Rolls-Royce Holdings plc
annual report 2013

Rolls-Royce

Trent XWB - First flight test engine
ready for the Airbus A350 XWB

better power for a changing world

"2013 was a year of good progress in which our order book, underlying revenue and underlying profit, all grew. Our priorities remain the 4 Cs: Customer, Concentration, Cost and Cash."

John Rishton, Chief Executive

INTRODUCTION

Rolls-Royce is a global company, providing integrated power solutions for customers in civil and defence aerospace, marine, energy and power markets.

Our vision is to deliver 'better power for a changing world'.

	2013	Restated* 2012	Change
Order book £m	**71,612**	60,146	+19%
Underlying revenue £m	**15,505**	12,209	+27%
Underlying profit before tax £m	**1,759**	1,434	+23%
Underlying earnings per share	**65.59p**	59.59p	+10%
Full year payment to shareholders	**22.0p**	19.5p	+13%
Reported revenue £m	**15,513**	12,161	+28%
Reported profit before tax £m	**1,759**	2,766	-36%
Reported earnings per share	**73.26p**	125.38p	-42%
Net cash £m	**1,939**	1,317	

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* and the change in accounting policy for RRSAs.

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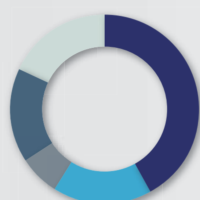
Forward-looking statements
This annual report contains forward-looking statements. Any statements that express forecasts, expectations and projections are not guarantees of future performance and will not be updated. By their nature, these statements involve risk and uncertainty, and a number of factors 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

As in previous years, our business priorities remain the 4 Cs: Customer, Concentration, Cost and Cash.

GROUP OVERVIEW 2013

2013 revenue by business segment

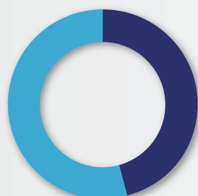


- 42% Civil aerospace
- 17% Defence aerospace
- 7% Energy
- 16% Marine
- 18% Power Systems

- The order book increased 19 per cent to £71.6 billion. This included a £1.6 billion contribution from Power Systems.
- Order intake was £26.9 billion in the year.
- Underlying revenue increased to £15.5 billion, with 53 per cent from original equipment (OE) and 47 per cent from services revenue.
- Underlying profit before tax increased 23 per cent to £1.8 billion, including £257 million from Tognum.

CIVIL AEROSPACE

Revenue mix



- 46% OE revenue
- 54% Services revenue

£6,655m
Underlying revenue 2013

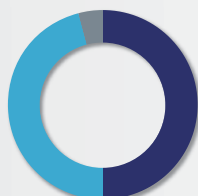
£844m
Underlying profit 2013

- First flight of the Airbus A350 XWB powered by Trent XWB engines
- First flight of the Boeing 787-9 powered by Trent 1000 engines
- Major new orders from JAL, IAG, Lufthansa, United, Singapore and Etihad
- Delivered 3,000th BR700 series engine

The Civil aerospace segment is a major manufacturer of aero engines for the airline and corporate jet markets. Rolls-Royce powers more than 30 types of commercial aircraft and has almost 13,000 engines in service around the world.

DEFENCE AEROSPACE

Revenue mix



- 50% OE revenue
- 46% Services revenue
- 4% Development

£2,591m
Underlying revenue 2013

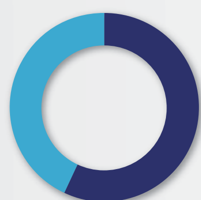
£438m
Underlying profit 2013

- TP400-powered A400M entered service
- MissionCare™ contract for Saudi Arabian EJ200 engines secured
- 1,500th AE 2100 engine delivered
- Upgraded AE 1107 engines for V-22 Osprey
- T56 engine enhancement kits gained first sales
- Delivered 40th Rolls-Royce LiftFan® for F-35B Lightning II fighter programme
- RTM322 helicopter engine programme sold to Turbomeca

Rolls-Royce is the second largest provider of defence aero-engine products and services globally, with around 16,000 engines in service with over 160 military customers in more than 100 countries.

MARINE

Revenue mix



- 57% OE revenue
- 43% Services revenue

£2,527m
Underlying revenue 2013

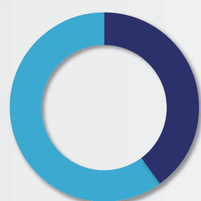
£281m
Underlying profit 2013

- Range of world 'firsts' of LNG-powered vessel types delivered
- MT30 selected for new UK MoD Type 26 Frigate
- £800 million contract agreed with UK MoD for provision of future nuclear submarine propulsion systems
- New UT 830 seismic survey vessel launched
- COSCO ordered new wave-piercing design of offshore vessels
- Third service centre in China opened

The Marine segment has 4,000 customers and equipment installed on over 25,000 vessels worldwide, including those of 70 navies.

ENERGY

Revenue mix



- 40% OE revenue
- 60% Services revenue

£1,048m
Underlying revenue 2013

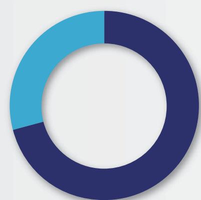
£26m
Underlying profit 2013

- 33 RB211s ordered for oil and gas applications
- Major service contract secured with Petrobras
- New Santa Cruz, Brazil, assembly plant operational
- Signed tripartite agreement with Rosatom and Fortum to assess nuclear reactor design for UK new build
- Renewed agreement with Westinghouse to provide nuclear inspection services in US

To date, Energy has sold 4,600 gas turbines with 180 million operating hours recorded. Rolls-Royce has over 50 years of experience in the nuclear industry.

