and sales of nuclear systems for civil power generation and naval propulsion systems (Nuclear) and power systems for the offshore oil & gas industry and electrical power generation (Energy) and aftermarket services. The Energy business was sold on 1 December 2014 - see note 24.

The operating results reviewed by the Board are prepared on an underlying basis, which the Board consider reflects better the economic substance of the Group's trading during the year. Additional disclosure of the two segments is also provided. The principles adopted to determine underlying results are:

Underlying revenues – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these reflect the achieved exchange rates arising on settled derivative contracts.

Underlying profit before financing – Where transactions are denominated in a currency other than the functional currency of the Group undertaking, this reflects the transactions at the achieved exchange rates on settled derivative contracts. In addition, adjustments have been made to exclude one-off past-service credits on post-retirement schemes, exceptional restructuring costs and the effect of acquisition accounting.

Underlying profit before taxation – In addition to those adjustments in underlying profit before financing:

- includes amounts realised from settled derivative contracts and revaluation of relevant assets and liabilities to exchange rates forecast to be achieved from future settlement of derivative contracts; and
- excludes unrealised amounts arising from revaluations required by IAS 39 *Financial Instruments: Recognition and Measurement*, changes in value of financial RRSA contracts arising from changes in forecast payments and the net impact of financing costs related to post-retirement scheme benefits.

Taxation – the tax effect of the adjustments above are excluded from the underlying tax charge. In addition, changes in the amount of recoverable advance corporation tax recognised that arise from the above adjustments, are also excluded.

This analysis also includes a reconciliation of the underlying results to those reported in the consolidated income statement.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 SEGMENTAL ANALYSIS CONTINUED

	Aerospace			Land & Sea						Total reportable segments £m
	Civil £m	Defence £m	Total £m	Power Systems £m	Marine £m	Nuclear & Energy £m	Intra- segment £m	Total £m	Inter- segment £m	
Year ended 31 December 2014										
Underlying revenue from sale of original equipment	3,265	816	4,081	1,893	1,070	556	(78)	3,441	–	7,522
Underlying revenue from aftermarket services	3,572	1,253	4,825	827	639	852	(77)	2,241	–	7,066
Total underlying revenue	6,837	2,069	8,906	2,720	1,709	1,408	(155)	5,682	–	14,588
Underlying operating profit excluding share of results of joint ventures and associates	849	350	1,199	256	138	42	(13)	423	–	1,622
Share of results of joint ventures and associates	93	16	109	(3)	–	3	–	–	–	109
Underlying profit before financing and taxation	942	366	1,308	253	138	45	(13)	423	–	1,731
Segment assets	10,976	1,683	12,659	3,607	1,820	1,124	(22)	6,529	(1,269)	17,919
Investments in joint ventures and associates	507	13	520	7	5	7	–	19	–	539
Segment liabilities	(7,885)	(1,891)	(9,776)	(1,118)	(1,196)	(993)	–	(3,307)	(1,269)	(11,814)
Net assets/(liabilities)	3,598	(195)	3,403	2,496	629	138	(22)	3,241	–	6,644
Investment in intangible assets, property, plant and equipment and joint ventures and associates	836	78	914	144	36	62	–	242	–	1,156
Depreciation, amortisation and impairment	381	49	430	221	38	53	–	313	–	742
Year ended 31 December 2013 ¹										
Underlying revenue from sale of original equipment	3,035	1,385	4,420	2,004	1,236	617	(72)	3,785	–	8,205
Underlying revenue from aftermarket services	3,620	1,206	4,826	827	801	921	(75)	2,474	–	7,300
Total underlying revenue	6,655	2,591	9,246	2,831	2,037	1,538	(147)	6,259	–	15,505
Underlying operating profit excluding share of results of joint ventures and associates	708	424	1,132	296	233	63	2	594	–	1,726
Share of results of joint ventures and associates	136	14	150	(2)	–	11	–	9	–	159
Underlying profit before financing and taxation	844	438	1,282	294	233	74	2	603	–	1,885
Segment assets	10,011	1,606	11,617	3,935	1,837	1,727	(10)	7,489	(734)	18,372
Investments in joint ventures and associates	495	17	512	29	5	55	–	89	–	601
Segment liabilities	(4,822)	(1,092)	(5,914)	(4,864)	(530)	(646)	–	(6,040)	733	(11,221)
Net assets/(liabilities)	5,684	531	6,215	(900)	1,312	1,136	(10)	1,538	(1)	7,752
Investment in intangible assets, property, plant and equipment and joint ventures and associates	891	103	994	142	23	80	–	245	–	1,239
Depreciation and amortisation	349	53	402	272	63	63	–	398	–	800

¹ The split between OE and aftermarket revenue for the year ended 31 December 2013 in Marine and Nuclear & Energy has been amended compared with that included on page 87 of the 2013 Annual Report.

2 SEGMENTAL ANALYSIS CONTINUED

RECONCILIATION TO REPORTED RESULTS

	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Discontinued business £m	Group £m
Year ended 31 December 2014						
Revenue from sale of original equipment	7,522	–	7,522	61	(283)	7,300
Revenue from aftermarket services	7,066	–	7,066	(200)	(430)	6,436
Total revenue	14,588	–	14,588	(139)	(713)	13,736
Operating profit excluding share of results of joint ventures and associates	1,622	(53) ¹	1,569	(274)	1	1,296
Share of results of joint ventures and associates	109	–	109	(13)	(2)	94
Profit on transfer of joint ventures to subsidiaries	–	–	–	2	–	2
Profit on disposal of businesses	–	–	–	6	–	6
Profit before financing and taxation	1,731	(53)	1,678	(279)	(1)	1,398
Net financing		(61)	(61)	(1,191)	–	(1,252)
Profit before taxation		(114)	1,617	(1,470)	(1)	146
Taxation		(387)	(387)	239	(3)	(151)
Profit for the year from continuing operations			1,226	(1,367)	–	(5)
Profit for the year from discontinued operations			4	–	138	142
Profit for the year			1,230	(1,231)	138	137
Attributable to:						
Ordinary shareholders			1,241	(1,231)	138	148
Non-controlling interests			(11)	–	–	(11)

Year ended 31 December 2013						
Revenue from sale of original equipment	8,205	–	8,205	70	(328)	7,947
Revenue from aftermarket services	7,300	–	7,300	(62)	(543)	6,695
Total revenue	15,505	–	15,505	8	(871)	14,642
Operating profit excluding share of results of joint ventures and associates	1,726	(53) ¹	1,673	(297)	(45)	1,331
Share of results of joint ventures and associates	159	–	159	1	(11)	149
Profit on transfer of joint ventures to subsidiaries	–	–	–	119	–	119
Profit on disposal of businesses	–	–	–	216	–	216
Profit before financing and taxation	1,885	(53)	1,832	39	(56)	1,815
Net financing		(72)	(72)	220	(3)	145
Profit before taxation		(125)	1,760	259	(59)	1,960
Taxation		(434)	(434)	54	3	(377)
Profit for the year from continuing operations			1,270	313	–	1,583
Profit for the year from discontinued operations			56	–	–	56
Profit for the year			1,326	313	–	1,639
Attributable to:						
Ordinary shareholders			1,225	402	–	1,627
Non-controlling interests			101	(89)	–	12

¹ Central corporate costs

DISCONTINUED OPERATIONS

	2014 £m	2013 £m
Revenue	713	871
Profit before taxation	1	59
Tax on ordinary activities	3	(3)
Profit for the year from ordinary activities	4	56
Profit on disposal of discontinued operations	136	–
Tax on profit on disposal of discontinued operations	2	–
Profit for the year from discontinued operations	142	56
Net cash (outflow)/inflow from operating activities	(127)	51
Net cash outflow from investing activities	(35)	(51)
Net cash inflow from financing activities	–	–
Net change in cash and cash equivalents	(162)	–

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 SEGMENTAL ANALYSIS CONTINUED

UNDERLYING ADJUSTMENTS

	2014				2013			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	14,588	1,678	(61)	(387)	15,505	1,832	(72)	(434)
Revenue recognised at exchange rate on date of transaction	(139)	–	–	–	8	–	–	–
Realised (gains) on settled derivative contracts ¹	–	(87)	(5)	–	–	(10)	(5)	–
Net unrealised fair value changes to derivative contracts ²	–	(15)	(1,141)	–	–	–	250	–
Effect of currency on contract accounting	–	13	–	–	–	(18)	–	–
Revaluation of trading assets and liabilities	–	(11)	(8)	–	–	–	–	–
Exchange differences and other unrealised changes in value	–	–	(8)	–	–	–	8	–
Effect of acquisition accounting ³	–	(142)	–	–	–	(265)	–	–
Pensions discretionary increase	–	–	–	–	–	(64)	–	–
Net post-retirement scheme financing	–	–	(29)	–	–	–	(26)	–
Profit on reclassification of joint ventures to subsidiaries	–	2	–	–	–	119	–	–
Profit on disposal of businesses	–	6	–	–	–	216	–	–
Exceptional restructuring ⁴	–	(39)	–	–	–	–	–	–
Other ⁵	–	(6)	–	–	–	61	(7)	–
Related tax effect	–	–	–	239	–	–	–	54
Total underlying adjustments	(139)	(279)	(1,191)	239	8	39	220	54
Discontinued operations	(713)	(1)	–	(3)	(871)	(56)	(3)	3
Reported per consolidated income statement	13,736	1,398	(1,252)	(151)	14,642	1,815	145	(377)

¹ Realised gains on settled derivative contracts include adjustments to reflect the gains in the same period as the related trading cash flows.

² Unrealised fair value changes to derivative contracts: (i) include those included in equity accounted joint ventures, which are included in profit before financing; and (ii) exclude those for which the related trading contracts have been cancelled when the fair value changes are recognised immediately in underlying profit.

³ The adjustment eliminates charges recognised as a result of recognising assets in acquired businesses at fair value.

⁴ Restructuring is excluded from the underlying performance when it relates to the closure of a significant business or a site.

⁵ In 2013, other included the exclusion of other operating income £63m and the revaluation of preference shares in RRP AG, which were acquired.

RECONCILIATION TO THE BALANCE SHEET

	2014 £m	2013 £m
Reportable segment assets	17,919	18,372
Investments in joint ventures and associates	539	601
Cash and cash equivalents and short-term investments	2,869	4,311
Fair value of swaps hedging fixed rate borrowings	80	47
Income tax assets	388	332
Post-retirement scheme surpluses	1,740	248
Total assets	23,535	23,911
Reportable segment liabilities	(11,814)	(11,221)
Borrowings	(2,261)	(2,371)
Fair value of swaps hedging fixed rate borrowings	(22)	(48)
Income tax liabilities	(1,422)	(1,096)
Post-retirement scheme deficits	(1,185)	(1,041)
Total liabilities	(16,704)	(15,777)
Net assets	6,831	8,134

2 SEGMENTAL ANALYSIS CONTINUED

GEOGRAPHICAL SEGMENTS

The Group's revenue by destination from continuing operations is shown below:

	2014 £m	2013 £m
United Kingdom	1,599	1,677
Norway	322	520
Germany	734	972
Switzerland	670	868
Spain	113	174
Italy	201	233
France	292	259
Russia	86	111
Rest of Europe	575	637
United States of America	3,751	3,910
Canada	472	474
South America	407	302
Saudi Arabia	327	544
Rest of Middle East	418	339
India	161	230
China	1,290	1,038
South Korea	485	452
Japan	272	235
Malaysia	280	235
Singapore	396	544
Rest of Asia	493	596
Africa	115	87
Australasia	207	143
Other	70	62
	13,736	14,642

No single customer represented 10% or more of the Group's revenue.

The carrying amounts of the Group's non-current assets, excluding financial instruments, deferred tax assets and post-retirement benefit surpluses, by the geographical area in which the assets are located, are as follows:

	£m	£m
United Kingdom	3,864	3,649
North America	827	872
Nordic countries	724	823
Germany	2,493	2,739
Other	912	924
	8,820	9,007

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

3 RESEARCH AND DEVELOPMENT AND OTHER INCOME

RESEARCH AND DEVELOPMENT

	2014 £m	2013 £m
Expenditure in the year	(818)	(725)
Capitalised as intangible assets	83	110
Amortisation of capitalised costs	(125)	(130)
Net research and development cost	(860)	(745)
Entry fees received	51	126
Entry fees deferred in respect of charges in future years	(38)	(50)
Recognition of previously deferred entry fees	54	11
Net cost recognised in the income statement	(793)	(658)
Underlying adjustments relating to effects of acquisition accounting and foreign exchange	63	59
Discontinued operations	(25)	(25)
Net underlying cost recognised in the income statement	(755)	(624)

OTHER INCOME

In October 2011, Rolls-Royce and United Technologies Corp. (UTC) announced their intention to form a new joint venture to develop an engine to power future mid-size aircraft (120-230 passenger aircraft). In September 2013, the parties agreed not to proceed with the partnership. Other operating income in 2013 includes £63 million as a result of this.

4 NET FINANCING

		2014		2013	
	Note	Per consolidated income statement £m	Underlying financing ¹ £m	Per consolidated income statement £m	Underlying financing ¹ £m
Financing income					
Interest receivable		17	17	15	15
Fair value gains on foreign currency contracts ²	16	2	–	287	–
Financial RRSAs – foreign exchange differences and other unrealised changes in value		–	–	8	–
Finance income on post-retirement scheme surpluses	18	13	–	17	–
		32	17	327	15
Financing costs					
Interest payable		(63)	(63)	(58)	(58)
Fair value losses on foreign currency contracts ²	16	(1,127)	–	(3)	–
Financial RRSAs – financing	16	(5)	(5)	(9)	(9)
Financial RRSAs – foreign exchange differences and other unrealised changes in value	16	(8)	–	–	–
Fair value losses on commodity derivatives ²	16	(15)	–	(34)	–
Finance cost on post-retirement scheme deficits	18	(42)	–	(43)	–
Net foreign exchange losses		(13)	–	(5)	–
Other financing charges		(11)	(10)	(30)	(20)
		(1,284)	(78)	(182)	(87)
Net financing		(1,252)	(61)	145	(72)
Analysed as:					
Net interest payable		(46)	(46)	(43)	(43)
Net post-retirement scheme financing		(29)	–	(26)	–
Net other financing		(1,177)	(15)	214	(29)
Net financing		(1,252)	(61)	145	(72)
¹ See note 2					
² Net (loss) / gain on fair value items through profit or loss	16	(1,140)	–	250	–

5 TAXATION

	UK		Overseas		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Current tax						
Current tax charge for the year	8	7	240	301	248	308
Less double tax relief	—	(1)	—	—	—	(1)
	8	6	240	301	248	307
Adjustments in respect of prior years	1	2	12	29	13	31
	9	8	252	330	261	338
Deferred tax						
Deferred tax (credit)/charge for the year	(72)	212	(77)	(68)	(149)	144
Adjustments in respect of prior years	(14)	(8)	(11)	(37)	(25)	(45)
Derecognition of advance corporation tax	64	—	—	—	64	—
Credit resulting from reduction in tax rates	—	(59)	—	(1)	—	(60)
	(22)	145	(88)	(106)	(110)	39
Recognised in the income statement	(13)	153	164	224	151	377

OTHER TAX (CHARGES)/CREDITS

	OCI				Equity	
	Items that will not be reclassified		Items that may be reclassified			
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Current tax:						
Share-based payments – direct to equity					3	5
Deferred tax:						
Movement in post-retirement schemes	(431)	10				
Share-based payments – direct to equity					(7)	8
Net investment hedge			(2)	1		
	(431)	10	(2)	1	(4)	13

TAX RECONCILIATION ON CONTINUING OPERATIONS

	2014 £m	2013 £m
Profit before taxation	146	1,960
Less share of results of joint ventures and associates (note 10)	(94)	(149)
Profit before taxation excluding joint ventures and associates	52	1,811
Nominal tax charge at UK corporation tax rate 21.5% (2013 23.25%)	11	421
UK R&D credit	(6)	(13)
Rate differences	71	59
Profit on reclassification of joint ventures to subsidiaries	—	(27)
Other permanent differences	22	12
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	(3)	(7)
Tax losses in year not recognised in deferred tax	4	6
Adjustments in respect of prior years	(12)	(14)
Derecognition of advance corporation tax	64	—
Reduction in closing deferred taxes resulting from decrease in tax rate	—	(60)
	151	377
Underlying items (note 2)	390	431
Non-underlying items	(239)	(54)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 TAXATION CONTINUED

TAX ON DISCONTINUED OPERATIONS

	2014 £m	2013 £m
Tax (credit)/charge on profit/loss on ordinary activities	(3)	3
Tax credit on profit on disposal of discontinued operations	(2)	—
	(5)	3

DEFERRED TAXATION ASSETS AND LIABILITIES

	2014 £m	2013 £m
At 1 January	(566)	(242)
Amount credited/(charged) to income statement	120	(53)
Amount (charged)/credited to other comprehensive income	(433)	11
Amount credited/(charged) to equity	(7)	8
Acquisition of businesses	(3)	(282)
Exchange differences	30	(8)
At 31 December	(859)	(566)
Deferred tax assets	369	316
Deferred tax liabilities	(1,228)	(882)

The analysis of the deferred tax position is as follows:

	At 1 January 2014 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Disposal of businesses £m	Exchange differences £m	At 31 December 2014 £m
Intangible assets	(511)	41	—	—	—	15	(455)
Property, plant and equipment	(210)	20	—	—	(6)	1	(195)
Other temporary differences	80	23	(2)	(10)	(1)	7	97
Amounts recoverable on contracts	(380)	(146)	—	—	—	—	(526)
Pensions and other post-retirement scheme benefits	153	(54)	(431)	—	—	8	(324)
Foreign exchange and commodity financial assets and liabilities	(92)	226	—	—	—	1	135
Losses	323	65	—	3	4	(2)	393
R&D expenditure credit	7	9	—	—	—	—	16
Advance corporation tax	64	(64)	—	—	—	—	—
	(566)	120	(433)	(7)	(3)	30	(859)
Included in: Taxation		110					
Discontinued operations		10					

	At 1 January 2013 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Exchange differences £m	At 31 December 2013 £m
Intangible assets	(232)	34	—	—	(311)	(2)	(511)
Property, plant and equipment	(158)	17	—	—	(70)	1	(210)
Other temporary differences	12	9	1	3	60	(5)	80
Amounts recoverable on contracts	(351)	(29)	—	—	—	—	(380)
Pensions and other post-retirement scheme benefits	110	—	10	—	36	(3)	153
Foreign exchange and commodity financial assets and liabilities	(56)	(36)	—	—	—	—	(92)
Losses	369	(55)	—	5	3	1	323
R&D expenditure credit	—	7	—	—	—	—	7
Advance corporation tax	64	—	—	—	—	—	64
	(242)	(53)	11	8	(282)	(8)	(566)
Included in: Taxation		(39)					
Discontinued operations		(14)					

5 TAXATION CONTINUED

UNRECOGNISED DEFERRED TAX ASSETS

	2014 £m	2013 £m
Advance corporation tax	182	118
Losses and other unrecognised deferred tax assets	35	39
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	217	157

DEFERRED TAXATION ASSETS AND LIABILITIES

The UK corporation tax rate reduced to 21% from 1 April 2014 and will reduce further to 20% from 1 April 2015. As the reduction was substantively enacted prior to year end, the closing deferred tax assets and liabilities have been calculated at this rate.