POWER SYSTEMS

Revenue mix



- 71% OE revenue
- 29% Services revenue

£2,831m
Underlying revenue 2013

£294m
Underlying profit 2013

- MTU Powerpacks ordered for UK Intercity Express Programme
- Fjord Line ordered Bergen engines for cruise ferries
- UK MoD selects MTU gensets alongside MT30 gas turbine
- Polish partnership created to supply and maintain cogeneration plants
- Mining trucks powered by MTU delivered to Rio Tinto in Australia

Rolls-Royce Power Systems is headquartered in Germany and specialises in reciprocating engines, propulsion systems and distributed energy systems.

CHAIRMAN'S REVIEW

In 2013, Rolls-Royce delivered another year of growth in underlying revenues, underlying profits and orders.

The Board is proposing an increase in the final payment to shareholders of 13.4p bringing the full year payment to 22.0p.

This is my first Chairman's review. Before I joined Rolls-Royce I sensed that it would be an extraordinary privilege to serve such a great company with such a rich history. So it has proved to be. In the past nine months I have travelled widely and met a broad cross-section of colleagues, customers, suppliers and investors. All have been free with their time and open with their perspectives.

I have two dominant initial impressions. The first is of the pride that people across the world have in the activities and achievements of the Group. We have a team that really does aspire to be 'trusted to deliver excellence' in everything it does, yet is under no illusions about what this will take. There is pride but no sense of complacency.

The second impression is of opportunity. Some of our business segments face strong headwinds and there will be some inevitable volatility. But, overall, Rolls-Royce competes in markets characterised by long-term demand growth and the opportunity to add value. This is as true of the services we provide as it is of our products. These opportunities are increasingly global in nature. Rolls-Royce has a great British history but its future has to be as a great global company.

In 2013, Rolls-Royce delivered another year of growth in revenues, profits and order book. This performance was achieved against a background of significant global economic and political uncertainty. The 13 per cent of increase in the payment to shareholders to 22.0 pence reflects the confidence that the Board has in the fundamentals of the business as well as in its future prospects.

The increase in the payment to shareholders also recognises the importance that many of our investors place on annual cash returns. Nevertheless a key characteristic of Rolls-Royce is that it is a long-term business with technologies that take years to develop. This creates the necessity of a long-term view and for long-term investment, together with a commensurate attitude and mindset for risk.

Our strategy must be directed towards creating a sustainable business. For Rolls-Royce that means driving profitable growth whilst achieving a positive economic, social and environmental impact. We will deliver better power to our customers, use innovation to secure a better future, and build on today's achievements to develop a better business, ready to meet the challenges ahead.

Research and development, and innovation more broadly, are crucial. They will become more so as we strive to improve the quality and performance of our power systems and services. The Trent XWB, for example, has proved to be the most efficient large civil aero engine in the world. Design and development of that engine started in 2006. In our Marine business, innovation and the development of liquefied natural gas (LNG) power systems has led to the possibility of a 40 per cent reduction in a ship's CO_2 emissions and the virtual elimination of sulphur and oxides of nitrogen emissions compared with conventional, diesel-powered craft. This presents a clear environmental and commercial opportunity. These innovations have also taken years to develop.

We are committed to both the short-term performance and to the long-term health of the Group. It is a matter of 'both-and', not 'either-or'. In my experience the most successful, most enduring organisations invest equivalent resource and imagination in the long-term health of their business as they do in their short to medium-term performance.

Ian Davis
Chairman

Dwelling on performance, I am totally supportive of John Rishton and the management team's operational focus on the 4 Cs – customer, concentration, cost and cash. John describes the progress, and the continuing opportunities, of these 4 Cs in this report. I am particularly pleased at the progress in improving customer service and delivery reliability. Engineering and technology companies can have an inbuilt tendency to focus on product rather than on customer. Yet it is our customers who pay our bills and finance our investments. It is of the highest strategic and commercial importance that we deliver on our product and service commitments to our customers.

Over and above the continuing need for investment, I would like to comment on a couple of themes relating to long-term health: diversity and good governance.

I have remarked already on the need for Rolls-Royce to establish itself as an even more global Group. This will require us to become more diverse in our workforce and in our people development. To achieve our aspirations we have to attract, retain and develop the best talent everywhere we operate – commercial as much as engineering, female as much as male.

We are making real progress. Our global apprenticeship programme enjoys world-wide renown. Our record graduate intake in 2013 includes 32 nationalities from 97 universities around the world. Additionally we continue to broaden internationally our network of University Technology Centres which are so important to our future. But more needs to be done.

We can and need to do more to attract and, particularly, retain exceptional women. The engineering sector has not always been a favoured destination for well-qualified women and there may be cultural and historical reasons for this. For a Group like Rolls-Royce, this should be as much an opportunity as a problem. Purposeful diversity is an important part of our long-term planning.

Fundamental to a healthy company are strong ethical standards and behaviours, supported by good governance. As John Rishton has repeatedly made clear, the Group will not tolerate improper conduct. We are striving to ensure that every single Rolls-Royce employee knows what is expected of them and understands the standards to be met. The Board and management are united in this endeavour. In particular, I will focus on ensuring that we have the appropriate governance arrangements and structures in place to reinforce the required conduct and behaviours, wherever we operate.

Over recent years, the Board and management have been greatly assisted by the wise counsel of our International Advisory Board (IAB) whose membership is described on page 38. The IAB's primary role is to provide context on political and economic developments around the world and to alert the Group to possible long-term opportunities, threats and risks. They are also available to provide counsel and support in specific areas of expertise. I am grateful to the IAB members for their contributions.

I am also indebted to my fellow Board directors for their hard work and remarkable commitment to our Group as well as for their patience and good humour in dealing with the new Chairman. The Board has been augmented in January 2014 by Lee Hsien Yang and Warren East, both of whom bring a wealth of experience in global technology oriented industries. Further details of their careers are included on pages 36 and 37. I am delighted that they have joined the Group.

In the Queen's Birthday Honours, Michel Dubarry, Rolls-Royce International President – France, Head of Europe and Northern Africa, was awarded an OBE. In the New Year's Honours, Hamid Mughal, Director of Manufacturing, received an OBE and my fellow Board member, Warren East, a CBE. Their recognition is well deserved and I congratulate each of them.

I would also like, in closing, to acknowledge Sir Simon Robertson for his inspirational chairmanship and leadership of the Board. I am sure that, over time, I will forgive him for being such a hard act to follow.

I feel honoured to have the opportunity to serve as Chairman of Rolls-Royce. We have, and will have, challenges. However, I would be disappointed if this review does not convey my deep sense of opportunity to improve both short-term performance and to build the long-term health of the Group. 2013 was a good year for Rolls-Royce and I would like to thank my colleagues for their hard work and efforts in making this happen.

Ian Davis
Chairman

12 February 2014

CHIEF EXECUTIVE'S REVIEW

In 2013, Rolls-Royce continued to grow its order book and expand its portfolio. The Group increased its underlying profits, and underlying revenues. The order book increased to £71.6 billion.

This performance demonstrates both the long-term demand for our products and services, and the confidence our customers place in us.

We strive continually to improve quality, performance and cost. To that end we invest in innovation, infrastructure and in the global workforce upon whose ability and ambition our current and future success entirely depends. I am impressed every day by the commitment and professionalism of my colleagues around the world and I thank them for their hard work.

The leaders of the Group have devoted considerable time and energy into articulating the vision, values, strategy and business priorities that we share, as well as setting out the standards of behaviours expected from everybody at Rolls-Royce. Providing clarity on these core beliefs, and making sure they are understood by everyone in the Group will enable us to better serve our customers and secure a profitable future for our employees and shareholders.

Vision: better power for a changing world

Values: trusted to deliver excellence

Strategy: customer, innovation, profitable growth

These are described in greater length on pages 8 and 9.

Our business priorities in 2013 remained the same as in previous years, and have been characterised as 'The 4 Cs':

Customer – deliver on the promises we have made

Concentration – decide where to grow and where not to

Cost and Cash – improve financial performance

In 2013, we have made progress in all of these, although there remains much more to do.

Customer

It is essential that we deliver on the promises made to our customers. Across the business we have significantly improved on-time delivery. This foundational step will strengthen our customer relationships and drive more efficient use of resources, such as inventory. In Civil aerospace, on-time delivery to our wide-body customers was 100 per cent in 2013 for the first time.

In 2013, major milestones were achieved in a number of important programmes. The Airbus A350 XWB flew for the first time powered by our Trent XWB engines. We have now received orders for more than 1,600 Trent XWBs, making this our best-selling Trent engine. The Trent 1000 engine, which powers the Boeing 787 Dreamliner, has achieved the best performance of any new wide-body engine entering service, with a 99.9 per cent despatch reliability. In June, it was selected by Singapore Airlines to power 50 Boeing 787 aircraft. In Marine, the first of our innovative Environships went to sea. This vessel combines a wave-piercing bow, gas-powered engines and advanced propulsion systems that together reduce CO_2 emissions by 40 per cent, compared with equivalent diesel-powered vessels. Lastly, BAE Systems announced that the UK's Type 26 Destroyer programme will feature four MTU diesel gensets from Power Systems, together with our Trent-derived MT30 gas turbines.

Concentration

Concentration means deciding where to invest for future growth and where not. We have two technology platforms: gas turbines and reciprocating engines. Within gas turbines, we have a strong Civil aerospace business, with over £60 billion in orders. We will continue to invest here, including in the next generation of narrow-body aircraft engines. We will also look for opportunities to expand in reciprocating engines.

In 2013, we acquired Hyper-Therm HTC, a specialist ceramics company, to increase our capabilities in ceramic matrix materials that will, in the future, play a critical part in improving the performance of gas turbine engines. We also acquired a Norwegian company, SmartMotor AS, a leader in the permanent magnet technology employed in our Marine business. We integrated PKMJ Technical Services, a US-based nuclear engineering services business with expertise in extending the life of nuclear plants.

Areas where we have decided not to grow include the sale of our 50 per cent holding in the RTM322 helicopter engine programme to Turbomeca, a Safran company.

Cost

The highly regulated nature of the aerospace industry means that it will take both time and tenacity to drive cost out of the business, and we are still not where we need to be. However there are a number of areas where progress is being made. We reduced indirect headcount by 11 per cent, with further savings identified for 2014. Unit cost fell in Marine, Energy and Power Systems, although this was more than offset by an increase in Civil, where capacity growth has preceded volume growth and the cost per unit has predictably risen. We are building newer, more efficient facilities and capacity that will support a doubling of production of Trent engines. We are moving production away from high cost countries, and we are consolidating our supply chain. These actions will deliver benefits over time.

We have prioritised investment that improves operational performance, adds to our technical capability and reduces cost. This includes a shop floor IT modernisation programme that will increase operational efficiency and an Integrated Production Systems programme that will improve delivery to customers while reducing cost.

Cash

The Group delivered a cash inflow of £359 million (£312 million excluding Tognum), after payments to shareholders, prior to acquisitions, disposals and foreign exchange. Inventory has been an area of significant focus. While substantially improving our on-time delivery to customers and preparing for the ramp-up in volumes, we have improved inventory turns from 3 times to 3.4 times, excluding Tognum. This is one of the largest one-year improvements in our stock turns.

We continue to invest significantly to deliver our order book. In 2013, capital expenditure was £687 million (£590 million excluding Tognum and £491 million in 2012). This included two new aero-engine test facilities: one at the NASA Stennis Space Center in Mississippi, US, and the other at Dahlewitz, Germany. We have extended our global Marine services network with a new facility in Guangzhou, China. An advanced aerofoil machining facility at Crosspointe in Virginia, US, will begin production in 2014. In the UK, production has started at our new state-of-the-art fan disc factory in Washington, Tyne and Wear and we are also close to completing a new turbine blade factory in Rotherham.