The deferred tax asset recognised relating to advance corporation tax has reduced during the year due to a decrease in the net deferred tax liabilities against which the asset can be offset. The main reason for this is the unrealised fair value change on derivative contracts.

The temporary differences associated with investments in subsidiaries, joint ventures and associates, for which a deferred tax liability has not been recognised, aggregate to **£512 million** (2013 £573 million). No deferred tax liability has been recognised on the potential withholding tax due on the remittance of undistributed profits as the Group is able to control the timing of such remittances and it is probable that consent will not be given in the foreseeable future.

6 EMPLOYEE INFORMATION

	2014 Number	2013 Number
Average number of employees¹		
United Kingdom	24,500	24,800
United States of America	7,900	8,500
Canada	1,500	1,600
Germany	10,500	10,500
Nordic countries	4,000	4,100
Rest of world	5,700	5,700
	54,100	55,200
Civil	23,900	23,400
Defence	7,000	7,900
Aerospace Division	30,900	31,300
Power Systems	10,700	10,700
Marine	6,400	6,900
Nuclear & Energy ²	6,100	6,300
Land & Sea Division	23,200	23,900
Group	54,100	55,200

	£m	£m
Group employment costs³		
Wages and salaries	2,646	2,843
Social security costs	362	374
Share-based payments (note 20)	21	79
Pensions and other post-retirement scheme benefits (note 18)	328	421
	3,357	3,717

¹ See page 34.

² The disposal of the Energy business on 1 December 2014 reduced employees by 2,000.

³ Remuneration of key management personnel is shown in note 23.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

7 AUDITORS' REMUNERATION

Fees payable to the Company's auditors and its associates were as follows:

	2014 £m	2013 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements	1.8	1.5
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	3.7	4.1
Total fees payable for audit services	5.5	5.6
Fees payable to the Company's auditors and its associates for other services:		
Audit related assurance services	0.8	0.5
Taxation compliance services	0.7	0.8
Taxation advisory services	–	0.1
Internal audit services	–	0.2
All other services	0.4	1.0
	7.4	8.2
Fees payable in respect of the Group's pension schemes:		
Audit	0.2	0.2
Taxation compliance services	–	0.1

8 INTANGIBLE ASSETS

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Contractual aftermarket rights ¹ £m	Customer relationships £m	Software £m	Other £m	Total £m
Cost:								
At 1 January 2013	1,111	740	1,028	499	45	385	142	3,950
Exchange differences	(18)	3	5	—	(3)	(1)	17	3
Additions	—	185	110	52	—	69	87	503
Acquisitions of businesses	773	—	508	—	433	—	286	2,000
Disposals	(5)	—	(5)	—	—	—	—	(10)
At 1 January 2014	1,861	928	1,646	551	475	453	532	6,446
Reclassifications ²	(8)	—	4	—	11	19	(28)	(2)
Exchange differences	(112)	(8)	(43)	—	(17)	(1)	(28)	(209)
Additions	—	159	100	93	—	83	42	477
Acquisitions of businesses	1	—	—	—	—	—	—	1
Disposal of business	(67)	—	—	(35)	—	(11)	—	(113)
At 31 December 2014	1,675	1,079	1,707	609	469	543	518	6,600
Accumulated amortisation:								
At 1 January 2013	9	225	323	295	12	144	41	1,049
Exchange differences	(1)	—	(7)	—	(8)	—	5	(11)
Charge for the year ³	—	40	130	28	61	54	91	404
Impairment	17	—	3	—	4	—	—	24
Disposals	(2)	—	(5)	—	—	—	—	(7)
At 1 January 2014	23	265	444	323	69	198	137	1,459
Reclassifications ²	(8)	—	4	—	(11)	5	6	(4)
Exchange differences	—	—	(9)	—	(4)	—	(6)	(19)
Charge for the year ³	—	46	125	37	42	63	53	366
Impairment	1	—	—	—	—	—	—	1
Disposal of business	—	—	—	—	—	(7)	—	(7)
At 31 December 2014	16	311	564	360	96	259	190	1,796
Net book value:								
At 31 December 2014	1,659	768	1,143	249	373	284	328	4,804
At 31 December 2013	1,838	663	1,202	228	406	255	395	4,987
At 1 January 2013	1,102	515	705	204	33	241	101	2,901

¹ Previously referred to as 'recoverable engine costs'.

² In 2013, following the acquisition of RRPS, the Group revised the classification of intangible assets. During 2014, a number of minor inconsistencies in these classifications have been identified and amended. The net movement of £2m relates to software previously included in property, plant and equipment.

³ Charged to cost of sales except development costs, which are charged to research and development costs.

GOODWILL

In accordance with the requirements of IAS 36 *Impairment of Assets*, goodwill is allocated to the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the business combination that gave rise to the goodwill as follows:

CASH-GENERATING UNIT (CGU) OR GROUP OF CGUs

	Primary reporting segment	2014 £m	2013 £m
Rolls-Royce Deutschland Ltd & Co KG	Aerospace	215	230
Commercial marine – arising from the acquisitions of Vinters Limited and Scandinavian Electric Holdings AS	Land & Sea	552	620
Commercial marine – arising from the acquisition of ODIM ASA	Land & Sea	77	88
Rolls-Royce Power Systems AG	Land & Sea	760	785
Other	Various	55	115
		1,659	1,838

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

8 INTANGIBLE ASSETS CONTINUED

Goodwill has been tested for impairment during 2014 on the following basis:

- The carrying values of goodwill have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long-term and established nature of many of the Group's products (product lives are often measured in decades), these forecasts generally cover the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates (2.0 – 2.75%) that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate.
- The key assumptions for the impairment tests are the discount rate and, in the cash flow projections, the programme assumptions, the growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs. Impairment tests are performed using prevailing exchange rates.
- The pre-tax cash flow projections have been discounted at **13%** (2013 13%), based on the Group's weighted average cost of capital, adjusted for specific risk where appropriate. The rate used for Rolls-Royce Power Systems AG takes account of the discount rate used for the agreement of the purchase price.

The principal value in use assumptions for goodwill balances considered to be individually significant are:

- **Rolls-Royce Power Systems AG** – Volume of equipment deliveries, pricing achieved and cost escalation. These are based on current and known future programmes, estimates of capture of market share and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into euros. For the purposes of the impairment only, cash flows from recent management forecasts for a five-year period have been included. Cash flows beyond five years are assumed to grow at **2%** (2013 management forecast for ten years; thereafter 2% growth). Following the recognition of RRPS at fair value on 1 January 2013, reasonably possible changes in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. Such changes include: a reduction in the level of cash generation of 14%; or an increase in the assumed discount rate of 4%.
- **Rolls-Royce Deutschland Ltd & Co KG** – Volume of engine deliveries, flying hours of installed fleet and cost escalation. These are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposure is on translating US dollar income into euros. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at **2.5%** (2013 2.5%). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 81% to cause an impairment of this balance.
- **Vinters Limited** – Volume of equipment deliveries, capture of aftermarket and cost escalation. These are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into Norwegian kroner. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at **2.5%** (2013 2.5%). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 75% to cause an impairment of this balance.

8 INTANGIBLE ASSETS CONTINUED

OTHER INTANGIBLE ASSETS

Certification costs and participation fees, development costs and contractual aftermarket rights have been reviewed for impairment in accordance with the requirements of IAS 36 *Impairment of Assets*. Where an impairment test was considered necessary, it has been performed on the following basis:

- The carrying values have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions over the lives of the respective programmes.
- The key assumptions underlying cash flow projections are assumed market share, programme timings, unit cost assumptions, discount rates, and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at **11%** (2013 11%), based on the Group's weighted average cost of capital.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Group's control (discount rate, exchange rate and airframe delays), could result in impairment in future years.

As described in the Directors' Report, the Group is currently engaged in a number of Trent 900 sales campaigns. The carrying value of intangible assets relating to the Trent 900 programme assumes that a proportion of these campaigns are successful. If no further orders are obtained, the carrying value of these intangible assets (£142 million) may be impaired.

9 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 2013	1,072	2,889	223	511	4,695
Exchange differences	(11)	(28)	(2)	(8)	(49)
Additions	17	150	83	437	687
Acquisitions of businesses	202	300	—	44	546
Disposals of businesses	—	(1)	—	—	(1)
Reclassifications	19	242	21	(282)	—
Disposals/write-offs	(2)	(62)	(1)	(2)	(67)
At 1 January 2014	1,297	3,490	324	700	5,811
Exchange differences	(23)	(42)	(1)	2	(64)
Additions	24	160	57	427	668
Acquisitions of businesses	—	—	38	—	38
Disposals of businesses	(88)	(94)	(77)	(28)	(287)
Reclassifications ¹	134	137	32	(305)	(2)
Disposals/write-offs	(10)	(51)	(52)	(1)	(114)
At 31 December 2014	1,334	3,600	321	795	6,050
Accumulated depreciation:					
At 1 January 2013	355	1,714	62	—	2,131
Exchange differences	(9)	(22)	(1)	—	(32)
Charge for the year ²	48	301	23	—	372
Reclassifications ¹	(8)	8	—	—	—
Disposals of businesses	—	(1)	—	—	(1)
Disposals/write-offs	—	(51)	—	—	(51)
At 1 January 2014	386	1,949	84	—	2,419
Exchange differences	(8)	(26)	—	—	(34)
Charge for the year ²	49	294	31	—	374
Impairment	—	—	—	1	1
Disposals of businesses	(29)	(62)	(9)	—	(100)
Disposals/write-offs	(7)	(46)	(3)	—	(56)
At 31 December 2014	391	2,109	103	1	2,604
Net book value:					
At 31 December 2014	943	1,491	218	794	3,446
At 31 December 2013	911	1,541	240	700	3,392
At 1 January 2013	717	1,175	161	511	2,564

¹ The net reclassification of £2m relates to software now included in intangible assets.

² Depreciation charged during the year is presented in the income statement or included in the cost of inventory as appropriate.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

9 PROPERTY, PLANT AND EQUIPMENT CONTINUED

Property, plant and equipment includes:

	2014 £m	2013 £m
Net book value of finance leased assets:		
Land and buildings	6	7
Plant and equipment	9	4
Aircraft and engines	43	—
Assets held for use in operating leases:		
Cost	267	320
Depreciation	(64)	(79)
Net book value	203	241
Capital expenditure commitments	194	317
Net book value of assets held as security for liabilities (excluding finance leased assets)	—	—
Cost of fully depreciated assets	792	899

The Group's share of equity accounted entities' capital commitments is **£82 million** (2013 £150 million).

10 INVESTMENTS

COMPOSITION OF THE GROUP

The principal entities contributing to the Group's financial results are listed on pages 123 and 124. These comprise 54 wholly-owned subsidiaries and 33 joint ventures which are located in the following countries.

	At 31 December 2014		At 31 December 2013		
	Wholly-owned subsidiaries	Joint ventures	Wholly-owned subsidiaries	Non-wholly-owned subsidiaries	Joint ventures
UK	13	8	13	1	9
Australia	—	—	—	—	1
Brazil	1	—	1	—	—
Canada	1	—	1	—	—
China	2	2	1	1	2
Finland	1	—	1	—	—
France	2	—	2	—	—
Germany	6	4	1	4	5
Guernsey	1	—	1	—	—
Hong Kong	1	1	—	1	1
India	3	1	3	—	1
Israel	—	1	—	—	1
Italy	2	—	1	1	—
Malaysia	—	—	—	—	1
Netherlands	1	—	—	1	—
Norway	2	—	1	1	—
Singapore	2	2	1	1	2
South Africa	1	—	—	—	—
Spain	1	1	—	1	1
Sweden	1	—	1	—	—
Turkey	1	—	—	1	—
United States of America	12	13	11	1	13

10 INVESTMENTS CONTINUED

The non-wholly owned subsidiaries above comprise the Rolls-Royce Power Systems group. On 7 March 2014, Daimler AG announced its intention to exercise its put option with the Company's ultimate holding company, Rolls-Royce Holdings plc, on its 50% of Rolls-Royce Power Systems Holding GmbH (RRPSH). Formal notice of this intention was served on 24 March 2014. From this date, the Group has an effective economic interest in RRPSH of 100% and NCI of £584 million was transferred to retained earnings. The Group acquired the shares on 26 August 2014, giving it a 100% interest in RRPSH. Non-controlling interests are as follows:

	Proportion of ownership interests held by NCI		Comprehensive income allocated to NCI		Accumulated NCI	
	2014	2013	2014 £m	2013 £m	2014 £m	2013 £m
Rolls-Royce Power Systems GmbH	—	50%	(12)	11	—	694
Other subsidiaries with NCI			1	1	5	4
			(11)	12	5	698

Summarised financial information for RRPSH is as follows:

	At 24 March 2014 ¹ £m	At 31 December 2013 £m
Current assets	1,529	1,776
Non-current assets	2,511	2,567
Current liabilities	(974)	(1,035)
Non-current liabilities	(1,118)	(1,134)
Equity attributable to Rolls-Royce shareholders	1,364	1,480
Non-controlling interests	584	694

¹ Immediately prior to the exercise of the put option.

	Period to 24 March 2014 £m	Year to 31 December 2013 £m
Revenue	551	2,834
(Loss)/profit for the period	(25)	21
Attributable to ordinary shareholders	(12)	10
Non-controlling interests	(12)	10
Total comprehensive income for the period	(69)	21
Attributable to ordinary shareholders	(35)	11
Non-controlling interests	(35)	11
Dividends paid to non-controlling interests	(76)	(60)
Cash flow from operating activities	33	220
Cash flow from investing activities	(17)	(167)
Cash flow from financing activities	(158)	(97)
Net cash outflow	(142)	(44)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

10 INVESTMENTS CONTINUED

EQUITY ACCOUNTED AND OTHER INVESTMENTS

	Equity accounted			Other
	Joint ventures £m	Associates £m	Total £m	Unlisted £m
At 1 January 2013	1,798	2	1,800	6
Exchange differences	(4)	–	(4)	1
Additions	43	–	43	1
Taxation paid by the Group	6	–	6	–
Transfer to subsidiary	(1,327)	–	(1,327)	–
Acquisition of business	30	–	30	20
Share of retained profit	61	–	61	–
Disposals	(2)	–	(2)	(1)
Share of OCI – may be reclassified to profit or loss	(6)	–	(6)	–
At 1 January 2014	599	2	601	27
Reclassification ¹	(25)	–	(25)	–
Exchange differences	7	–	7	(2)
Additions	15	2	17	11
Taxation paid by the Group	3	–	3	–
Transfer to subsidiary	(1)	–	(1)	–
Share of retained profit	23	–	23	–
Disposals	(70)	–	(70)	–
Consolidation of previously non-consolidated subsidiary	–	–	–	(5)
Return of capital	(3)	–	(3)	–
Share of OCI – may be reclassified to profit or loss	(13)	–	(13)	–
At 31 December 2014	535	4	539	31

¹ The reclassification relates to an adjustment in the prior year relating to transactions between the Group and a joint venture which was included in creditors. It has now been transferred to investments in joint ventures.