In January 2013, we appointed Lord Gold to lead a review of our process and procedures regarding compliance and business ethics. This followed our report to the Serious Fraud Office (SFO) of concerns about bribery and corruption involving intermediaries in overseas markets. In December, the SFO confirmed that it had begun a formal investigation into these matters. We have co-operated fully with the regulatory authorities and will continue to do so.

During the year, we published a new Global Code of Conduct. Under a programme implemented in 2013, all employees are asked to certify they have: received a copy of the Global Code; read and understood it; will comply with it; and have received a management briefing. I have made it explicit that we will not tolerate improper business conduct of any sort. We have updated and re-launched our confidential reporting line for employees, now known as the Ethics Line, available 24 hours a day, to make sure that we can hear about and address any matters of concern.

It is important that everyone at Rolls-Royce recognises that they are an ambassador for the Group. We have set out three common behaviours that will make sure we maintain high ethical standards, build trust with our customers and each other and help secure the long-term success of our business:

win right – securing business fair and square;

focus with firm resolve – decide what needs to be done, then focus relentlessly on delivery – refusing to be distracted; and

communicate – simply, consistently and often.

Every aspect of the Group's performance results from the endeavours of the 55,000 men and women who share a vision of delivering 'better power for a changing world'. It is their ingenuity and commitment alongside our continued investment in technology, that allows us to seize the opportunities that our changing world presents and to face the future with confidence.

John Rishton
Chief Executive

12 February 2014

OUR VISION, BUSINESS MODEL, STRATEGY AND VALUES

Rolls-Royce is a global Group, providing integrated power solutions for customers in civil and defence aerospace, marine, energy and power markets. Our products work in mission-critical environments where safety is paramount.

Read more on pages 14 to 23.

OUR VISION

Better power for a changing world

Since its earliest days, Rolls-Royce has been striving to achieve ever higher standards. Our vision is delivering 'better power for a changing world'.

Better: we will succeed only by continually raising standards. We constantly improve quality, performance and cost. We are inquisitive, energetic and 'better' every day. Even when we may be the best, we must continue to get better.

Power: we are a power systems company that develops, sells and services mission-critical products. Our customers demand innovation that improves performance and reduces the environmental impact of our power systems.

Changing world: the world around is changing rapidly and the pace of change is accelerating. New markets are emerging, shifting the balance of economic power. Regulation is, rightly, driving the requirement for cleaner power and setting new standards for business conduct. Our continuous investment in technology, our ingenuity and our commitment to excellence allow us to seize the opportunities that change presents and to face the future with confidence.

OUR BUSINESS MODEL

Our business model places emphasis on reducing costs so that we can generate the funds we need to deliver our vision of 'better power for a changing world'.

The business model is built around our core strategic themes of **customer, innovation** and **profitable growth**. We are a power systems company based on two technology platforms, gas turbines and reciprocating engines. Continuous investment in **innovation** delivers better products and services on behalf of **customers**. This allows us to meet their needs and **grow profitably** to the benefit of our shareholders.

Around the core strategic themes of the model we:

Grow sales for original equipment and the associated aftermarket through developing strong routes to market based on customer relationships, understanding and knowledge. **Allocate capital** in a disciplined way, choosing where to grow, and where not to. **Reduce costs and generate cash**, to enable profitable growth from our order book and the maintenance of a strong balance sheet. **Fund research, development, infrastructure** and future programmes. Our financial resilience and resources provide a firm foundation from which to invest. Risk and Revenue Sharing Arrangements are a particular feature of the civil aerospace sector as a means of sharing risk due to the scale of investment required for large gas turbines.

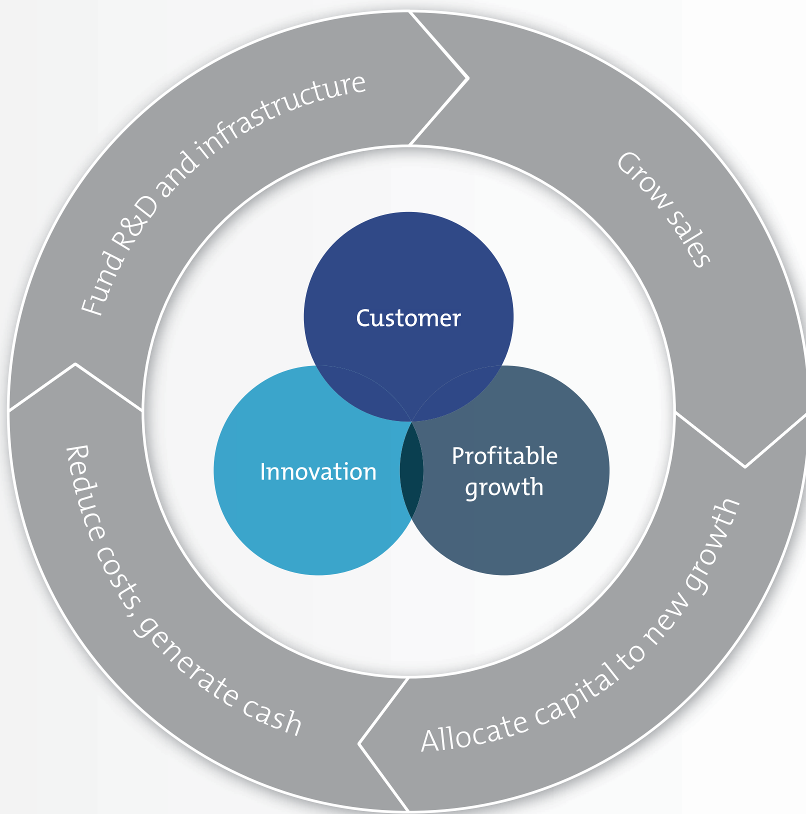
OUR STRATEGY

We operate in competitive markets. Our competitors are well-funded, ambitious and full of smart people.

Our strategy will enable us to win by focusing on three powerful themes: customer; innovation and profitable growth.

CUSTOMER

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



OUR VALUES

We say we are 'trusted to deliver excellence', but simply being Rolls-Royce does not give us the right to make that claim. Trust takes a long time to earn and can be lost in an instant.

Trust: is earned by doing what we say we will. It demands care, consistency, courage and competence. Trust commits us to high ethical standards – it is central to who and what we are.

Deliver: part of being trusted. We must deliver on our promises, meeting our customers' requirements for quality, delivery, responsiveness and reliability, always recognising that the safety of our products and our people is paramount.

Excellence: if we are trusted, and we deliver, then we will be regarded as excellent.

INNOVATION

Innovation: is our lifeblood. We must 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. But most importantly, we ensure our innovation is relevant to our customers' needs.

PROFITABLE GROWTH

Profitable growth: by focusing on our customers, and offering them a competitive portfolio of products and services, we will create the opportunity to grow our market share. Of course we have got 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.

CHIEF FINANCIAL OFFICER'S REVIEW

Summary

	2013	Restated* 2012	Change
Order book £m	**71,612**	60,146	+19%
Underlying revenue £m	**15,505**	12,209	+27%
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Reported profit before tax £m	**1,759**	2,766	-36%
Reported earnings per share	**73.26p**	125.38p	-42%
Net cash £m	**1,939**	1,317	
Average net cash/(debt) £m	**350**	(145)	

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* and the change in accounting policy for RRSAs.

2013 was another good year for the Group, with significant growth in our order book, good growth in underlying revenues and profits, coupled with a cash inflow, but as ever, there are some areas where progress has been slower than I would have liked. Our confidence in the future remains high, reflected in our increased final payment to shareholders but, as you would expect me to say, we have more to do on cost and cash across the Group to deliver the future performance implicit in this confidence.

The results reflect the full consolidation of Rolls-Royce Power Systems AG (formerly Tognum AG) from 1 January 2013. Previously, Tognum was accounted for as a joint venture.

Order intake in the year of £26.9 billion saw the order book grow yet again to reach record levels. This reflects £2.5 billion from Power Systems and £18.9 billion from our Civil business reflecting a very successful year for the Trent XWB. This vote of confidence from our customers gives good visibility and underpins our confidence to invest for the future.

Underlying revenues and profit before tax increased by 27 per cent and 23 per cent respectively. Prior to the impact of consolidating Power Systems, underlying revenue growth was six per cent and profit advanced by 11 per cent. The 11 per cent growth in profits reflected strong margins in Defence, the benefit of the IAE International Aero Engines AG (IAE) restructuring which was executed in the middle of 2012 and a lower research and development charge against profits. Profits were adversely impacted by price pressure in our Marine business and the pace of cost reduction in our Civil business.

Our largest business, Civil aerospace, was the backbone of the Group's order increase and saw revenue grow steadily. The installed base saw more engines flying more hours. Profit benefited from the higher volumes, the new IAE trading arrangements and higher entry fees from our partners. However, our Civil profits were held back by higher unit costs where progress has lagged our expectations, but the actions we have taken in 2013 will yield savings in 2014.

Defence aerospace performed very well in 2013, largely due to higher export sales and lower research and development (R&D) spend. Services held up well, albeit with some softness on flying hours of military transport aircraft. We expect a 15-20 per cent decline in both Defence revenue and profit in 2014 as we complete some major export delivery schedules. We expect original equipment revenue to decrease by 30-40 per cent due to fewer deliveries of engines to power the C130Js, V-22 Ospreys and Typhoons, as well as fewer Adour engine kits.

As always, it is important to put this into perspective. Our Defence business has had two very good years of revenue and profit growth. Which means the numbers we are guiding for in 2014, bring us back only to 2011 revenue levels, and we expect growth again in 2015.

Marine's offshore and merchant markets continue to see intense competition driven by overcapacity and price pressure. This affected the order intake during the year that sees order cover for 2014 at a lower level than we started 2013. In this challenging environment, we made some good progress on cost, but have more to do if we are to compete more effectively. Our Naval business remains stable.

Energy saw some improvement in 2013 and we continue to work hard to improve further its financial performance.

Power Systems delivered a very strong second half performance, contributing £2.6 billion to revenue in 2013 (nil in 2012) and an underlying profit before tax of £257 million (2012 £77 million). We are very pleased with Power Systems and it remains a key part of our desire to go to market via two strong technology platforms: gas turbines and reciprocating engines.

Our cost base can be broadly split between 85 per cent relating directly to our delivered product, ten per cent indirect (commercial and administration) and five per cent on R&D. We continue to push hard on product cost as we work with the internal and external supply chains and although Civil unit costs increased in 2013, we did realise improvements in Marine and Energy. We expect to see progress across all our segments in 2014. In terms of indirect cost, we achieved our objectives to reduce headcount by 11 per cent, primarily through voluntary severance arrangements. After taking into account the related restructuring costs during the year, the benefits to this reduction will be seen in future years.

We were pleased with the cash inflow of £359 million at Group level, prior to acquisitions, disposals and foreign exchange, which included an inflow of £47 million from Power Systems. Net working capital improved slightly, reflecting a good second half performance on inventory and higher deposits, mainly in Civil, flowing from the order intake. We made good progress on inventory, improving turns from 3 to 3.4 times (excluding Power Systems), helped by a consistent focus in the second half of the year.

Cost and cash remain areas of intense focus going forward.

In terms of financial reporting, please note the following:

1. To better align our reporting structure with our organisation, going forward we will report as: Aerospace and Marine & Industrial Power Systems (MIPS). Aerospace comprises Civil aerospace and Defence aerospace. MIPS comprises our Marine, Power Systems, Energy and Nuclear businesses. Our Nuclear Submarines business will be reported within Energy and Nuclear. We will continue to report the same level of financial detail for our business segments as we normally do.