Reconciliation to the income statement and cash flow statement

	Continuing operations		Discontinued operations		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Share of profit after tax	94	149	2	11	96	160
Dividends received	(71)	(94)	(2)	(5)	(73)	(99)
Share of retained profit	23	55	–	6	23	61

The following joint ventures are considered to be individually material to the Group:

	Principal location	Activity	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	45.0%
Singapore Aero Engine Services Pte Limited (SAESL)	Singapore	Aero engine repair and overhaul	39.0%
Industria de Turbo Propulsores SA (ITP)	Spain	Aero engine component manufacture and maintenance	46.9%

10 INVESTMENTS CONTINUED

Summarised financial information of the Group's individually material joint ventures is as follows:

	APL		HAESL		SAESL		ITP	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Revenue	105	89	652	898	815	1,150	529	528
Profit from continuing operations	39	45	34	67	60	88	24	57
Post-tax profit from discontinued operations	—	—	—	—	—	—	—	—
Profit for the year	39	45	34	67	60	88	24	57
Other comprehensive operations	—	—	—	—	—	—	—	—
Total comprehensive income for the year	39	45	34	67	60	88	24	57
Dividends received during the year	(13)	(11)	(30)	(61)	(56)	(86)	(19)	(24)
Profit for the year included the following:								
Depreciation and amortisation	(47)	(40)	(8)	(8)	(5)	(6)	(37)	(37)
Interest income	—	—	—	—	—	—	19	12
Interest expense	(15)	(18)	(1)	(1)	(1)	(1)	(12)	(14)
Income tax expense	(11)	—	(7)	(13)	—	—	4	15
Current assets	72	85	159	222	207	217	603	672
Non-current assets	1,171	891	86	79	102	82	525	659
Current liabilities	(62)	(58)	(61)	(133)	(88)	(95)	(415)	(493)
Non-current liabilities	(959)	(757)	(37)	(34)	(106)	(99)	(418)	(461)
Net assets	222	161	147	134	115	105	295	377
Included in the above:								
Cash and cash equivalents	11	16	8	5	11	13	94	243
Current financial liabilities ¹	(13)	(8)	—	—	—	—	(10)	(3)
Non-current financial liabilities ¹	(815)	(633)	(29)	(27)	(106)	(99)	(282)	(353)

¹ Excluding trade and other payables

Reconciliation to the carrying amount recognised in the consolidated financial statements

Ownership interest	50.0%	50.0%	45.0%	45.0%	39.0%	39.0%	46.9%	46.9%
Group share of net assets above	111	81	66	60	45	41	138	177

At the option of the current owner, the Group has an agreement to purchase the shares in ITP that it does not own. If the option is exercised, the price payable would be fair value, determined on a basis agreed between the parties taking into account earnings multiples and discounted cash flows. As the exercise price would be at the fair value of the shares, the Group does not consider that this derivative has a significant fair value.

The summarised aggregated results of the Group's share of equity accounted investments is as follows:

	Joint ventures		Associates		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Profit from continuing operations	94	149	—	—	94	149
Post-tax profit from discontinued operations	2	11	—	—	2	11
Profit for the year	96	160	—	—	96	160
Other comprehensive income	(13)	(6)	—	—	(13)	(6)
Total comprehensive income for the year	83	154	—	—	83	154

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

11 INVENTORIES

	2014 £m	2013 £m
Raw materials	553	593
Work in progress	984	1,177
Long-term contracts work in progress	22	15
Finished goods	1,149	1,426
Payments on account	60	108
	2,768	3,319
Inventories stated at net realisable value	265	447
Amount of inventory write-down	62	89
Reversal of inventory write-down	1	5

12 TRADE AND OTHER RECEIVABLES

	2014 £m	2013 £m
Trade receivables	1,531	1,601
Amounts recoverable on contracts	2,684	2,239
Amounts owed by joint ventures and associates	309	380
Amounts owed by parent undertaking	1,311	848
Other receivables	785	637
Prepayments and accrued income	200	235
	6,820	5,940
Analysed as:		
Financial instruments (note 16):		
Trade receivables and similar items	1,981	2,118
Other non-derivative financial assets	671	527
Non-financial instruments	4,168	3,295
	6,820	5,940
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	40	51
Amounts recoverable on contracts	2,444	1,751
Other receivables	61	41
Prepayments and accrued income	55	84
	2,600	1,927

Amounts recoverable on contracts include **£2,492 million** (2013 £1,901 million) of TotalCare assets.

13 CASH AND CASH EQUIVALENTS

	2014 £m	2013 £m
Cash at bank and in hand	739	982
Money-market funds	692	1,157
Short-term deposits	1,431	1,851
Cash and cash equivalents	2,862	3,990
Overdrafts (note 15)	—	(3)
Cash and cash equivalents per cash flow statement (page 55)	2,862	3,987
Cash held as collateral against third party obligations (note 23)	42	50

Cash and cash equivalents at 31 December 2014 includes **£30 million** (2013 £286 million) that is not available for general use by the Group. This balance relates to cash held in the Group's captive insurance company and non-wholly owned subsidiaries. The principal reason for the significant decrease is that Power Systems is now a wholly owned subsidiary (2013 50% interest).

14 BORROWINGS

	Current		Non-current		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Unsecured						
Overdrafts	—	3	—	—	—	3
Bank loans	12	204	392	412	404	616
7 ³ / ₈ % Notes 2016 £200m	—	—	200	200	200	200
6.55% Notes 2015 US\$83m ¹	55	—	—	55	55	55
6.75% Notes 2019 £500m ²	—	—	547	535	547	535
2.125% Notes 2021 €750m ¹	—	—	615	611	615	611
3.375% Notes 2026 £375m ²	—	—	395	350	395	350
Secured						
Obligations under finance leases ³	1	—	44	1	45	1
	68	207	2,193	2,164	2,261	2,371

¹ These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge.

² 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.

³ Obligations under finance leases are secured by related leased assets.

15 TRADE AND OTHER PAYABLES

	Current		Non-current		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Payments received on account ¹	1,291	1,594	860	750	2,151	2,344
Trade payables	1,348	1,370	13	16	1,361	1,386
Amounts owed to parent undertaking	889	891	—	—	889	891
Amounts owed to joint ventures and associates	235	191	4	—	239	191
Other taxation and social security	109	101	1	—	110	101
Other payables	1,756	1,820	320	143	2,076	1,963
Accruals and deferred income	2,052	1,969	1,247	1,229	3,299	3,198
	7,680	7,936	2,445	2,138	10,125	10,074
¹ Includes payments received on account from joint ventures and associates	158	180	99	151	257	331

Included within trade and other payables are government grants of **£80 million** (2013 £100 million). During the year, **£24 million** (2013 £26 million) of government grants were released to the income statement.

Included in accruals and deferred income are deferred receipts from RRSA workshare partners of **£244 million** (2013 £260 million) and TotalCare liabilities of **£687 million** (2013 £559 million).

Trade and other payables are analysed as follows:

	2014 £m	2013 £m
Financial instruments (note 16):		
Trade payables and similar items	3,049	2,989
Other non-derivative financial liabilities	831	806
Non-financial instruments	6,245	6,279
	10,125	10,074

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 FINANCIAL INSTRUMENTS

CARRYING VALUES AND FAIR VALUES OF FINANCIAL INSTRUMENTS

			Assets				Liabilities		Total
	Notes	Basis for determining fair value	Fair value through profit or loss £m	Loans and receivables £m	Available for sale £m	Cash £m	Fair value through profit or loss £m	Other £m	£m
At 31 December 2014									
Unlisted non-current asset investments	10	A	—	31	—	—	—	—	31
Trade receivables and similar items	12	B	—	1,981	—	—	—	—	1,981
Other non-derivative financial assets	12	B	—	671	—	—	—	—	671
Derivative financial assets ¹		C	129	—	—	—	—	—	129
Short-term investments		B	—	7	—	—	—	—	7
Cash and cash equivalents	13	B	—	1,431	692	739	—	—	2,862
Borrowings	14	D	—	—	—	—	—	(2,261)	(2,261)
Derivative financial liabilities ¹		C	—	—	—	—	(759)	—	(759)
Financial RRSAs		E	—	—	—	—	—	(145)	(145)
Trade payables and similar items	15	B	—	—	—	—	—	(3,049)	(3,049)
Other non-derivative financial liabilities	15	B	—	—	—	—	—	(831)	(831)
			129	4,121	692	739	(759)	(6,286)	(1,364)
At 31 December 2013									
Unlisted non-current asset investments	10	A	—	27	—	—	—	—	27
Trade receivables and similar items	12	B	—	2,118	—	—	—	—	2,118
Other non-derivative financial assets	12	B	—	527	—	—	—	—	527
Derivative financial assets		C	748	—	—	—	—	—	748
Short-term investments		B	—	321	—	—	—	—	321
Cash and cash equivalents	13	B	—	1,851	1,157	982	—	—	3,990
Borrowings	14	D	—	—	—	—	—	(2,371)	(2,371)
Derivative financial liabilities		C	—	—	—	—	(295)	—	(295)
Financial RRSAs		E	—	—	—	—	—	(167)	(167)
Trade payables and similar items	15	B	—	—	—	—	—	(2,989)	(2,989)
Other non-derivative financial liabilities	15	B	—	—	—	—	—	(806)	(806)
			748	4,844	1,157	982	(295)	(6,333)	(1,103)

¹ In the event of counterparty default relating to derivative financial assets and liabilities, off-setting would apply and financial assets and liabilities held with the same counterparty would net off. If this occurred with every counterparty total financial assets would be £15m and financial liabilities £645m.

Fair values equate to book values for both 2014 and 2013, with the following exceptions:

	2014		2013	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	(2,261)	(2,362)	(2,371)	(2,495)
Financial RRSAs	(145)	(152)	(167)	(184)

The fair value of a financial instrument is the price at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms length transaction. Fair values have been determined with reference to available market information at the balance sheet date, using the methodologies described below.

A These primarily comprise unconsolidated companies where fair value approximates to the book value.

B Fair values are assumed to approximate to cost either due to the short-term maturity of the instruments or because the interest rate of the investments is reset after periods not exceeding six months.

C Fair values of derivative financial assets and liabilities are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. These financial instruments are included on the balance sheet at fair value, derived from observable market prices (Level 2 as defined by IFRS 13 *Fair Value Measurement*).

D Borrowing are carried at amortised cost. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date.

E The fair value of RRSAs is estimated by discounting expected future cash flows. The contractual cash flows are based on future trading activity, which is estimated based on latest forecasts (Level 3 as defined by IFRS 13).

IFRS 13 defines a three level valuation hierarchy:

Level 1 – quoted prices for similar instruments

Level 2 – directly observable market inputs other than Level 1 inputs; and

Level 3 – inputs not based on observable market data

16 FINANCIAL INSTRUMENTS CONTINUED

CARRYING VALUES OF OTHER FINANCIAL ASSETS AND LIABILITIES

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Financial RRSAs £m	Total £m
At 31 December 2014						
Non-current assets	28	–	79	107	–	107
Current assets	22	–	–	22	–	22
Assets	50	–	79	129	–	129
Current liabilities	(144)	(21)	–	(165)	(22)	(187)
Non-current liabilities	(545)	(22)	(27)	(594)	(123)	(717)
Liabilities	(689)	(43)	(27)	(759)	(145)	(904)
	(639)	(43)	52	(630)	(145)	(775)
At 31 December 2013						
Non-current assets	631	–	43	674	–	674
Current assets	72	2	–	74	–	74
Assets	703	2	43	748	–	748
Current liabilities	(63)	(16)	(1)	(80)	(22)	(102)
Non-current liabilities	(142)	(25)	(48)	(215)	(145)	(360)
Liabilities	(205)	(41)	(49)	(295)	(167)	(462)
	498	(39)	(6)	453	(167)	286

DERIVATIVE FINANCIAL INSTRUMENTS

The Group uses various financial instruments to manage its exposure to movements in foreign exchange rates. Where the effectiveness of a hedging relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the cash flow hedge reserve and released to match actual payments on the hedged item. The Group uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals). To hedge the currency risk associated with a borrowing denominated in US dollars, the Group has currency derivatives designated as part of fair value hedges. The Group uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates.

Movements in the fair values of derivative financial assets and liabilities were as follows:

	Foreign exchange instruments		Commodity instruments		Interest rate instruments		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
At 1 January	498	272	(39)	(13)	(6)	88	453	347
Business acquisitions	–	4	–	(1)	–	–	–	3
Movements in fair value hedges ¹	3	3	–	–	58	(91)	61	(88)
Movements in other derivative contracts ²	(1,125)	284	(15)	(34)	–	–	(1,140)	250
Contracts settled ³	(15)	(65)	11	9	–	(3)	(4)	(59)
At 31 December	(639)	498	(43)	(39)	52	(6)	(630)	453

¹ Loss on related hedged items £61m (2013 £88m gain).

² Included in financing.

³ 2013 included £17m contracts settled in fair value hedges. Contracts settled in 2014 include a loss of £76m in relation to contracts put in place to hedge the buy-out of the non-controlling interest in RRP5.

NON-DERIVATIVE 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 FINANCIAL INSTRUMENTS CONTINUED

Movements in the carrying values of financial RRSAs were as follows:

	2014 £m	2013 £m
At 1 January	(167)	(193)
Exchange adjustments included in OCI	3	(4)
Financing charge ¹	(5)	(9)
Excluded from underlying profit:		
Changes in forecast payments ¹	–	2
Exchange adjustments ¹	(8)	4
Cash paid to partners	32	33
At 31 December	(145)	(167)

¹ Included in financing.

RISK MANAGEMENT POLICIES AND HEDGING ACTIVITIES

The principal financial risks to which the Group is exposed are: foreign currency exchange rate risk; liquidity risk; credit risk; interest rate risk; and commodity price risk. The Board has approved policies for the management of these risks.

Foreign currency exchange rate risk – The Group has significant cash flows (most significantly US dollars, followed by the euro) denominated in currencies other than the functional currency of the relevant trading entity. To manage its exposures to changes in values of future foreign currency cash flows, so as to maintain relatively stable long-term foreign exchange rates on settled transactions, the Group enters into derivative forward foreign currency transactions. For accounting purposes, these derivative contracts are not designated as hedging instruments.

The Group also has exposures to the fair values of non-derivative financial instruments denominated in foreign currencies. To manage the risk of changes in these fair values, the Group enters into derivative forward foreign exchange contracts, which are designated as fair value hedges for accounting purposes.

The Group regards its interests in overseas subsidiary companies as long-term investments. The Group aims to match its translational exposures by matching the currencies of assets and liabilities. Where appropriate, foreign currency financial liabilities may be designated as hedges of the net investment.

Liquidity risk – The Group's policy is to hold financial investments and maintain undrawn committed facilities at a level sufficient to ensure that the Group has available funds to meet its medium-term capital and funding obligations and to meet any unforeseen obligations and opportunities. The Group holds cash and short-term investments, which together with the undrawn committed facilities, enable the Group to manage its liquidity risk.

Credit risk – The Group is exposed to credit risk to the extent of non-payment by either its customers or the counterparties of its financial instruments. The effective monitoring and controlling of credit risk is a key component of the Group's risk management activities. The Group has credit policies covering both trading and financial exposures. Credit risks arising from treasury activities are managed by a central treasury function in accordance with the Group credit policy. The objective of the policy is to diversify and minimise the Group's exposure to credit risk from its treasury activities by ensuring the Group transacts strictly with 'BBB+' or higher rated financial institutions based on pre-established limits per financial institution. At the balance sheet date, there were no significant concentrations of credit risk to individual customers or counterparties. The maximum exposure to credit risk at the balance sheet date is represented by the carrying value of each financial asset, including derivative financial instruments.

Interest rate risk – The Group's interest rate risk is primarily in relation to its fixed rate borrowings (fair value risk), floating rate borrowings and cash and cash equivalents (cash flow risk). Interest rate derivatives are used to manage the overall interest rate profile within the Group policy, which is to maintain a higher proportion of net debt at floating rates of interest as a natural hedge to the net cash position. These are designated as either fair value or cash flow hedges as appropriate.

16 FINANCIAL INSTRUMENTS CONTINUED

Commodity risk – The Group has exposures to the price of jet fuel and base metals arising from business operations. To minimise its cash flow exposures to changes in commodity prices, the Group enters into derivative commodity transactions. For accounting purposes, these derivative contracts are not designated as hedging instruments.

Other price risk – The Group's cash equivalent balances represent investments in money market instruments, with a term of up to three months. The Group does not consider that these are subject to significant price risk.

DERIVATIVE FINANCIAL INSTRUMENTS

The nominal amounts, analysed by year of expected maturity, and fair values of derivative financial instruments are as follows:

	Expected maturity					Fair value	
	Nominal amount £m	Within one year £m	Between one and five years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
At 31 December 2014							
Foreign exchange contracts:							
Fair value hedges	46	46	–	–	–	6	–
Non-hedge accounted	20,889	5,431	4,793	10,665	–	44	(689)
Interest rate contracts:							
Fair value hedges	1,512	53	–	500	959	74	(22)
Non-hedge accounted	2	2	–	–	–	5	(5)
Commodity contracts:							
Non-hedge accounted	240	79	62	71	28	–	(43)
	22,689	5,611	4,855	11,236	987	129	(759)
At 31 December 2013							
Foreign exchange contracts:							
Fair value hedges	46	–	46	–	–	3	–
Non-hedge accounted	19,654	4,759	4,530	9,493	872	700	(205)
Interest rate contracts:							
Fair value hedges	1,550	–	50	–	1,500	43	(48)
Non-hedge accounted	5	–	5	–	–	–	(1)
Commodity contracts:							
Non-hedge accounted	262	79	62	80	41	2	(41)
	21,517	4,838	4,693	9,573	2,413	748	(295)

As described above, all derivative financial instruments are entered into for risk management purposes, although these may not be designated into hedging relationships for accounting purposes.

CURRENCY ANALYSIS

Derivative financial instruments related to foreign exchange risks are denominated in the following currencies:

	Currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2014					
Currencies sold forward:					
Sterling	–	429	–	199	628
US dollar	16,659	–	2,014	938	19,611
Euro	150	61	–	185	396
Other	167	9	114	10	300
At 31 December 2013					
Currencies sold forward:					
Sterling	–	429	–	10	439
US dollar	15,936	–	2,036	913	18,885
Euro	4	–	–	249	253
Other	22	23	75	3	123

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 FINANCIAL INSTRUMENTS CONTINUED

Other derivative financial instruments are denominated in the following currencies:

	2014 £m	2013 £m
Sterling	877	880
US dollar	292	300
Euro	584	637

Non-derivative financial instruments are denominated in the following currencies:

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2014					
Unlisted non-current investments	–	–	30	1	31
Trade receivables and similar items	232	1,180	479	90	1,981
Other non-derivative financial assets	400	53	101	117	671
Short-term investments	–	–	–	7	7
Cash and cash equivalents	513	1,404	619	326	2,862
Assets	1,145	2,637	1,229	541	5,552
Borrowings	(1,341)	(101)	(819)	–	(2,261)
Financial RRSAs	–	(97)	(48)	–	(145)
Trade payables and similar items	(1,489)	(887)	(545)	(128)	(3,049)
Other non-derivative financial liabilities	(248)	(333)	(161)	(89)	(831)
Liabilities	(3,078)	(1,418)	(1,573)	(217)	(6,286)
	(1,933)	1,219	(344)	324	(734)
At 31 December 2013					
Unlisted non-current investments	–	–	26	1	27
Trade receivables and similar items	199	995	829	95	2,118
Other non-derivative financial assets	289	48	89	101	527
Short-term investments	282	–	4	35	321
Cash and cash equivalents	1,619	1,080	980	311	3,990
Assets	2,389	2,123	1,928	543	6,983
Borrowings	(1,490)	(55)	(826)	–	(2,371)
Financial RRSAs	–	(114)	(53)	–	(167)
Trade payables and similar items	(1,501)	(641)	(653)	(194)	(2,989)
Other non-derivative financial liabilities	(208)	(328)	(158)	(112)	(806)
Liabilities	(3,199)	(1,138)	(1,690)	(306)	(6,333)
	(810)	985	(238)	237	(650)

16 FINANCIAL INSTRUMENTS CONTINUED

CURRENCY EXPOSURES

The Group's actual currency exposures after taking account of derivative foreign currency contracts, which are not designated as hedging instruments for accounting purposes are as follows:

Functional currency of Group operations	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2014					
Sterling	—	28	2	35	65
US dollar	(2)	—	(1)	8	5
Euro	2	5	—	11	18
Other	5	19	6	1	31
At 31 December 2013					
Sterling ¹	—	13	3	12	28
US dollar	8	—	—	7	15
Euro	(1)	(2)	—	—	(3)
Other	(5)	41	(11)	(4)	21

AGEING BEYOND CONTRACTUAL DUE DATE OF FINANCIAL ASSETS

The ageing beyond contractual due date of the Group's financial assets is:

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
At 31 December 2014					
Unlisted non-current asset investments	31	—	—	—	31
Trade receivables and similar items	1,657	206	104	14	1,981
Other non-derivative financial assets	667	4	—	—	671
Derivative financial assets	129	—	—	—	129
Short-term investments	7	—	—	—	7
Cash and cash equivalents	2,862	—	—	—	2,862
	5,353	210	104	14	5,681
At 31 December 2013					
Unlisted non-current asset investments	27	—	—	—	27
Trade receivables and similar items	1,769	240	90	19	2,118
Other non-derivative financial assets	523	1	1	2	527
Derivative financial assets	748	—	—	—	748
Short-term investments	321	—	—	—	321
Cash and cash equivalents	3,990	—	—	—	3,990
	7,378	241	91	21	7,731

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 FINANCIAL INSTRUMENTS CONTINUED

CONTRACTUAL MATURITY ANALYSIS OF FINANCIAL LIABILITIES

	Gross values				Discounting £m	Carrying Value £m
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m		
At 31 December 2014						
Borrowings	(148)	(385)	(214)	(1,880)	366	(2,261)
Derivative financial liabilities	(174)	(115)	(324)	(181)	35	(759)
Financial RRSAs	(17)	(19)	(72)	(52)	15	(145)
Trade payables and similar items	(3,012)	(32)	(2)	(3)	–	(3,049)
Other non-derivative financial liabilities	(650)	(95)	(20)	(66)	–	(831)
	(4,001)	(646)	(632)	(2,182)	416	(7,045)
At 31 December 2013						
Borrowings	(290)	(140)	(609)	(1,894)	562	(2,371)
Derivative financial liabilities	(87)	(76)	(146)	(90)	104	(295)
Trade payables and similar items	(2,972)	(17)	–	–	–	(2,989)
Other non-derivative financial liabilities	(751)	(28)	(16)	(11)	–	(806)
	(4,133)	(295)	(836)	(2,070)	706	(6,628)

INTEREST RATE RISK

In respect of income earning financial assets and interest bearing financial liabilities, the following table indicates their effective interest rates and the periods in which they reprice. The value shown is the carrying amount.

	Effective interest rate	Total £m	Period in which interest rate reprices	
			6 months or less £m	6-12 months £m
At 31 December 2014				
Short-term investments ¹		7	5	2
Cash and cash equivalents ²		2,862	2,862	–
Unsecured bank loans				
Other borrowings		(12)	(1)	–
Interest rate swaps	5.8156%	–	2	(2)
£200m floating rate loan	GBP LIBOR + 0.267	–	–	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–
€125m fixed rate loan	2.6000%	(97)	–	–
€75m fixed rate loan	2.0600%	(59)	–	–
€50m fixed rate loan	2.3500%	(36)	–	–
Unsecured bond issues				
7¾% Notes 2016 £200m	7.3750%	(200)	–	–
6.55% Notes 2015 US\$83m	6.5500%	(55)	–	(55)
Effect of interest rate swaps	USD LIBOR + 1.24	–	(55)	55
6.75% Notes 2019 £500m	6.7500%	(547)	–	–
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(547)	–
2.125% Notes 2021 €750m	2.1250%	(615)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.7005	–	(615)	–
3.375% Notes 2026 £375m	3.3750%	(395)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.8930	–	(395)	–
Other secured				
Obligations under finance leases	4.1089%	(45)	(1)	(1)
		608		

16 FINANCIAL INSTRUMENTS CONTINUED

	Effective interest rate %	Total £m	Period in which interest rate reprices	
			6 months or less £m	6-12 months £m
At 31 December 2013				
Short-term investments ¹		321	318	3
Cash and cash equivalents ²		3,990	3,990	—
Unsecured bank loans				
Other borrowings		(10)	(5)	—
Interest rate swaps	5.3225%	—	5	—
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	—
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	—
€125m fixed rate loan	2.6000%	(104)	—	—
€75m fixed rate loan	2.0600%	(63)	—	—
€50m fixed rate loan	2.3500%	(42)	—	—
Unsecured bond issues				
7⅜% Notes 2016 £200m	7.3750%	(200)	—	—
6.55% Notes 2015 US\$83m	6.5500%	(55)	—	—
Effect of interest rate swaps	USD LIBOR + 1.24	—	(55)	—
6.75% Notes 2019 £500m	6.7500%	(535)	—	—
Effect of interest rate swaps	GBP LIBOR + 2.9824	—	(535)	—
2.125% Notes 2021 €750m	2.1250%	(611)	—	—
Effect of interest rate swaps	GBP LIBOR + 0.7005	—	(611)	—
3.375% Notes 2026 £375m	3.3750%	(350)	—	—
Effect of interest rate swaps	GBP LIBOR + 0.8930	—	(350)	—
Other secured				
Obligations under finance leases	5.0000%	(1)	(1)	—
		1,940		

¹ Interest on the short-term investments are at fixed rates.

² Cash and cash equivalents comprises bank balances and demand deposits and earns interest at rates based on daily deposit rates.

Some of the Group's borrowings are subject to the Group meeting certain obligations, including customary financial covenants. If the Group fails to meet its obligations these arrangements give rights to the lenders, upon agreement, to accelerate repayment of the facilities. There are no rating triggers contained in any of the Group's facilities that could require the Group to accelerate or repay any facility for a given movement in the Group's credit rating.

In addition, the Group has **£1,277 million** of undrawn committed borrowing facilities (2013 £1,250 million) expiring after two years.

SENSITIVITY ANALYSIS

	2014 £m	2013 £m
Sensitivities at 31 December (all other variables held constant) – impact on profit after tax and equity		
Sterling 10% weaker against the US dollar	(1,336)	(1,177)
Sterling 10% stronger against the US dollar	1,093	963
Euro 10% weaker against the US dollar	(147)	(128)
Euro 10% stronger against the US dollar	123	100
Sterling 10% weaker against the Euro	15	(95)
Sterling 10% stronger against the Euro	(12)	78
Commodity prices 10% lower	(15)	(16)
Commodity prices 10% higher	15	16

At 31 December 2014 the Group had no material sensitivity to changes in interest rates on that date. The main interest rate sensitivity for the Group arises as a result of the gross up of net cash and this is mitigated as described under the interest rate risk management policies on page 88.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 PROVISIONS FOR LIABILITIES AND CHARGES

	At 1 January 2014 £m	Exchange differences £m	Disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At 31 December 2014 £m
Warranty and guarantees	419	(18)	(14)	(27)	181	(115)	426
Contract loss	67	(1)	(11)	(9)	16	(21)	41
Restructuring	25	1	–	–	121	(25)	122
Customer financing	73	–	–	(34)	15	(7)	47
Insurance	62	–	–	(13)	35	(19)	65
Other	87	(3)	(9)	(13)	76	(32)	106
	733	(21)	(34)	(96)	444	(219)	807
Current liabilities	348						433
Non-current liabilities	385						374

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.

Provisions for contract loss and restructuring are generally expected to be utilised within two years.

In connection with the sale of its products the Group will, on some occasions, provide financing support for its customers – generally in respect of civil aircraft. The Group's commitments relating to these financing arrangements are spread over many years, relate to a number of customers and a broad product portfolio and are generally secured on the asset subject to the financing. These include commitments of US\$1.8 billion to provide borrowing facilities to enable customers to purchase aircraft (of which approximately US\$300 million could be called in 2015). These facilities may only be used if the customer is unable to obtain financing elsewhere and are priced at a premium to the market rate. Consequently the directors do not consider that there is a significant exposure arising from the provision of these facilities.

17 PROVISIONS FOR LIABILITIES AND CHARGES CONTINUED

Customer financing provisions cover guarantees provided for asset value and/or financing. These guarantees, the risks arising and the process used to assess the extent of the risk are described under the heading 'Customer financing' in the Financial Review on page 20. It is estimated that the provision will be utilised as follows:

	2014 £m	2013 £m
Potential claims with specific claim dates:		
In one year or less	32	29
In more than one year but less than five years	11	38
In more than five years	4	5
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	–	1
	47	73

Commitments on delivered aircraft in excess of the amounts provided are shown in the table below. These are reported on a discounted basis at the Group's borrowing rate to reflect better the time span over which these exposures could arise. These amounts do not represent values that are expected to crystallise. The commitments are denominated in US dollars. As the Group does not generally adopt cash flow hedge accounting for future foreign exchange transactions, this amount is reported, together with the sterling equivalent at the reporting date spot rate. The values of aircraft providing security are based on advice from a specialist aircraft appraiser.

	2014		2013	
	£m	\$m	£m	\$m
Gross commitments	388	605	356	589
Value of security ¹	(245)	(382)	(217)	(360)
Indemnities	(84)	(132)	(80)	(132)
Net commitments	59	91	59	97
Net commitments with security reduced by 20% ²	90	140	78	129
¹ Security includes unrestricted cash collateral of:	42	66	50	83

² Although sensitivity calculations are complex, the reduction of relevant security by 20% illustrates the sensitivity to changes in this assumption.

There are also commitments in respect of undelivered aircraft, but it is not considered practicable to estimate these, as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

The Group's captive insurance company retains a portion of the exposures it insures on behalf of the remainder of the Group. Significant delays occur in the notification and settlement of claims and judgement is involved in assessing outstanding liabilities, the ultimate cost and timing of which cannot be known with certainty at the balance sheet date. The insurance provisions are based on information currently available, however it is inherent in the nature of the business that ultimate liabilities may vary. Provisions for outstanding claims are established to cover the outstanding expected liability as well as claims incurred but not yet reported.

Other provisions comprise a number of liabilities with varying expected utilisation rates.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 POST-RETIREMENT BENEFITS

The Group operates a number of defined benefit and defined contribution schemes.

UK defined benefit schemes are funded, with the assets held in separate trustee administered funds. Employees are entitled to retirement benefits based on either their final or career average salaries and length of service.

Overseas defined benefit schemes are a mixture of funded and unfunded plans and provide benefits in line with local practice. Additionally in the US, and to a lesser extent in some other countries, the Group's employment practices include the provision of healthcare and life insurance benefits for retired employees. These schemes are unfunded.

The valuations of the defined benefit schemes are based on the most recent funding valuations, where relevant, updated by the scheme actuaries to 31 December 2014.

The defined benefit schemes expose the Group to actuarial risks such as longevity, interest rate, inflation and investment risks. In the UK, and in the principal US pension schemes, the Group has adopted investment policies to mitigate some of these risks. This involves investing a significant proportion of the schemes' assets in liability driven investment (LDI) portfolios, which hold investments designed to offset interest rate and inflation rate risks. In addition, in the UK, the Rolls-Royce Pension Fund has invested in a longevity swap, which is designed to offset longevity risks in respect of existing pensioners.

AMOUNTS RECOGNISED IN THE INCOME STATEMENT

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost and administrative expenses	156	45	201	153	55	208
Past-service cost	(18)	(13)	(31)	66	5	71
	138	32	170	219	60	279
Defined contribution schemes ¹	32	97	129	30	86	116
Operating cost	170	129	299	249	146	395
Net financing (income)/charge in respect of defined benefit schemes	(11)	40	29	(12)	38	26
Total income statement charge	159	169	328	237	184	421

¹ The 2013 figures reported did not include defined contribution costs for Rolls-Royce Power Systems AG.

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2014 £m	2013 £m	2014 £m	2013 £m	2014 £m	2013 £m
Cost of sales – included in underlying profit	117	141	84	74	201	215
Commercial and administrative costs	21	104	23	23	44	127
Research and development	27	28	17	14	44	42
	165	273	124	111	289	384
Discontinued operations	5	6	5	5	10	11
	170	279	129	116	299	395

18 POST-RETIREMENT BENEFITS CONTINUED

The Group operates a PaySave scheme in the UK. This is a salary sacrifice scheme under which employees elect to stop making employee contributions and the Group makes additional contributions in return for a reduction in gross contractual pay. As a result, there is a decrease in wages and salaries and a corresponding increase in pension costs of **£35 million** (2013 £37 million) in the year.

Net financing comprises:

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Financing on scheme obligations	390	64	454	371	59	430
Financing on scheme assets	(427)	(24)	(451)	(431)	(21)	(452)
Financing on unrecognised surpluses and minimum funding liability	26	–	26	48	–	48
Net financing (income)/charge in respect of defined benefit schemes	(11)	40	29	(12)	38	26
Financing income on scheme surpluses	(13)	–	(13)	(16)	(1)	(17)
Financing costs on scheme deficits	2	40	42	4	39	43

AMOUNTS RECOGNISED IN OCI IN RESPECT OF DEFINED BENEFIT SCHEMES

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Actuarial gains and losses arising from demographic assumptions	23	(17)	6	(87)	(12)	(99)
Actuarial gains and losses arising from financial assumptions	(1,099)	(228)	(1,327)	(200)	116	(84)
Actuarial gains and losses arising from experience adjustments	(343)	(17)	(360)	65	31	96
Return on scheme assets excluding financing income	2,258	55	2,313	(363)	(42)	(405)
Movement in unrecognised surplus and related finance cost	513	–	513	407	–	407
Movement in minimum funding liability and related finance cost	47	–	47	133	–	133
	1,399	(207)	1,192	(45)	93	48

AMOUNTS RECOGNISED IN THE BALANCE SHEET IN RESPECT OF DEFINED BENEFIT SCHEMES

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(10,606)	(664)	(11,270)	(9,046)	(558)	(9,604)
Fair value of scheme assets	12,341	593	12,934	9,776	504	10,280
Net asset/(liability) on funded schemes	1,735	(71)	1,664	730	(54)	676
Present value of unfunded obligations	–	(1,109)	(1,109)	–	(935)	(935)
Unrecognised surplus ¹	–	–	–	(488)	–	(488)
Minimum funding liability ²	–	–	–	(46)	–	(46)
Net asset/(liability) recognised in the balance sheet	1,735	(1,180)	555	196	(989)	(793)
Post-retirement scheme surpluses	1,735	5	1,740	242	6	248
Post-retirement scheme deficits	–	(1,185)	(1,185)	(46)	(995)	(1,041)

¹ Where a surplus has arisen on a scheme, in accordance with IAS 19 and IFRIC 14, the surplus is recognised as an asset only if it represents an unconditional economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet. During 2014, the rules of one scheme were amended, which removed the restriction on recognising the surplus.

² A minimum funding liability arises where the statutory funding requirements require future contributions in respect of past service that will result in a future unrecognisable surplus.

Overseas schemes are located in the following countries:

	2014			2013		
	Assets	Obligations	Net	Assets	Obligations	Net
Canada	160	(208)	(48)	135	(181)	(46)
Germany	–	(592)	(592)	–	(500)	(500)
US pension schemes	414	(508)	(94)	347	(420)	(73)
US healthcare schemes	–	(423)	(423)	–	(352)	(352)
Other	19	(42)	(23)	22	(40)	(18)
Net asset/(liability) recognised in the balance sheet	593	(1,773)	(1,180)	504	(1,493)	(989)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 POST-RETIREMENT BENEFITS CONTINUED

DEFINED BENEFIT SCHEMES

ASSUMPTIONS

Significant actuarial assumptions for UK schemes (weighted average by size of the obligation) used at the balance sheet date were as follows:

	2014	2013
Discount rate	3.6%	4.4%
Inflation assumption (RPI) ¹	3.2%	3.5%
Rate of increase in salaries	4.2%	4.5%
Male life expectancy from age 65 – current pensioner	22.5 years	22.5 years
– future pensioner currently aged 45	24.1 years	24.2 years

¹ The Consumer Price Index is assumed to be 1.1% lower.