Mark Morris
Chief Financial Officer

2. Consistent with past practice and IFRS accounting standards, 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 since the transition to IFRS in 2005.

3. The Group has changed its accounting policy in respect of entry fees arising from Risk and Revenue Sharing Arrangements (RRSAs) following discussions with the Conduct Committee of the Financial Reporting Council (FRC). This is covered further in note 1 to the financial statements.

RRSAs with key suppliers are a feature of our Civil aerospace business. Under these arrangements the workshare partner shares in the risks and costs of developing an engine and during the production phase, supplies components and receives a share of the programme revenues over the life of the engine programme. The share of development costs borne by the workshare partner and of the revenues it receives reflect the proportionate forecast cost of providing their parts compared to the overall forecast manufacturing cost of the engine.

The contribution to the development costs is achieved by the workshare partner performing their own development work, providing parts in the development phase and paying a non-refundable cash entry fee, such that both parties bear their proportionate share of the forecast non-recurring development costs.

Historically, we recognised the entry fee as income when received, which we believed matched it to the recognition of non-recurring development costs incurred on behalf of the workshare partner. However, this did not take account of the fact that we capitalise some of our non-recurring development costs. Therefore, where we capitalise those costs, we will now defer the equivalent portion of the entry fee received and recognise it as the related costs are amortised in the production phase. As required by Adopted IFRS, we have made this change retrospectively; the impact of the change in policy in 2012 has been to increase profit before tax by £25 million and to reduce net assets at 31 December 2011 and 2012 by £184 million and £170 million respectively. Had the policy not been amended, profit before tax in 2013 would have been £39 million higher and at 31 December 2013 net assets £208 million higher.

Adopted IFRS does not explicitly deal with payments of this nature from suppliers and so, in developing an accounting treatment for entry fees that best reflects the commercial objectives of the contractual arrangement, we have analysed key features of RRSAs in the context of relevant accounting pronouncements and have had to weigh the importance of each feature in faithfully representing the overall commercial effect. Consequently this is a judgemental area. The judgements we have taken in respect of this matter are set out in detail in note 1 to the financial statements. In summary, our 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 development costs as described above.

The FRC Conduct Committee's 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 pre-determined 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 FRC Conduct Committee has confirmed that, in view of the change to the policy and the additional disclosure we have made, it does not intend to pursue its consideration of this accounting policy further. We will keep the size of the difference under review, and do not currently expect the difference between the two approaches to become material in the foreseeable future.

We consider that the policy we have adopted best reflects the commercial effect of the agreements and is in accordance with Adopted IFRS. So far as we can tell, it is also aligned with the approach taken by others in our industry under both IFRS and US accounting standards (which we believe does not conflict with IFRS in this regard).

The impact of the different approaches on profit before tax and net assets is as follows:

	2013			2012		
	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
Previous policy	1,798	1,798	6,511	2,741	1,409	6,166
Difference	(39)	(39)	(208)	25	25	(170)
Adopted policy	1,759	1,759	6,303	2,766	1,434	5,996
Difference	(37)	(37)	(365)	(10)	(10)	(323)
Alternative policy [1]	1,722	1,722	5,938	2,756	1,424	5,673

[1] Consistent with FRC Conduct Committee's view

CHIEF FINANCIAL OFFICER'S REVIEW

Underlying revenue increased £3.3 billion to £15.5 billion, of which £2.6 billion was due to the inclusion of Rolls-Royce Power Systems AG (RRPS) from 1 January 2013. The remaining increase (six per cent) reflects a seven per cent growth in OE revenue and a four per cent increase in services revenue. Original equipment performance included growth of 21 per cent in Energy, 13 per cent in Defence aerospace and 12 per cent in Marine. Underlying services revenue continues to represent around half (47 per cent) of the Group's underlying revenue. In 2013, services revenue grew in all businesses, as the installed base of products continued to grow and the services network expanded.

Underlying profit before financing and taxation increased 22 per cent to £1.8 billion, including £190 million from the consolidation of RRPS from 1 January 2013. Excluding RRPS, the increase was due to a number of factors: increased revenue; continued strong margins in Defence aerospace and the restructured relationship with IAE.

Further discussion of trading is included in the business segment reports on pages 14 to 23.

Underlying financing costs increased 18 per cent to £72 million, including £10 million from RRPS.

Underlying taxation was £434 million, an underlying tax rate of 24.7 per cent compared with 22.1 per cent in 2012. The Group's tax payments are described on page 137.

Underlying EPS increased 10 per cent to 65.59 pence, lower than the increase in the underlying profit after tax due to the NCI share of RRPS.

Payments to shareholders: at the AGM on 1 May 2014, the directors will recommend an issue of 134 C Shares with a total nominal value of 13.4 pence for each ordinary share. Together with the interim issue on 2 January 2014 of 86 C Shares for each ordinary share with a total nominal value of 8.6 pence, this is the equivalent of a total annual payment to ordinary shareholders of 22.0 pence for each ordinary share. Further details are on page 43.

Net underlying R&D charged to the income statement increased by 18 per cent to £624 million including £174 million from RRPS, reflecting a combination of increased spend of £33 million offset by higher net capitalisation of £61 million (due to the phasing of major new programmes, in particular the certification of the Trent XWB 84k), R&D tax credits of £28 million and net deferral of RRSA entry fees of £26 million. The Group continues to expect net R&D investment to remain within four to five per cent of Group underlying revenue.