Discount rates are determined by reference to the market yields on AA rated corporate bonds. The rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. In prior years, only bonds with an average AA rating by the three main agencies were included. The population of such bonds has reduced and limited the reliability of the derived yield curve, consequently this has been changed so that bonds rated AA by at least one agency are included. The impact of this change is to increase the discount rate at 31 December 2014 by approximately 0.3%.

The Inflation assumption is determined by the market implied assumption based on the yields on long-term indexed linked government securities and increases in salaries are based on actual experience, allowing for promotion, of the real increase above inflation.

The mortality assumptions adopted for the UK pension schemes are derived from the SAP actuarial tables, with future improvements in line with the CMI 2014 core projections and long-term improvements of 1.25%. Where appropriate, these are adjusted to take account of the relevant scheme's actual experience.

Other assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and the assumptions used in the most recent funding valuation. The rate of increase of pensions in payment is based on the rules of the relevant scheme, combined with the inflation assumption where the increase is capped.

Assumptions for overseas schemes are less significant and are based on advice from local actuaries. The principal assumptions are:

	2014	2013
Discount rate	3.3%	4.5%
Inflation assumption	2.2%	2.3%
Long-term healthcare cost trend rate	5.0%	3.7%
Male life expectancy from age 65: – current pensioner	21.1 years	19.6 years
– future pensioner currently aged 45	23.3 years	20.7 years

18 POST-RETIREMENT BENEFITS CONTINUED

CHANGES IN PRESENT VALUE OF DEFINED BENEFIT OBLIGATIONS

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	(9,046)	(1,493)	(10,539)	(8,569)	(1,178)	(9,747)
Exchange differences	–	(7)	(7)	–	16	16
Current service cost	(151)	(44)	(195)	(147)	(53)	(200)
Past-service cost	18	16	34	(66)	(4)	(70)
Finance cost	(390)	(63)	(453)	(371)	(59)	(430)
Contributions by employees	(4)	(5)	(9)	(4)	(4)	(8)
Benefits paid out	376	71	447	334	63	397
Acquisition of businesses	–	–	–	(1)	(402)	(403)
Disposal of businesses	10	16	26	–	–	–
Actuarial (losses)/gains	(1,419)	(266)	(1,685)	(222)	134	(88)
Settlement curtailment	–	6	6	–	–	–
Other movements	–	(4)	(4)	–	(6)	(6)
At 31 December	(10,606)	(1,773)	(12,379)	(9,046)	(1,493)	(10,539)
Funded schemes	(10,606)	(664)	(11,270)	(9,046)	(558)	(9,604)
Unfunded schemes	–	(1,109)	(1,109)	–	(935)	(935)
The defined benefit obligations are in respect of:						
Active plan participants	(4,170)	(974)	(5,144)	(3,492)	(849)	(4,341)
Deferred plan participants	(2,009)	(97)	(2,106)	(1,647)	(74)	(1,721)
Pensioners	(4,427)	(702)	(5,129)	(3,907)	(570)	(4,477)
Weighted average duration of obligations	17	16	17	16	13	16

CHANGES IN FAIR VALUE OF SCHEME ASSETS

	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	9,776	504	10,280	9,794	534	10,328
Exchange differences	–	18	18	–	(19)	(19)
Administrative expenses	(5)	(1)	(6)	(6)	(2)	(8)
Financing	427	24	451	431	21	452
Return on plan assets excluding financing	2,258	55	2,313	(363)	(42)	(405)
Contributions by employer	257	65	322	249	66	315
Contributions by employees	4	5	9	4	4	8
Benefits paid out	(376)	(71)	(447)	(334)	(63)	(397)
Acquisition of businesses	–	–	–	1	5	6
Settlements/curtailment	–	(6)	(6)	–	–	–
At 31 December	12,341	593	12,934	9,776	504	10,280
Total return on scheme assets	2,685	79	2,764	68	(21)	47

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 POST-RETIREMENT BENEFITS CONTINUED

FAIR VALUE OF SCHEME ASSETS AT 31 DECEMBER

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Sovereign debt	7,282	167	7,449	5,929	231	6,160
Derivatives on sovereign debt	(2,622)	2	(2,620)	(987)	2	(985)
Corporate debt instruments	2,053	237	2,290	1,045	190	1,235
Interest rate swaps	4,218	–	4,218	1,361	–	1,361
Inflation swaps	(360)	–	(360)	(13)	–	(13)
Cash and similar instruments	193	127	320	257	44	301
Liability driven investment (LDI) portfolios¹	10,764	533	11,297	7,592	467	8,059
Longevity swap ²	10	–	10	3	–	3
Listed equities	787	3	790	994	3	997
Unlisted equities	216	–	216	172	–	172
Sovereign debt	105	4	109	215	4	219
Corporate debt instruments	15	–	15	540	4	544
Cash	166	32	198	253	4	257
Other	278	21	299	7	22	29
At 31 December	12,341	593	12,934	9,776	504	10,280

¹ A portfolio of gilt and swap contracts, backed by LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

² Under the longevity swap, the Rolls-Royce Pension Fund (RRPF) has agreed an average life expectancy of pensioners with a counterparty. If pensioners live longer than expected the counterparty will make payments to the RRPF to offset the additional cost of paying pensioners. If the reverse applies the cost of paying pensioners will be reduced but the scheme will be required to make payments to the counterparty. The longevity swap is valued on an external fair market basis, rather than using the same assumptions as used for the valuation of the scheme's liabilities.

The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group. The longevity swap is valued by the scheme actuaries based on the difference between the agreed longevity assumptions at inception and actual longevity experience. All other fair values are provided by the fund managers. Where available, the fair values are quoted prices (eg listed equity, sovereign debt and corporate bonds). Unlisted investments (private equity) are included at values provided by the fund manager in accordance with relevant guidance. Other significant assets are valued based on observable inputs such as yield curves.

MOVEMENTS IN UNRECOGNISED SURPLUS AND MINIMUM FUNDING LIABILITY

	2014			2013		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	(534)	–	(534)	(1,026)	–	(1,026)
Movements in unrecognised surplus through OCI	513	–	513	407	–	407
Movements in minimum funding liability through OCI	47	–	47	133	–	133
Related finance costs	(26)	–	(26)	(48)	–	(48)
At 31 December	–	–	–	(534)	–	(534)

FUTURE CONTRIBUTIONS

The Group expects to contribute approximately £250 million to its defined benefit schemes in 2015.

In the UK, the funding is set on the basis of a triennial funding valuation by the actuaries for which the assumptions may differ from those above. In particular, the discount rate used to value the obligations takes account of the investment strategy, rather than being based on market yields of AA corporate bonds. As a result of these valuations, the Group and the scheme trustees agree a Schedule of Contributions (SoC), which sets out the required contributions from the employer and employees for current service. Where the scheme is in deficit, the SoC also includes required contributions from the employer to eliminate the deficit. The most recent agreed triennial valuations for the principal schemes are:

	Obligations at 31 December 2014	Valuation date
Rolls-Royce Pension Fund	7,330	31 March 2012
Rolls-Royce Group Pension Scheme	1,779	5 April 2013
Vickers Group Pension Scheme	696	31 March 2013

18 POST-RETIREMENT BENEFITS CONTINUED

SENSITIVITIES

The calculations of the defined benefit obligations are sensitive to the assumptions set out above. The following table summarises how the estimated impact of a change in a significant assumption would affect the UK defined benefit obligation at 31 December 2014, while holding all other assumptions constant. This sensitivity analysis may not be representative of the actual change in the defined benefit obligation as it is unlikely that the change in assumptions would occur in isolation of one another as some of the assumptions may be correlated.

For the most significant funded schemes, the investment strategies are designed to hedge the risks from interest rates, inflation on an economic basis and in the Rolls-Royce Pension Fund in the UK, the longevity of pensioners. Where appropriate, the table also includes the corresponding movement in the value of the plan assets.

		£m
Reduction in the discount rate of 0.25% ¹	Obligation	(473)
	Plan assets (LDI portfolio)	591
Increase in inflation of 0.25%	Obligation	(241)
	Plan assets (LDI portfolio)	209
Increase in real increase in salaries of 0.25%	Obligations	(95)
One year increase in life expectancy	Obligations	(250)

¹ The difference between the sensitivities on obligations and plan assets arises largely due to differences in the methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is approximately 96%.

19 SHARE CAPITAL

	Equity	
	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid		
At 1 January 2013 and 31 December 2014	1,631	326

The rights attaching to ordinary shares are described on page 48.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

20 SHARE-BASED PAYMENTS

EFFECT OF SHARE-BASED PAYMENT TRANSACTIONS ON THE GROUP'S RESULTS AND FINANCIAL POSITION

	2014 £m	2013 £m
Total charge recognised for equity-settled share-based payments transactions	26	61
Total (credit)/charge recognised for cash-settled share-based payments transactions	(5)	18
Share-based payments recognised in the consolidated income statement	21	79
Liability for cash-settled share-based payment transactions	13	19

MOVEMENTS IN THE GROUP'S SHARE-BASED PAYMENT PLANS DURING THE YEAR

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2013	26.8	447	0.1	77	14.0	4.0
Granted	10.0	961	–	–	2.8	1.6
Additional entitlements arising from TSR performance	–	–	–	–	0.6	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(0.6)	483	–	–	(0.6)	(0.1)
Exercised	(10.2)	404	(0.1)	77	(4.8)	(2.5)
Outstanding at 1 January 2014	26.0	660	–	–	12.0	3.1
Granted	–	–	–	–	2.9	1.1
Additional entitlements arising from TSR performance	–	–	–	–	0.5	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(1.0)	775	–	–	(1.2)	(0.2)
Exercised	(0.5)	487	–	–	(4.4)	(1.7)
Outstanding at 31 December 2014	24.5	660	–	–	9.8	2.4
Exercisable at 31 December 2014	–	–	–	–	–	–
Exercisable at 31 December 2013	–	–	–	–	–	–

As share options are exercised throughout the year, the weighted average share price during the year of **1013p** (2013 1123p) is representative of the weighted average share price at the date of exercise. The closing price at 31 December 2014 was **870p** (2013 1275p).

FAIR VALUES OF SHARE-BASED PAYMENT PLANS

The weighted average fair value per share of equity-settled share-based payment plans granted during the year, estimated at the date of grant, are as follows:

	2014	2013
PSP – 25% TSR uplift	1105p	1128p
PSP – 50% TSR uplift	1227p	1254p
ShareSave – 3 year grant	n/a	287p
ShareSave – 5 year grant	n/a	349p
APRA	984p	1027p

PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value of the award relative to the share price at the date of grant.

SHARESAVE

The fair value of the options granted under the ShareSave plan is calculated using a binomial pricing model that assumes that participants will exercise their options at the beginning of the six-month window if the share price is greater than the exercise price. Otherwise it assumes that options are held until the expiration of their contractual term. This results in an expected life that falls somewhere between the start and end of the exercise window.

APRA

The fair value of shares awarded under APRA is calculated as the share price on the date of the award, excluding expected dividends (or equivalent).

21 LEASES

OPERATING LEASES

LEASES AS LESSEE

	2014 £m	2013 £m
Rentals paid – hire of plant and machinery	123	134
– hire of other assets	75	55
Non-cancellable operating lease rentals are payable as follows:		
Within one year	182	179
Between one and five years	542	545
After five years	438	507
	1,162	1,231

LEASES AS LESSOR

	2014 £m	2013 £m
Rentals received – credited within revenue from aftermarket services	15	56
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	16	19
Between one and five years	30	48
After five years	13	23
	59	90

The Group acts as lessee and lessor for both land and buildings and gas turbine engines, and acts as lessee for some plant and equipment.

- Sublease payments of **£1 million** (2013 £1 million) and sublease receipts of **£12 million** (2013 £27 million) were recognised in the income statement in the year.
- Purchase options exist on aero engines, land and buildings and plant and equipment with the period to the purchase option date varying between one to eight years.
- Renewal options exist on aero engines, land and buildings and plant and equipment with the period to the renewal option varying between one to 42 years at terms to be negotiated upon renewal.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total future minimum sublease payments expected to be made is **£6 million** (2013 £8 million) and sublease receipts expected to be received is **£31 million** (2013 £42 million).

FINANCE LEASES

LEASES AS LESSEE

Finance lease liabilities are payable as follows:

	2014			2013		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Within one year	3	2	1	—	—	—
Between one and five years	13	7	6	1	—	1
After five years	47	9	38	—	—	—
	63	18	45	1	—	1

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

22 CONTINGENT LIABILITIES

Contingent liabilities in respect of customer financing commitments are described in note 17.

On 6 December 2012, the Company announced that it had passed information to the Serious Fraud Office (SFO), following a request from the SFO for information about allegations of malpractice in overseas markets. On 23 December 2013, the Company announced that it had been informed by the SFO that it had commenced a formal investigation. Since the initial announcement, the Company has continued its investigations and is engaging with the SFO and other authorities in the UK, the USA and elsewhere in relation to the matters of concern.

The consequence of these disclosures will be decided by the regulatory authorities. It is too early to predict the outcomes, but these could include the prosecution of individuals and of the Group. Accordingly, the potential for fines, penalties or other consequences cannot currently be assessed. As the investigation is ongoing, it is not yet possible to identify the timescale in which these issues might be resolved.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Group has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Group is no longer fully insured against known and potential claims from employees who worked for certain of the Group's UK based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group.

The Group's share of equity accounted entities' contingent liabilities is **£11 million** (2013 £13 million).

23 RELATED PARTY TRANSACTIONS

	2014 £m	2013 £m
Sales of goods and services to joint ventures and associates	2,138	3,149
Purchases of goods and services from joint ventures and associates	(2,544)	(3,269)
Operating lease payments to joint ventures and associates	(81)	(69)
Guarantees of joint ventures' and associates' borrowings	9	7
Dividends received from joint ventures and associates	73	99
RRSA receipts from joint ventures and associates	2	4
Other income received from joint ventures and associates	2	1

The aggregated balances with joint ventures are shown in notes 12 and 15. Transactions with Group pension schemes are shown in note 18.

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.

Key management personnel are deemed to be the directors and the members of the ELT as set out in the Annual report of Rolls-Royce Holdings plc. Remuneration for key management personnel is shown below:

	2014 £m	2013 £m
Salaries and short-term benefits	9	11
Post-retirement schemes	1	1
Share-based payments	4	7
	14	19

24 ACQUISITIONS AND DISPOSALS

ACQUISITIONS

On 5 March 2014, the Group acquired the 50% of Gate Leasing Limited that it did not already own for \$5 million. The principal assets and liabilities acquired were aircraft engines (£37 million) and borrowings (£30 million).

DISPOSALS

On 1 December 2014, the Group sold its Energy business for £785 million which included a contribution to the costs of separating the Energy business from the Group's continuing activities, most significantly the creation of a stand-alone IT system. In addition, Rolls-Royce has received a further £200 million for a 25 year licensing agreement¹ granting Siemens access to relevant Rolls-Royce aero-derivative technology for use in the 4 to 85 megawatt power output gas turbine range. The Energy business disposal gave rise to a cash inflow of £1,027 million. In accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*, the disposal of the Energy business has been accounted for as a discontinued operation.

In addition, on 1 October 2014, the Group sold its interest in MTU Australia Pty. Limited for £24 million. The principal activity of this company was to hold the Group's joint venture interest in MTU Detroit Diesel Australia Pty. Limited.

	Energy (discontinued operation) £m	MTU Australia £m
PROCEEDS		
Cash consideration	985	24
Adjustments and future obligations to the purchaser	(28)	—
Total consideration before deferrals	957	24
Receipt of licensing agreement proceeds deferred as at 1 December 2014 ¹	(58)	—
Total consideration after deferrals	899	24
ASSETS AND LIABILITIES DISPOSED		
Intangible assets	106	—
Property, plant and equipment	187	—
Investment in joint venture	56	14
Inventory	320	—
Deposits (payments received on account)	(11)	—
Trade and other receivables	337	—
Cash and cash equivalents	4	—
Trade and other payables	(253)	—
Provisions for liabilities and charges	(34)	—
Net assets disposed	712	14
PROFIT ON DISPOSAL		
Profit on disposal before disposal costs and continuing obligations	187	10
Cumulative currency translation gain/(loss)	32	(3)
Disposal costs and ongoing obligations ²	(98)	(1)
Post-retirement scheme net credit ³	15	—
Profit on disposal of business before tax	136	6
Tax on disposal	2	—
Profit on disposal of business after tax	138	6

RECONCILIATION TO CASH FLOW STATEMENT

Total consideration after deferrals	899	24
Adjustments, future obligations and receipts of licensing agreement proceeds deferred at 1 December 2014 ⁴	158	—
Cash and cash equivalents disposed	(4)	—
Disposal costs paid in the year	(26)	—
Cash inflow per cash flow statement	1,027	24

¹ The £200m licensing agreement contained £142m to provide intellectual property which has been recognised in the period, whilst £58m relating to the provision of engineering services and supply of parts has been deferred up to 25 years.

² Disposal costs of £98 million (incurred and accrued) include costs to separate the Energy business including items such as IT, legal and transactional fees.

³ Profit on the sale of business includes pension and other post-retirement benefit plan curtailment gains of £26million (note 18) and an accrual to settle a pension deficit that is expected to transfer to Siemens during 2015.

⁴ £58m of costs relating to future obligations to Siemens not yet incurred have been accrued and £58m relating to the licensing agreement have been deferred. In addition, the Energy disposal is subject to customary post-closing adjustments that are estimated to be £42m, which may include adjustments to working capital. Such adjustments may result in the final amounts received from the purchaser differing from the disposal proceeds above.

COMPANY BALANCE SHEET

AT 31 DECEMBER 2014

	Notes	2014 £m	2013 £m
Fixed assets			
Intangible assets	3	951	872
Tangible assets	4	1,348	1,270
Investments – subsidiary undertakings	5	1,724	1,749
– joint ventures	5	72	70
		4,095	3,961
Current assets			
Stocks	6	1,237	1,237
Debtors – amounts falling due within one year	7	6,141	3,447
– amounts falling due after one year	7	676	475
Other financial assets – amounts falling due within one year	8	103	83
– amounts falling due after one year	8	137	687
Short-term deposits		1,279	1,973
Cash at bank and in hand		662	1,237
Assets held for resale		–	2
		10,235	9,141
Creditors – amounts falling due within one year			
Borrowings	9	(1,100)	(805)
Other financial liabilities	8	(218)	(142)
Other creditors	10	(7,570)	(6,940)
		(8,888)	(7,887)
Net current assets		1,347	1,254
Total assets less current liabilities		5,442	5,215
Creditors – amounts falling due after one year			
Borrowings	9	(1,957)	(1,951)
Other financial liabilities	8	(753)	(403)
Other creditors	10	(1,399)	(1,130)
		(4,109)	(3,484)
Provisions for liabilities and charges	11	(174)	(140)
Net assets excluding post-retirement schemes		1,159	1,591
Post retirement schemes – surpluses	13	1,039	332
Net assets		2,198	1,923
Capital and reserves			
Called-up share capital	14	326	326
Share premium account	15	631	631
Revaluation reserve	15	21	26
Other reserves	15	167	167
Profit and loss account	15	1,053	773
Total shareholders' funds		2,198	1,923

The financial statements on pages 106 to 122 were approved by the Board on 12 February 2015 and signed on its behalf by:

John Rishton Chief Executive

David Smith Chief Financial Officer

Company's registered number 1003142

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

FOR THE YEAR ENDED 31 DECEMBER 2014

	2014 £m	2013 £m
(Loss)/profit attributable to the shareholders of Rolls-Royce plc	(347)	448
Net movement on post-retirement schemes	759	(561)
Related tax movements	(152)	149
Total recognised gains relating to the year	260	36

RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

FOR THE YEAR ENDED 31 DECEMBER 2014

	2014 £m	2013 £m
At 1 January	1,923	2,758
Total recognised gains for the year	260	36
Dividends paid	—	(900)
Share-based payments – direct to equity	15	29
At 31 December	2,198	1,923

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES

Basis of accounting

The financial statements have been prepared in accordance with applicable accounting standards on the historical cost basis, modified to include the revaluation of land and buildings, and on a going concern basis as described on page 50.

As permitted by the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements.

As permitted by FRS 1 *Cash Flow Statements*, no cash flow statement has been prepared, as a consolidated cash flow statement has been prepared by the ultimate parent company.

Revenue recognition

Revenue comprises sales to external customers after discounts, and excluding value added tax.

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured.

Sales of services and long-term contracts are recognised when the outcome of the transaction can be reliably estimated. Revenue is recognised by reference to the stage of completion based on services performed to date as a percentage of the total contractual obligation. The assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on: costs incurred to the extent these relate to services performed up to the reporting date; achievement of contractual milestones where appropriate; or flying hours or equivalent for long-term aftermarket arrangements.

Linked sales of product and services are treated as a single long-term contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single project with an overall profit margin. Revenue is recognised on the same basis as for other sales of products and services as described above.

Full provision is made for any estimated losses to completion of contracts having regard to the overall substance of the arrangements.

Progress payments received on long-term contracts, when greater than recorded turnover, are deducted from the value of work in progress except to the extent that payments on account exceed the value of work in progress on any contract where the excess is included in creditors. The amount by which recorded turnover of long-term contracts is in excess of payments on account is classified as 'amounts recoverable on contracts' and is separately disclosed within debtors.

Risk and revenue sharing arrangements (RRSAs)

The Company enters into arrangements with certain workshare partners under which these suppliers: (i) contribute to the forecast costs of developing an engine; and (ii) supply components for the production phase for which they receive consideration, which is an agreed proportion of the total programme revenues. Both the suppliers' contributions to the forecast costs and their consideration are determined by reference to their proportionate scopes of supply relative to that of the engine overall. Once the forecast costs and the scopes of supply have been agreed, each party is then accountable for its own incurred costs. The suppliers' contributions to the costs of developing the engine include: (i) development work; and/or (ii) development components supplied; and/or (iii) non-refundable cash payments. No accounting entries are recorded where the suppliers undertake development work or where development components are supplied. Cash sums received are recognised in the profit and loss account to match the expensing of the Group's related costs - where the cash sums are received in advance of the related costs being expensed or where the related costs are capitalised as intangible assets, the recognition of the cash received is deferred to match the recognition of the related expense or the amortisation of the related intangible asset respectively. The payments to suppliers of their shares of the programme revenues for their production components are charged to the profit and loss account as programme revenues arise.

The Company has arrangements with partners who do not undertake development work or supply parts. Such arrangements are considered to be financial instruments as defined by FRS 25 *Financial Instruments: Presentation* and are accounted for using the amortised cost method.

Government investment

Where a government or similar body has previously invested in a development programme, the Company treats payments to that body as royalty payments, which are matched to related sales.

Research and development

The charge to the profit and loss account consists of research and development expenditure incurred in the year, excluding known recoverable costs on contracts, contributions to shared engineering programmes and application engineering. Application engineering expenditure, incurred in the adaptation of existing technology to new products, is capitalised and amortised over the programme life, up to a maximum of 15 years, where both the technical and commercial risks are considered to be sufficiently low.

Interest

Interest receivable/payable is credited/charged to the profit and loss account using the effective interest method.

1 ACCOUNTING POLICIES CONTINUED

Taxation

Provision for taxation is made at the current rate and for deferred taxation at the projected rate on all timing differences that have originated, but not reversed at the balance sheet date. Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled.

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.

Foreign currency translation

Transactions in overseas currencies are translated into local currency at the exchange rate ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rate ruling at the year-end. Exchange differences arising on foreign exchange transactions and the retranslation of assets and liabilities into sterling at the rate ruling at the year-end are taken into account in determining profit on ordinary activities before taxation.

Financial instruments

FRS 26 *Financial instruments: recognition and Measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different. Rolls-Royce has classified its financial instruments as follows:

- Short-term investments are generally classified as **available for sale**.
- Short-term deposits (principally comprising funds held with banks and other financial institutions), trade receivables and short-term investments not designated as available for sale are classified as **loans and receivables**.
- Borrowings, trade creditors and financial RRSAs are classified as **other liabilities**.
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as **held for trading**.

Financial instruments are recognised at the contract date and initially measured at fair value. Their subsequent measurement depends on their classification:

- **Available for sale** assets are held at fair value. Changes in fair value arising from changes in exchange rates are included in the profit and loss account. All other changes in fair value are taken to reserves. On disposal, the accumulated changes in value recorded in reserves are included in the gain or loss recorded in the profit and loss account.
- **Loans and receivables** and **other liabilities** are held at amortised cost and not revalued (except for changes in exchange rates, which are included in the profit and loss account) unless they are included in a fair value hedge accounting relationship. Where such a relationship exists, the instruments are revalued in respect of the risk being hedged. If instruments held at amortised cost are hedged, generally by interest rate swaps, and the hedges are effective, the carrying values are adjusted for changes in fair value, which are included in the profit and loss account.
- **Held for trading** instruments are held at fair value. Changes in fair value are included in the profit and loss account unless the instrument is included in a cash flow hedge. If the instruments are included in a cash flow hedging relationship, which is effective, changes in value are taken to reserves. When the hedged forecast transaction occurs, amounts previously recorded in reserves are recognised in the profit and loss account.

Financial instruments are derecognised on expiry or when all contractual rights and obligations are transferred.

Hedge accounting

The Company does not apply hedge accounting in respect of forward foreign exchange contracts held to manage the cash flow exposures of forecast future transactions denominated in foreign currencies.

The Company does not apply hedge accounting in respect of commodity swaps held to manage the cash flow exposures of forecast future transactions in those commodities.

The Company applies hedge accounting in respect of transactions entered into to manage the fair value and cash flow exposures of its borrowings. Forward foreign exchange contracts are held to manage the fair value exposures of borrowings denominated in foreign currencies and are designated as fair value hedges. Interest rate swaps are held to manage the interest rate exposures and are designated as fair value or cash flow hedges of fixed and floating rate borrowings respectively.

Changes in the fair values of derivatives designated as fair value hedges and changes in fair value of the related hedged item are recognised directly in the profit and loss account.

Changes in the fair values of derivatives that are designated as cash flow hedges and are effective are recognised directly in reserves. Any ineffectiveness in the hedging relationships is included in the profit and loss account. The amounts deferred in reserves are recognised in the profit and loss account to match the recognition of the hedged item.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or 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 reserves, is retained in reserves until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss previously recognised in reserves is transferred to the profit and loss account.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES CONTINUED

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in reserves. The ineffective portion is recognised immediately in the profit and loss account.

Certification costs and participation fees

Costs incurred in respect of meeting regulatory certification requirements for new civil engine/aircraft combinations and payments made to airframe manufacturers for this, and participation fees, are carried forward in intangible assets to the extent that they can be recovered out of future sales and are charged to the profit and loss account over the programme life, up to a maximum of 15 years from the entry-into-service of the product.

Software

The cost of acquiring software that is not specific to an item of tangible fixed assets is classified as an intangible asset.

Tangible fixed assets and depreciation

Tangible fixed assets are stated at cost or valuation less accumulated depreciation and any provision for impairments in value.

Depreciation is provided on a straight-line basis to write-off the cost or valuation, less the estimated residual value, over the estimated useful life. Estimated useful lives are as follows:

- i) Land and buildings, as advised by the Group's professional valuers:
 - a) Freehold buildings – five to 45 years (average 26 years).
 - b) Leasehold land and buildings – lower of valuers' estimates or period of lease.
 - c) No depreciation is provided in respect of freehold land.
- ii) Plant and equipment – five to 25 years (average 13 years).
- iii) Aircraft and engines – five to 20 years (average 10 years).
- iv) No depreciation is provided on assets in the course of construction.

Impairment of fixed assets

Impairment of fixed assets is considered in accordance with FRS 11 *Impairment of Fixed Assets and Goodwill*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the income-generating unit to which the asset belongs.

Intangible assets not yet available for use are tested for impairment annually. Other fixed assets 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.

Recoverable amount is the higher of value in use or fair value less costs to sell – if this is readily available. The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset.

If the recoverable amount of an asset (or income-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense.

Operating leases

Payments made and rentals received under operating lease arrangements are charged/credited to the income statement on a straight-line basis.

Stock

Stock and work in progress are valued at the lower of cost and net realisable value on a first-in, first-out basis. Cost comprises direct materials and, where applicable, direct labour costs and those overheads, including depreciation of property, plant and equipment, that have been incurred in bringing the inventories to their present location and condition. Net realisable value represents the estimated selling prices less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

Provisions

Provisions are recognised when the Company has a present obligation as a result of a past event, and it is probable that the Company will be required to settle that obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

Post-retirement benefits

Pensions and similar benefits are accounted for under FRS 17 *Post-retirement Benefits*. For defined benefit plans, obligations are measured at discounted present value whilst plan assets are recorded at fair value. The service and financing costs of such plans are recognised separately in the profit and loss account; service costs are spread systematically over the lives of employees and financing costs are recognised in the periods in which they arise. Actuarial gains and losses are recognised immediately in the statement of total recognised gains and losses. Surplus in schemes are recognised as assets only if they represent economic benefits that are available to the Company in the future.

Payments to defined contribution schemes are charged as an expense as they fall due.

1 ACCOUNTING POLICIES CONTINUED

Share-based payments

The Company participates in Rolls-Royce Holdings plc employee share-based payment arrangements. These are 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, based on the Company's estimate of shares or options that will eventually vest. The costs of these share-based payments are treated as a capital contribution from the parent company. Any payments made by the Company to its parent company, in respect of these arrangements, are treated as a return of this capital contribution.

The fair values of the share-based payment arrangements are measured as follows:

- i) ShareSave – using the binomial pricing method;
- ii) Performance Share Plan – using a pricing model adjusted to reflect non-entitlement to dividends (or equivalent) and the Total Shareholder Return market based condition;
- iii) Annual performance Related Award plan and free shares under the Share Incentive plan – share price on the date of the award.

See note 17 for further description of the share-based payment plans.

2 EMOLUMENTS OF DIRECTORS

	2014		2013	
	Highest paid director £000	Other directors £000	Highest paid director £000	Other directors £000
Aggregate emoluments excluding deferred share plans	1,337	3,340	1,793	3,959
Aggregate amounts relating to deferred share plans	2,512	2,714	330	3,406
Aggregate value of Company contributions to Company defined contribution pensions schemes	42	349	50	395
Accrued pension of highest paid director	–	n/a	–	n/a
Gains realised on exercise of share options ¹	–	n/a	–	6

	2014 Number	2013 Number
Number of directors with accruing retirement benefits:		
Defined contribution schemes	2	2
Defined benefit schemes ²	1	3
Number of directors exercising share options	–	1
Number of directors receiving shares as part of long-term incentives schemes	4	4

¹ Includes gains under the ShareSave plan.

² Directors were contributing members of both defined contribution and defined benefit schemes (2013 one director).

3 INTANGIBLE ASSETS

	Certification costs and participation fees £m	Software and other £m	Total £m
Cost:			
At 1 January 2014	839	490	1,329
Additions	107	67	174
At 31 December 2014	946	557	1,503
Accumulated amortisation:			
At 1 January 2014	257	200	457
Charge for the year	40	55	95
At 31 December 2014	297	255	552
Net book value:			
At 31 December 2014	649	302	951
At 1 January 2014	582	290	872

NOTES TO THE COMPANY FINANCIAL STATEMENTS

4 TANGIBLE ASSETS

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost or valuation:					
At 1 January 2014	486	1,668	57	302	2,513
Reclassifications	71	50	7	(128)	–
Additions	8	64	24	163	259
Transferred from 'Assets held for resale'	–	–	(5)	–	(5)
Disposals	(6)	(29)	(13)	–	(48)
At 31 December 2014	559	1,753	70	337	2,719
Accumulated depreciation:					
At 1 January 2014	179	1,039	25	–	1,243
Reclassifications	–	(6)	6	–	–
Charge for the year	18	137	7	–	162
Transferred from 'Assets held for resale'	–	–	(3)	–	(3)
Disposals	(4)	(25)	(2)	–	(31)
At 31 December 2014	193	1,145	33	–	1,371
Net book value:					
At 31 December 2014	366	608	37	337	1,348
At 1 January 2014	307	629	32	302	1,270
Tangible fixed assets include:					2014 £m
Net book value of finance leased assets					2013 £m
Non-depreciable land					9
Land and buildings at cost or valuation comprise:					10
Cost					68
Valuation at 31 December 1996					68
					397
					327
					162
					159
					559
					486
On an historical cost basis the net book value of land and buildings would have been as follows:					
Cost					533
Depreciation					456
					(189)
					(175)
					344
					281
Capital expenditure commitments					71
					145

5 INVESTMENTS

	Subsidiary undertakings ¹	Joint ventures ¹		Total £m
	Shares at cost ² £m	Shares at cost £m	Loans £m	
At 1 January 2014	1,749	36	34	70
Additions	3	5	2	7
Business disposal	–	(5)	–	(5)
Impairment	(28)	–	–	–
At 31 December 2014	1,724	36	36	72

¹ The principal subsidiary and joint venture undertakings are listed on pages 123 and 124.

² The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited, one of its subsidiaries. At 31 December 2014, this guarantee was £25m (2013 £25m).

6 STOCKS

	2014 £m	2013 £m
Raw materials	58	75
Work in progress	378	389
Finished goods	793	764
Payments on account	8	9
	1,237	1,237

7 DEBTORS

	Falling due within one year		Falling due after one year	
	2014 £m	2013 £m	2014 £m	2013 £m
Trade debtors	379	300	–	–
Amounts recoverable on contracts	12	8	182	182
Amounts owed by – subsidiary undertakings	3,646	1,565	–	–
– joint ventures	293	335	–	–
– parent undertaking	1,311	845	–	–
Deferred tax assets (note 12)	–	–	442	215
Other debtors	431	328	2	–
Prepayments and accrued income	69	66	50	78
	6,141	3,447	676	475

8 OTHER FINANCIAL ASSETS AND LIABILITIES

Details of the Company's policies on the use of financial instruments are given in the accounting policies on pages 108 to 111.