Reported profit before tax has reduced from £2,766 million to £1,759 million. In addition to the changes in underlying profit before tax described above, reported profit before tax has been affected by (i) the impact of mark-to-market adjustments on derivative contracts (£497 million reduction); (ii) the impact of consolidating RRPS (£322 million reduction, comprising the unrealised profit on reclassification to a subsidiary, the additional amortisation on recognised intangible assets and the revaluation of the put option on NCI); (iii) the net impact of disposals (£483 million reduction, disposal of RTM322 in 2013 more than offset by the restructuring of IAE in 2012); and (iv) the cost of providing discretionary pension increases (£64 million). The reported tax charge is affected by the related tax impact of these items and the reduction of tax rates in the UK. This is set out in more detail in note 2 to the financial statements.

Intangible assets (note 9) represent long-term assets of the Group. These assets increased by £121 million with additional development, certification and software costs being largely 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 2013.

Property, plant and equipment increased by £283 million due to the ongoing development and refreshment of facilities and tooling as the Group prepares for increased production volumes.

Net post-retirement scheme deficits (note 19) reduced by £100 million as a result of adopting the amendments to IAS 19. During the year, the net deficit fell by £49 million, principally due to the movements in the assumptions used to

Underlying income statement

£ million	2013	Restated* 2012	Change
Revenue	**15,505**	12,209	+27%
Civil aerospace	**6,655**	6,437	+3%
Defence aerospace	**2,591**	2,417	+7%
Marine	**2,527**	2,249	+12%
Energy	**1,048**	962	+9%
Power Systems	**2,831**	287	+886%
Intra-segment	**(147)**	(143)	
Profit before financing and taxation	**1,831**	1,495	+22%
Civil aerospace	**844**	743	+14%
Defence aerospace	**438**	395	+11%
Marine	**281**	294	-4%
Energy	**26**	19	+37%
Power Systems	**294**	109	+170%
Intra-segment	**2**	(11)	
Central costs	**(54)**	(54)	
Net financing	**(72)**	(61)	-18%
Profit before taxation	**1,759**	1,434	+23%
Taxation	**(434)**	(317)	-37%
Profit for the year	**1,325**	1,117	+19%
EPS	**65.59p**	59.59p	+10%
Payments to shareholders	**22.0p**	19.5p	+13%
Other items			
Gross R&D investment	**1,118**	919	+22%
Net R&D charged to the income statement	**624**	531	+18%

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* and the change in accounting policy for RRSAs.

Strategic report
Directors' report
Financial statements
Other information

value the underlying assets and liabilities in accordance with IAS 19. This reduction in the deficit was after agreeing to fund additional pension increases in the Rolls-Royce Pension Fund, where there is no indexation for pre-1997 service, at a cost of £64 million.

Overall funding across the schemes has improved in recent years as the Group has adopted a lower 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 11 per cent of scheme assets.

The Group's funding of its defined benefit schemes is expected to increase modestly in 2014, largely as a result of funding the discretionary benefits.

Net funds increased by £0.6 billion to £1.9 billion due in part to the £250 million proceeds received on the sale of the Group's interest in the RTM322 engine. Average net funds were £350 million.

Investments in joint ventures and associates increased by 15 per cent, largely as a result of retained profits in existing joint ventures.

Provisions largely relate to warranties and guarantees provided to secure the sale of OE and services.

Net financial assets and liabilities relate to the fair value of foreign exchange, commodity and interest rate contracts, financial RRSAs and the put option on the NCI of Rolls-Royce Power Systems Holding GmbH, set out in detail in note 17. The change largely reflects the inclusion of the put option. There is also an impact of the change in the GBP/USD exchange rate on the valuation of foreign exchange contracts and the movement in put options on NCI of £259 million.

The USD hedge book increased ten per cent to US$24.7 billion. This represents around four years of net exposure and has an average book rate of £1 to US$1.59.

Net TotalCare® assets relate to Long-Term Service Agreement (LTSA) contracts 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.

Balance sheet

£ million	2013	1 January 2013 including Power Systems	Restated* 31 December 2012
Intangible assets	**4,987**	4,866	2,901
Property, plant and equipment	**3,392**	3,109	2,564
Net post-retirement scheme deficits	**(793)**	(842)	(445)
Net working capital	**(970)**	(819)	(1,321)
Net funds	**1,939**	1,354	1,317
Provisions	**(733)**	(741)	(461)
Net financial assets and liabilities	**(1,587)**	(154)	(127)
Joint ventures and associates	**601**	523	1,800
Other net assets and liabilities	**(533)**	(515)	(232)
Net assets	**6,303**	6,781	5,996
Other items			
USD hedge book (US$ billion)	**24.7**		22.5
TotalCare assets [1]	**1,901**		1,629
TotalCare liabilities [2]	**(314)**		(317)
Net TotalCare Assets	**1,587**		1,312
Gross customer finance contingent liabilities	**356**		569
Net customer finance contingent liabilities	**59**		70

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* and the change in accounting policy for RRSAs.
[1] Included in amounts recoverable on contracts (note 13).
[2] Included in accruals and deferred income (note 16).

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 generally to customers of the Civil aerospace business and takes the form of various types of credit and asset value guarantees. These exposures produce contingent liabilities that are outlined in note 18. The contingent liabilities represent the maximum aggregate discounted gross and net exposure in respect of delivered aircraft, regardless of the point in time at which such exposures may arise.

During 2013, the Group's gross exposure reduced by £213 million to £356 million, due largely to the expiry of guarantees. On a net basis, exposures reduced by £11 million.

Segmental reporting

During 2013, we have revised the internal structure of the business to focus on (i) aerospace; and (ii) marine and industrial markets. The internal reporting structure has been developed to reflect this. Consequently, in accordance with IFRS 8 *Operating Segments*, from 1 January 2014, we will report the Group's segments as follows:

Aerospace, comprising Civil aerospace and Defence aerospace; and

Marine and Industrial Power Systems, comprising Marine, Power Systems, Energy and Nuclear.

The 2013 figures on the revised basis are included in note 26 to the financial statements.