The fair values of other financial instruments held by the Company are as follows:

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Derivative financial instruments £m	Financial RRSAs £m	Total £m
At 31 December 2014						
Assets – amounts falling due within one year	103	–	–	103	–	103
– amounts falling due after one year	59	–	78	137	–	137
Liabilities – amounts falling due within one year	(156)	(20)	–	(176)	(42)	(218)
– amounts falling due after one year	(545)	(23)	(27)	(595)	(158)	(753)
	(539)	(43)	51	(531)	(200)	(731)
At 31 December 2013						
Assets – amounts falling due within one year	81	2	–	83	–	83
– amounts falling due after one year	644	–	43	687	–	687
Liabilities – amounts falling due within one year	(85)	(16)	(1)	(102)	(40)	(142)
– amounts falling due after one year	(143)	(25)	(48)	(216)	(187)	(403)
	497	(39)	(6)	452	(227)	225

DERIVATIVE FINANCIAL INSTRUMENTS

The Company uses various financial instruments to manage its exposure to movements in foreign exchange rates. The Company uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals). To hedge the currency risk associated with a borrowing denominated in US dollars, the Company has currency derivatives designated as part of a fair value hedge. The Company uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates. Where the effectiveness of the hedge relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the hedging reserve and released to match actual payments on the hedged item.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

8 OTHER FINANCIAL ASSETS AND LIABILITIES CONTINUED

Movements in the fair values of derivative financial instruments were as follows:

	Foreign exchange instruments £m	Commodity instruments £m	Interest rate instruments £m	Total £m
At 1 January 2013	248	(13)	88	323
Movements in fair value hedges ¹	3	–	(91)	(88)
Movements in other derivative contracts	278	(35)	–	243
Contracts settled	(32)	9	(3)	(26)
At 1 January 2014	497	(39)	(6)	452
Movements in fair value hedges ¹	3	–	57	60
Movements in other derivative contracts	(888)	(15)	–	(903)
Contracts settled	(151)	11	–	(140)
At 31 December 2014	(539)	(43)	51	(531)

¹ Gain on related hedged items £60m (2013 £88m).

Where applicable, market values have been used to determine fair values. Where market values are not available, fair values have been calculated by discounting expected future cash flows at prevailing interest rates and translating at prevailing exchange rates.

FINANCIAL RISK AND REVENUE SHARING ARRANGEMENTS (RRSAs)

The Company 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.

The amortised cost values of financial RRSAs were as follows:

	2014 £m	2013 £m
At 1 January	(227)	(226)
Cash paid to partners	41	50
Financing charge	(12)	(16)
Exchange adjustments	(8)	(35)
Changes in forecast payments	6	–
At 31 December	(200)	(227)

9 BORROWINGS

	Falling due within one year		Falling due after one year	
	2014 £m	2013 £m	2014 £m	2013 £m
Unsecured				
Overdrafts	1,045	605	–	–
Bank loans	–	200	200	200
7.375% Notes 2016 £200m	–	–	200	200
6.55% Notes 2015 US\$83m ¹	55	–	–	55
6.75% Notes 2019 £500m ²	–	–	547	535
2.125% Notes 2021 €750m ¹	–	–	615	611
3.375% Notes 2026 £375m ²	–	–	395	350
	1,100	805	1,957	1,951
Repayable – otherwise than by instalments				
Between one and two years			200	55
Between two and five years			747	200
After five years			1,010	1,696
			1,957	1,951

¹ These notes are the subject of interest rate swap agreements under which the Company has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge.

² These notes are the subject of interest rate swap agreements under which the Company has undertaken to pay floating rates of interest which form a fair value hedge.

10 OTHER CREDITORS

	Falling due within one year		Falling due after one year	
	2014 £m	2013 £m	2014 £m	2013 £m
Payments received on account ¹	386	444	778	651
Trade creditors	622	555	–	14
Amounts owed to – subsidiary undertakings	4,053	3,458	–	–
– joint ventures	230	182	4	1
Corporate taxation	82	84	–	–
Other taxation and social security	35	33	–	–
Other creditors	1,133	1,181	207	84
Accruals and deferred income	1,029	1,003	410	380
	7,570	6,940	1,399	1,130
¹ Includes payments received from joint ventures	73	65	99	151

11 PROVISIONS FOR LIABILITIES AND CHARGES

	At 31 December 2013 £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At 31 December 2014 £m
Warranties and guarantees	28	–	1	(1)	28
Contract loss	17	(4)	(2)	–	11
Customer financing	71	(34)	15	(7)	45
Restructuring	24	–	67	(25)	66
Other	–	–	24	–	24
	140	(38)	105	(33)	174

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.

Provisions for contract loss and restructuring are generally expected to be utilised within two years.

Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 18. Timing of utilisation is uncertain.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

12 DEFERRED TAXATION

	£m
At 1 January 2014	132
Amount credited to profit and loss account	202
Amount charged to statement of total recognised gains and losses	(152)
At 31 December 2014	182

There are other deferred tax assets totalling £162m (2013 £102m) that have not been recognised on the basis that their future economic benefit is uncertain.

The UK corporation tax rate reduced to 21% from 1 April 2014 and will reduce further to 20% from 1 April 2015. These reductions were substantively enacted on 2 July 2013. As the reduction to 20% was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been calculated at this rate.

The amount of deferred tax asset recognised relating to advance corporation tax has reduced during the year due to a decrease in the net deferred tax liabilities against which the asset can be offset. The main reasons for this are the unrealised fair value change on derivative contracts.

The analysis of the deferred tax position is as follows:

	2014 £m	2013 £m
Fixed asset timing differences	(72)	(84)
Other timing differences	(8)	17
Pensions and other post-retirement scheme benefits	(260)	(83)
Foreign exchange and commodity financial assets and liabilities	135	(92)
Losses	373	307
Advance corporation tax	–	61
Research and development expenditure credit withholding tax	14	6
	182	132
Included within:		
Debtors – amounts falling due after one year	442	215
Post-retirement scheme – surpluses	(260)	(83)
– deficits	–	–
	182	132

The above figures exclude taxation payable on capital gains which might arise from the sale of fixed assets at the values at which they are stated in the Company's balance sheet.

13 POST-RETIREMENT BENEFITS

DEFINED BENEFIT SCHEMES

For the defined benefit schemes the assets are held in separate trustee administered funds and employees are entitled to retirement benefits based on either their final or career average salaries and length of service.

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to 31 December 2014. The most recent funding valuations of the main schemes were:

Scheme	Valuation date
Rolls-Royce Pension Fund	31 March 2012
Rolls-Royce Group Pension Scheme	5 April 2013
Vickers Group Pension Scheme	31 March 2013

The principal actuarial assumptions used at the balance sheet date were as follows:

	2014 %	2013 %
Rate of increase in salaries	4.2	4.5
Discount rate	3.6	4.4
Expected rate of return on scheme assets	2.8	4.0
Inflation assumption ¹	3.2	3.5

¹ For the UK schemes, this is the assumptions for the Retail Price Index. The Consumer Price Index is assumed to be 1.1% lower.

The discount rates are determined by reference to the market yields on AA rated corporate bonds. For the main schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. For less significant schemes the rate is determined as the market yield at the average duration of the forecast benefit payments. The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities.

The overall expected rate of return is calculated by weighting the individual returns expected from each asset class (see below) in accordance with the actual asset balance in the schemes' investment portfolios.

The mortality assumptions adopted for the pension schemes are derived from the SAPS actuarial tables, with future improvements in line with the CMI 2014 core projections and long-term improvements of 1.25%. Where appropriate, these are adjusted to take account of the relevant scheme's actual experience. The resulting range of life expectancies in the principal schemes are as follows:

MALE LIFE EXPECTANCY FROM AGE 65

	2014	2013
Current pensioner	22.5 years	22.5 years
Future pensioner currently aged 45	24.1 years	24.2 years

Other demographic assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and other relevant data. The assumptions are reviewed and updated as necessary as part of the periodic actuarial valuation of the schemes.

AMOUNTS RECOGNISED IN THE BALANCE SHEET

	2014 £m	2013 £m
Present value of funded obligations	(10,506)	(8,970)
Fair value of scheme assets	12,038	9,539
Unrecognised surplus ¹	(233)	(154)
Surplus	1,299	415
Related deferred tax liability	(260)	(83)
Net asset recognised in the balance sheet	1,039	332
Analysed as:		
Post-retirement scheme surpluses	1,039	332
Post-retirement scheme deficits	—	—

¹ Where a surplus has arisen on a scheme, in accordance with FRS 17 *Retirement benefits*, the surplus is recognised as an asset only if it represents a future economic benefit available to the Company. Any surplus in excess of this benefit is not recognised in the balance sheet. Surpluses have arisen largely as a result of differences between the actuarial and FRS 17 valuation assumptions.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

13 POST-RETIREMENT BENEFITS CONTINUED

CHANGES IN PRESENT VALUE OF DEFINED BENEFIT OBLIGATIONS

	2014 £m	2013 £m
At 1 January	(8,970)	(8,533)
Current service cost	(141)	(138)
Past-service cost	18	(66)
Finance cost	(388)	(370)
Contributions by employees	(3)	(3)
Benefits paid out	375	334
Actuarial losses	(1,407)	(194)
Disposal of business	10	—
At 31 December	(10,506)	(8,970)

CHANGES IN FAIR VALUE OF SCHEME ASSETS

	2014 £m	2013 £m
At 1 January	9,539	9,734
Expected return on assets	379	301
Contributions by employer	247	235
Contributions by employees	3	3
Benefits paid out	(375)	(334)
Actuarial gains	2,245	(400)
At 31 December	12,038	9,539
Actual return on plan assets	2,624	(99)

The fair value of the scheme assets and the expected rates of return at 31 December were as follows:

	2014		2013	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
LDI portfolio ¹	2.5	10,763	3.6	7,592
Longevity swap ²	3.6	(184)	4.4	(156)
Equities	5.7	983	6.9	1,151
Sovereign debt	2.4	41	3.6	169
Corporate bonds	—	—	4.1	527
Other	2.2	435	3.6	256
	2.8	12,038	4.0	9,539

¹ A portfolio of gilt and swap contracts, backed by LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

² Under the longevity swap the scheme has agreed an average life expectancy with a counterparty. If pensioners live longer than expected the counterparty will make payments to the scheme to offset the additional cost of paying pensions. If the reverse applies the cost of paying pensions will be reduced but the scheme will be required to make payments to the counterparty.

The scheme assets do not include any financial instruments of the Rolls-Royce Holdings plc group, nor any property occupied by, or other assets used by, the group.

The expected rate of return for LDI portfolios is determined by the implicit yield on the portfolio at the balance sheet date.

The expected rates of return on individual categories of scheme assets are determined by reference to gilt yields. Equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25% and 0.5% per annum respectively.

The expected rates of return above are the weighted average of the rates for each scheme.

13 POST-RETIREMENT BENEFITS CONTINUED

FUTURE CONTRIBUTIONS

The Company expects to contribute approximately £173 million to its defined benefit schemes in 2015.

SENSITIVITIES

The investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. The impacts of the principal sensitivities are:

	2014 £m	2013 £m
Defined benefit obligations – 0.25% reduction in discount rate ¹	(466)	(406)
Defined benefit assets – 0.25% reduction in interest rates ¹	586	461
Defined benefit obligations – 0.25% increase in inflation	(234)	(196)
Defined benefit assets – 0.25% increase in inflation	204	181
Defined benefit obligations - longevity increases by one year	(247)	(210)
Defined benefit obligations - 0.25% increase in rate of increase in salaries	(86)	(80)

HISTORY OF DEFINED BENEFIT SCHEMES

The history of the schemes for the current and prior years is as follows:

	2014 £m	2013 £m	2012 £m	2011 £m	2010 £m
<i>Balance sheet</i>					
Present value of defined benefit obligations	(10,506)	(8,970)	(8,533)	(7,713)	(7,039)
Fair value of scheme assets	12,038	9,539	9,734	9,519	7,783
Unrecognised surplus	(233)	(154)	(187)	(696)	(164)
Asset	1,299	415	1,014	1,110	580
<i>Experience gains/(losses)</i>					
Actuarial gains/(losses) on scheme assets	2,245	(400)	(31)	1,407	444
Experience (losses)/gains on scheme liabilities	(1,407)	(194)	(660)	(617)	(142)
Movement in unrecognised surplus	(79)	33	509	(532)	(89)
Total amount recognised in the statement of total recognised gains and losses	759	(561)	(182)	258	213
Cumulative amount recognised in the statement of total recognised gains and losses ¹	(6)	(765)	(204)	(22)	(280)

¹ Since January 1, 2002.

DEFINED CONTRIBUTION SCHEMES

The Company operates a number of defined contribution schemes. The total expense recognised in the profit and loss account was **£25 million** (2013 £23 million).

14 SHARE CAPITAL

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At 1 January and 31 December 2014	2,000	400
Issued and fully paid		
At 1 January and 31 December 2014	1,631	326

NOTES TO THE COMPANY FINANCIAL STATEMENTS

15 MOVEMENTS IN CAPITAL AND RESERVES

	Non-distributable reserves				Profit and loss account £m	Total equity £m
	Share capital £m	Share premium £m	Revaluation reserve £m	Other reserves £m		
At 1 January 2014	326	631	26	167	773	1,923
Total recognised gains relating to the year	–	–	–	–	260	260
Transfers between reserves	–	–	(5)	–	5	–
Share-based payments – direct to equity	–	–	–	–	15	15
At 31 December 2014	326	631	21	167	1,053	2,198

16 OPERATING LEASE ANNUAL COMMITMENTS

	2014 £m	2013 £m
Leases of land and buildings which expire:		
Within one year	–	1
Between one and five years	2	2
After five years	10	10
Other leases which expire:		
Within one year	1	2
Between one and five years	3	5
After five years	–	–

17 SHARE-BASED PAYMENTS

EFFECT OF SHARE-BASED PAYMENT TRANSACTIONS ON THE COMPANY'S RESULTS

	2014 £m	2013 £m
Total expense recognised for equity-settled share-based payment transactions	18	37

SHARE-BASED PAYMENT PLANS IN OPERATION DURING THE YEAR

During the year, the Company participated in the following share-based payment plans operated by Rolls-Royce Holdings plc.

PERFORMANCE SHARE PLAN (PSP)

This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market based performance condition (Total Shareholder Return – TSR) over a three-year period.

SHARESAVE SHARE OPTION PLAN

Based on a three or five year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20% below the share price when the contract is entered into. Vesting of the options is not subject to the achievement of a performance target. The plan is HM Revenue & Customs approved.

EXECUTIVE SHARE OPTION PLAN (ESOP)

This plan involved the grant of market value share options to participants. It terminated in 2009 and no further grants may be made. Remaining options under the plan are subject to a non-market based performance condition (growth in EPS) and have a maximum contractual life of ten years.

ANNUAL PERFORMANCE RELATED AWARD (APRA) PLAN DEFERRED SHARES

A proportion of the APRA annual incentive scheme is delivered in the form of a deferred share award. The release of deferred share awards is not dependent on the achievement of any further performance conditions other than that participants remain employed by the Company for two years from the date of the award in order to retain the full number of shares. During the two year deferral period, participants are entitled to receive dividends, or equivalent, on the deferred shares.

17 SHARE-BASED PAYMENTS CONTINUED

MOVEMENTS IN THE COMPANY'S SHARE-BASED PAYMENT PLANS DURING THE YEAR

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2013	16.6	445p	0.1	77p	7.9	2.2
Granted	5.7	961p	—	—	1.4	1.0
Additional entitlements arising from TSR performance	—	—	—	—	0.6	—
Forfeited	(0.3)	499p	—	—	(0.3)	(0.1)
Exercised	(6.3)	405p	(0.1)	77p	(2.8)	(1.3)
Outstanding at 1 January 2014	15.7	646.0	—	—	6.8	1.8
Granted	—	—	—	—	1.7	0.7
Additional entitlements arising from TSR performance	—	—	—	—	0.4	—
Forfeited	(0.5)	757p	—	—	(0.7)	(0.1)
Exercised	(0.2)	469p	—	—	(2.4)	(1.0)
Outstanding at 31 December 2014	15.0	646p	—	—	5.8	1.4

As share options are exercised throughout the year, the weighted average share price during the year of **1013p** (2013 1123p) is representative of the weighted average share price at the date of exercise. The middle market closing price at 31 December 2014 was **870p** (2013 1275p).

There were no exercisable options as at 31 December 2013.

FAIR VALUES OF SHARE-BASED PAYMENT PLANS

The weighted average fair values per share of equity-settled share-based payment plans granted during the year, estimated at the date of grant are as follows:

	2014	2013
PSP – 25% TSR uplift	1105p	1128p
PSP – 50% TSR uplift	1227p	1254p
ShareSave – 3 year grant	n/a	287p
ShareSave – 5 year grant	n/a	349p
APRA	984p	1027p

Expected volatility is based on the historical volatility of Rolls-Royce Holdings plc's share price over the seven years prior to the grant or award date. Expected dividends are based on Rolls-Royce Holdings plc's payments to shareholders in respect of the previous year.

PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value of the award relative to the share price at the date of grant.

SHARESAVE

The fair value of the options granted under the ShareSave plan is calculated using a binomial pricing model that assumes that participants will exercise their options at the beginning of the six month window if the share price is greater than the exercise price. Otherwise it assumes that options are held until the expiration of their contractual term. This results in an expected life that falls somewhere between the start and end of the exercise window.

APRA

The fair value of shares awarded under APRA is calculated as the share price on the date of the award, excluding expected dividends (or equivalent).

NOTES TO THE COMPANY FINANCIAL STATEMENTS

18 CONTINGENT LIABILITIES

In connection with the sale of its products the Company will, on some occasions, provide financing support for its customers. The Company's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio.

Contingent liabilities are disclosed on a discounted basis. As the directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a value that is expected to crystallise. However, the amounts are discounted at the Company's borrowing rate to reflect better the time span over which these exposures could arise. The contingent liabilities are denominated in US dollars. As the Company does not adopt cash flow hedge accounting for forecast foreign exchange transactions, this amount is reported together with the sterling equivalent at the reporting date spot rate.

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions were:

	2014		2013	
	£m	\$m	£m	\$m
Gross contingent liabilities	388	605	356	589
Value of security*	(245)	(382)	(217)	(360)
Indemnities	(84)	(132)	(80)	(132)
Net commitments	59	91	59	97
Net commitments with security reduced by 20% ²	90	140	78	129
¹ Security includes cash collateral of:	42	66	50	83

² Although sensitivity calculations are complex, the reduction of the relevant security by 20% illustrates the sensitivity of the contingent liability to this assumption.

There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

Contingent liabilities exist in respect of guarantees provided by the Company in the ordinary course of business for product delivery, performance and reliability. The Company has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. The Company is party 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 Company is no longer fully insured against known and potential claims from employees who worked for certain of the Company's UK based businesses for a period prior to the acquisition of those businesses by the Company. 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 Company.

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee. At 31 December 2014, there were Company guarantees in respect of joint ventures amounting to **£9m** (2013 £7m)

The Company participates in a Cash Pooling Arrangement. Under the Pooling Arrangement the Company benefits from more favourable interest rates than would be available outside of the Pooling Arrangement as well as more streamlined treasury functions. As part of the Pooling Arrangement, the Company cross-guarantees the borrowings of other pooling participants. At 31 December 2014 these guarantees amounted to **£8m** (2013 £8m)

19 RELATED PARTY TRANSACTIONS

The Company is a wholly owned subsidiary of Rolls-Royce Group plc and therefore has taken advantage of the exemption in FRS 8 *Related party disclosures* not to disclose related party transactions with its parent company and other wholly owned group companies.

There are no significant related party transactions with non wholly owned group companies.

The aggregated balances with joint ventures are shown in notes 7 and 10.

20 ULTIMATE HOLDING COMPANY

The ultimate holding company is Rolls-Royce Holdings plc, incorporated in Great Britain. The financial statements for Rolls-Royce Holdings plc may be obtained from the Company Secretary, Rolls-Royce Holdings plc, 62 Buckingham Gate, London SW1E 6AT.

SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

The companies listed below are indirectly held by Rolls-Royce plc unless marked*. Each company's principal place of business is its country of incorporation and the effective group interest is 100%.

In accordance with Section 410 of the Companies Act 2006, the subsidiaries, jointly controlled entities and associates are those where the results or financial position, in the opinion of the directors, principally affect the financial statements. A list of all related undertakings will be included in the Company's annual return to Companies House.

	Country of incorporation	Principal activity
Rolls-Royce Brasil Limitada*	Brazil	Aero engine repair and overhaul and marine aftermarket support services
Rolls-Royce Canada Limited	Canada	Aero engine sales, service and overhaul
MTU Engineering (Suzhou) Company Limited	China	Service and spare parts centre
Rolls-Royce Marine Manufacturing (Shanghai) Limited	China	Manufacture and supply of marine equipment and marine aftermarket support services
Composite Technology and Applications Limited*	England	Development of aero engine fan blades and fan cases
MTU UK Limited	England	Sale and services of off-highway diesel engines
Rolls-Royce Controls and Data Services Limited	England	Development and manufacture of aero engine controls and monitoring systems
Rolls-Royce International Limited*	England	International support and commercial information services
Rolls-Royce Leasing Limited*	England	Engine leasing
Rolls-Royce Marine Electrical Systems Limited	England	Marine electrical systems
Rolls-Royce Marine Power Operations Limited*	England	Nuclear submarine propulsion systems
Rolls-Royce Power Development Limited*	England	Generation of electricity from independent power projects
Rolls-Royce Power Engineering plc*	England	Marine systems
Rolls-Royce Total Care Services Limited*	England	Aero engine aftermarket support services
Vinters Engineering Limited	England	Production, repair and overhaul of power generation, transmission and conversion equipment for military and commercial activities
Rolls-Royce OY AB	Finland	Manufacture of marine winches and propeller systems
Rolls-Royce Civil Nuclear SAS	France	Instrumentation and control systems and life-cycle management for nuclear power plants
Rolls-Royce Technical Support SARL	France	Aero engine project support
L'Orange GmbH	Germany	Development and production of high-pressure injection systems for diesel engines
MTU Friedrichshafen GmbH	Germany	Development, production and distribution of gas turbines and engines
MTU Onsite Energy GmbH	Germany	Sales and service of gas engines
MTU Onsite Energy Systems GmbH	Germany	Manufacture and distributor of diesel-powered generating sets
Rolls-Royce Deutschland Ltd & Co KG	Germany	Aero engine design, development and manufacture
Rolls-Royce Power Systems AG	Germany	Supplier of engines and power trains for marine propulsion, distributed power generation and industrial off-highway sectors
Nightingale Insurance Limited	Guernsey	Insurance services
MTU Hong Kong Limited	Hong Kong	Distributor for off-highway products and after-sales service
Rolls-Royce India Private Limited	India	Diesel engine project management and customer support
Rolls-Royce Marine India Private Limited	India	Provision of marine support services
Rolls-Royce Operations (India) Private Limited	India	Engineering support services
Europea Microfusioni Aerospaziali S.p.A.*	Italy	Manufacture of gas turbine engine castings
MTU Italia S.r.l.	Italy	Distributor for off-highway products and after-sales service
MTU Benelux B.V.	Netherlands	Sales and after-sales support for diesel engines
Bergen Engines AS	Norway	Design and manufacture of medium-speed diesel engines
Rolls-Royce Marine AS	Norway	Design and manufacture of ship equipment
MTU Asia Pte. Limited	Singapore	Distributor of diesel engines and spare parts
Rolls-Royce Singapore Pte. Limited	Singapore	Aero engine parts manufacturing and engine assembly and marine aftermarket support services
MTU South Africa (Pty.) Limited	South Africa	Distributor of off-highway products and after-sales service
MTU Ibérica Propulsión y Energía S.L.	Spain	Sales and service of transmission equipment with diesel and gas engines
Rolls-Royce AB	Sweden	Manufacture of marine propeller systems
MTU Motor Türbin Sanayi ve Tic. A.S.	Turkey	Production of diesel engines and manufacturer of control systems
Data Systems & Solutions LLC	US	Instrumentation and control systems and life-cycle management for nuclear power plants
MTU America Inc.	US	Sales and service of engines and systems
Optimized Systems and Solutions Inc.	US	Equipment health management and advanced data management services
PKMJ Technical Services Inc.	US	Civil nuclear engineering services and software solutions
R. Brooks Associates Inc.	US	Specialist civil nuclear reactor services
Rolls-Royce Corporation	US	Design, development and manufacture of gas turbine engines
Rolls-Royce Crosspointe LLC	US	Manufacturing facility for aero engine parts
Rolls-Royce Defense Services Inc.	US	Aero engine repair and overhaul

SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

continued

	Country of incorporation	Principal activity
Rolls-Royce Energy Systems Inc.	US	Energy turbine generator packages
Rolls-Royce Engine Services – Oakland Inc.	US	Aero engine repair and overhaul
Rolls-Royce High Temperature Composites Inc.	US	Production of state-of-the-art composite materials
Rolls-Royce Marine North America Inc.	US	Design and manufacture of marine equipment and aftermarket support services

The companies listed below are indirectly held by Rolls-Royce plc unless marked*. Each company's principal place of business is its country of incorporation.

	Country of incorporation		Class of shares	% of class held	Group interest held %
Shanxi North MTU Diesel Co. Ltd*	China	Manufacturer of aero engine parts	Ordinary	49	49
Xian XR Aero Components Co Limited*	China	Manufacturer of aero engine parts	Ordinary	49	49
Airtanker Holdings Limited*	England	Strategic tanker aircraft PFI project	Ordinary	20	20
Airtanker Services Limited*	England	Provision of aftermarket services for strategic tanker aircraft	Ordinary	22	22
Alpha Partners Leasing Limited	England	Aero engine leasing	A ordinary	100	50
Genistics Holdings Limited*	England	Trailer-mounted field mobile generator sets	A ordinary	100	50
Rolls-Royce Snecma Limited*	England	Aero engine collaboration	B shares	100	50
TRT Limited*	England	Aero engine turbine blade repair services	B ordinary	100	49.5
Turbine Surface Technologies Limited*	England	Aero engine turbine surface coatings	B ordinary	100	50
Turbo-Union Limited*	England	RB199 engine collaboration	Ordinary A shares	40 37.5	40
EPI Europrop International GmbH* (effective group interest held 35.5%)	Germany	A400M engine collaboration	Ordinary	28	28
EUROJET Turbo GmbH* (effective group interest held 39%)	Germany	EJ200 engine collaboration	Ordinary	33	33
MTU, Turbomeca, Rolls-Royce GmbH*	Germany	MTR390 engine collaboration	Ordinary	33.3	33.3
N3 Engine Overhaul Services GmbH & Co KG	Germany	Aero engine repair and overhaul	Ordinary	50	50
Hong Kong Aero Engine Services Limited	Hong Kong	Aero engine repair and overhaul	Ordinary	45	45
International Aerospace Manufacturing Private Limited	India	Manufacturer of aero engine parts	Ordinary	50	50
Techjet Aerofoils Limited	Israel	Manufacturer of aero engine parts	A ordinary B ordinary	50 50	50
International Engine Component Overhaul Pte Limited	Singapore	Aero engine repair and overhaul	Ordinary	50	50
Singapore Aero Engine Services Private Limited (effective group interest 39%)	Singapore	Aero engine repair and overhaul	Ordinary	30	30
Industria de Turbo Propulsores SA*	Spain	Aero engine component manufacture and maintenance	Ordinary	46.9	46.9
Alpha Leasing (US) LLC, Alpha Leasing (US) (No.2) LLC, Alpha Leasing (US) (No.4) LLC, Alpha Leasing (US) (No.5) LLC, Alpha Leasing (US) (No.6) LLC, Alpha Leasing (US) (No.7) LLC, Alpha Leasing (US) (No.8) LLC, Rolls-Royce & Partners Finance (US) LLC, Rolls-Royce & Partners Finance (US) (No.2) LLC	US	Aero engine leasing	Partnerships (no equity held)	–	50
Exostar LLC	US	Business to business internet exchange	Partnership (no equity held)	–	18.5
LG Fuel Cell Systems Inc.	US	Development of fuel cells	Common Stock	32	32
Texas Aero Engine Services, LLC	US	Aero engine repair and overhaul	Partnership (no equity held)	–	50

UNINCORPORATED

Light Helicopter Turbine Engine Company (LHTEC)	US	T800 engine development and market	Partnership (no equity held)	–	50
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INDEPENDENT AUDITOR'S REPORT

to the members of Rolls-Royce Holdings plc only

We have audited the financial statements of Rolls-Royce plc for the year ended 31 December 2014 set out on pages 52 to 122. The financial reporting framework that has been applied in the preparation of the group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITOR

As explained more fully in the Directors' Responsibilities Statement set out on page 50, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

SCOPE OF THE AUDIT OF THE FINANCIAL STATEMENTS

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

OPINION ON FINANCIAL STATEMENTS

In our opinion:

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 December and of the group's profit for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice;
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

OPINION ON OTHER MATTER PRESCRIBED BY THE COMPANIES ACT 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

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

JIMMY DABOO (SENIOR STATUTORY AUDITOR)

for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
15 Canada Square
London E14 5GL
12 February 2015

ADDITIONAL FINANCIAL INFORMATION

FOREIGN EXCHANGE

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

		2014	2013	Change
USD per GBP	Year end spot rate	1.56	1.65	-5%
	Average spot rate	1.65	1.56	+6%
EUR per GBP	Year end spot rate	1.28	1.20	+7%
	Average spot rate	1.24	1.18	+5%

THE GROUP'S APPROACH TO MANAGING ITS TAX AFFAIRS

The Board is involved in setting the Group's tax policies which govern the way its tax affairs are managed. In summary, this means:

- i) the Group manages its tax costs through maximising the tax efficiency of business transactions. This includes taking advantage of available tax incentives and exemptions;
- ii) this must be done in a way which is aligned with the Group's commercial objectives and meets its legal obligations and ethical standards;
- iii) the Group also has regard for the intention of the legislation concerned rather than just the wording itself;
- iv) the Group is committed to building constructive working relationships with tax authorities based on a policy of full disclosure in order to remove uncertainty in its business transactions and to allow the authorities to review possible risks;
- v) where appropriate and possible, the Group enters into consultation with tax authorities to help shape proposed legislation and future tax policy; and
- vi) the Group seeks to price transactions between Group companies as if they were between unrelated parties, in compliance with the OECD Transfer Pricing Guidelines and the laws of the relevant jurisdictions.

THE GROUP'S GLOBAL CORPORATE INCOME TAX CONTRIBUTION

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

In common with most multinational groups, the total of all profits in respect of which corporate tax is paid is not the same as the consolidated profit before tax reported on page 95. The main reasons for this are:

- i) the consolidated income statement is prepared under Adopted IFRS whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;

- ii) accounting rules require certain income and costs relating to our commercial activities to be eliminated from, or added to, the aggregate of all the profits of the Group companies when preparing the consolidated income statement ('consolidation adjustments'); and
- iii) specific tax rules including exemptions or incentives as determined by the tax laws in each country.

The Group's total corporation tax payments in 2014 were £276 million. The level of tax paid in each country is impacted by the above. In most cases, (i) and (ii) are only a matter of timing and therefore tax will be paid in an earlier or later year. As a result they only have a negligible impact on the Group's underlying tax rate which, excluding joint ventures, would be 25.5% (the underlying tax rate including joint ventures can be found on page 19). This is due to deferred tax accounting, details of which can be found in note 5 to the Financial Statements. The impact of (iii) will often be permanent depending on the relevant tax law.

INVESTMENTS AND CAPITAL EXPENDITURE

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

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

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

FINANCIAL RISK MANAGEMENT

The Board has established a structured approach to financial risk management. The Financial risk committee (Frc) is accountable for managing, reporting and mitigating the Group's financial risks and exposures. These risks include the Group's principal counterparty, currency, interest rate, commodity price, liquidity and credit rating risks outlined in more depth in note 16. The Frc is chaired by the Chief Financial Officer. The Group has a comprehensive financial risk policy that advocates the use of financial instruments to manage and hedge business operations risks that arise from movements in financial, commodities, credit or money markets. The Group's policy is not to engage in speculative financial transactions. The Frc sits quarterly to review and assess the key risks and agree any mitigating actions required.

CAPITAL STRUCTURE

£ million	2014	2013
Total equity	6,831	8,134
Cash flow hedges	81	68
Group capital	6,912	8,202
Net funds	666	1,939

Operations are funded through various shareholders' funds, bank borrowings, bonds and notes. The capital structure of the Group reflects the judgement of the Board as to the appropriate balance of funding required.

Funding is secured by the Group's continued access to the global debt markets. Borrowings are funded in various currencies using derivatives where appropriate to achieve a required currency and interest rate profile. The Board's objective is to retain sufficient financial investments and undrawn facilities to ensure that the Group can both meet its medium-term operational commitments and cope with unforeseen obligations and opportunities.

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

During the year, the Group repaid a £200 million EIB loan.

At year end, the Group retained aggregate liquidity of £4.1 billion. This liquidity included net funds of £666 million and aggregate borrowing facilities of £3.5 billion, of which £1.3 billion remained undrawn.

The maturity profile of the borrowing facilities is regularly reviewed to ensure that refinancing levels are manageable in the context of the business and market conditions. The only facility to mature in 2015 is a US\$83 million note. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating.

The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This debt is further outlined in note 10.

CREDIT RATING

	Rating	Outlook	Grade
Moody's Investors Service	A3	Stable	Investment
Standard & Poor's	A	Stable	Investment

The Group's holding company, Rolls-Royce Holdings plc, subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings.

At 31 December 2014, the Group maintained investment grade ratings from both agencies.

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

ACCOUNTING

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

With effect from 1 January 2014, the Group has adopted IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*. The impact of these and other changes to IFRS which have not been adopted in 2014 is included within the accounting policies in note 1.

GLOSSARY

ABC	anti-bribery and corruption
AGM	Annual General Meeting
ANA	All Nippon Airways
APRA	Annual Performance Related Award plan
C&A	commercial and administrative
CARs	contractual aftermarket rights
CEO	chief executive officer
CFO	chief financial officer
CGU	cash-generating unit
CO₂	carbon dioxide
Company	Rolls-Royce plc
ELT	Executive Leadership Team
EPS	earnings per ordinary share
EU	European Union
EUR	euro
FRC	Financial Reporting Council
FX	foreign exchange
GBP	Great British pound or pound sterling
GHG	greenhouse gas
Global Code	Global Code of Conduct
Group	Rolls-Royce Holdings plc and its subsidiaries
HMRC	HM Revenue & Customs
HS&E	health, safety and environment
I&C	instrumentation and control
IAS	International Accounting Standards
IFRIC	International Financial Reporting Interpretations Committee

IFRS	International Financial Reporting Standards
KPIs	key performance indicators
ktCO₂e	kilotonnes carbon dioxide equivalent
LIBOR	London Inter-Bank Offered Rate
LTSA	long-term service agreement
LNG	liquefied natural gas
NCI	non-controlling interest
NO_x	nitrogen oxides
OCI	other comprehensive income
OE	original equipment
OECD	Organisation for Economic Cooperation and Development
PBT	profit before tax
PSP	Performance Share Plan
R&D	research and development
REACH	Registration, Evaluation Authorisation and restriction of CHemicals
RRPS	Rolls-Royce Power Systems AG
RRSAs	risk and revenue sharing arrangements
SFO	Serious Fraud Office
SO_x	sulphur oxides
STEM	science, technology, engineering and mathematics
TCA	TotalCare agreement
TRI	total reportable injuries
TSR	total shareholder return
UAV	unmanned aerial vehicle
USD/US\$	United States dollar
UTCs	University Technology Centres



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