Group 2014 guidance

For the full year 2014, we expect underlying Group revenue and profit to be flat. This reflects a significant decline in Defence revenue, as we complete the delivery phase of a number of major export programmes. Additionally, the largest part of our Marine business, Offshore, will generate lower revenue in 2013. We expect growth to resume in 2015 as Civil and Defence deliveries increase.

We expect profitability to be much stronger in the second half of 2014, reflecting the timing and mix of trading and cost reduction. To be more consistent with market practice, our cash guidance in the future will be based on free cash flow. We expect our 2014 free cash flow to be similar to 2013 (£781 million).

Additional financial information can be found on pages 137 and 138.

CIVIL AEROSPACE

We remain focused on delivering on all of our major programme commitments.

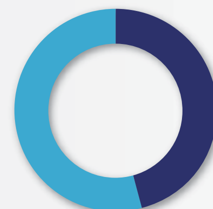
Tony Wood
President – Aerospace

OVERVIEW

Underlying revenue (£m)

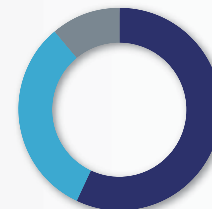
£6,655m
Underlying revenue 2013

Revenue mix 2013



- 46% OE revenue
- 54% Services revenue

Revenue by sector 2013



- 57% Wide-body
- 32% Corporate and regional
- 11% Narrow-body

Highlights

- First flight of the Airbus A350 XWB powered by Trent XWB engines
- First flight of the Boeing 787-9 powered by Trent 1000 engines
- Major new Trent orders from JAL, IAG, Lufthansa, United, Singapore and Etihad
- Delivered the 3,000th BR700 series engine

Key financial data

	2009	2010	2011	2012	**2013**
Order book £m*	47,102	48,490	51,942	49,608	**60,296**
	+8%	+3%	+7%	-4%	**+22%**
Engine deliveries*	844	846	962	668	**753**
Underlying revenue £m	4,481	4,919	5,572	6,437	**6,655**
	0%	+10%	+13%	+16%	**+3%**
Underlying OE revenue £m	1,855	1,892	2,232	2,934	**3,035**
Underlying service revenue £m	2,626	3,027	3,340	3,503	**3,620**
Underlying profit before financing £m	493	392	499	743	**844**
	-13%	-20%	+27%	+49%	**+14%**

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

Rolls-Royce powers more than 30 types of commercial aircraft and has almost 13,000 engines in service around the world.

What we do

The Civil aerospace segment is a major manufacturer of aero engines for the airliner and corporate jet markets. We have particular strengths in the wide-body market where Rolls-Royce has a 54 per cent share of aircraft on order. Demand for our products and services remains robust.

2013 financial review

The order book increased 22 per cent, including new orders of £18.9 billion (£10.3 billion in 2012). Trent engines and aftermarket services now constitute 73 per cent of the Civil aerospace order book.

Revenue increased three per cent, including three per cent growth in OE revenue. There was a 20 per cent increase in business jet engine deliveries and a small increase in Trent engines. Profit increased 14 per cent, reflecting higher volumes, the £112 million higher benefit from the restructured trading relationship with IAE and £26 million higher RRSA entry fees.

In 2014, we expect modest growth in revenue and good growth in profit.

How we are performing

The airline industry saw global passenger traffic up around five per cent in 2013. Airlines in developed markets benefited from a modest economic recovery. In many developing markets there were significant increases in traffic supported by economic growth and market liberalisation.

Civil Large Engines: Nearly 1,400 Trent 700 engines for the Airbus A330 have been delivered to date and during 2013 Airbus delivered the 1,000th aircraft. The milestone aircraft and its Trent 700 engines were accepted by Cathay Pacific, the first airline to put the Trent 700 into service in 1995.

Important milestones were achieved in two major Civil Large Engine programmes. In June, the first flight of the new Airbus A350 XWB was powered by our Trent XWB engines. Then in September, the Boeing 787-9 version of the Dreamliner took to the skies for the first time, powered by our Trent 1000 engines.

Singapore Airlines Group placed a major order with us to power 50 Boeing 787 aircraft with Trent 1000 engines.

In July, we celebrated the first delivery of two new Rolls-Royce powered aircraft to the British Airways fleet – the Airbus A380 and the Boeing 787 Dreamliner.

In September, we announced that, due to the current regulatory environment, we would not proceed with a planned joint venture with United Technologies Corporation to develop an engine to power future mid-size aircraft. Rolls-Royce remains fully committed to this important market segment and we continue to invest in technologies that will enable us to take advantage of opportunities as they arise.

The Trent XWB will enter service in 2014 with Qatar Airways. This is the best-selling Trent engine yet, with more than 1,600 engines already on order.

Significant orders for the Trent XWB came from airlines in Europe, North America, the Middle East and Asia and these included a landmark first ever engine order for Rolls-Royce from Japanese airline JAL.

Corporate and regional: In our corporate and regional engine business, we delivered the 3,000th BR700 series engine. This engine series powers the Gulfstream G500 and G550, the Bombardier Global 5000 and Global 6000 (BR710), the Boeing 717 (BR715) and the Gulfstream G650 (BR725).

The first production version of the Cessna Citation X business jet flew in August, powered by our AE 3007C engines. Deliveries of the new aircraft are due to begin in early 2014.

Services: Revenue from services for civil airliners increased by three per cent in 2013, reflecting continued growth in the fleet of widebodied engines. More than 1,100 aircraft in service are covered by TotalCare.

Some 1,500 business aircraft are covered by CorporateCare® and in 2013 more than 70 per cent of customers for new Rolls-Royce powered business jets enrolled in CorporateCare.

Future priorities and opportunities

In 2014, particular priority will be given to supporting the smooth entry into service of the Airbus A350 XWB. Rolls-Royce is the sole engine supplier for this new aircraft, and orders for the Trent XWB represent 53 per cent of the Civil aerospace order book.

Significant management attention will continue to be paid to financial performance, in particular reducing costs and improving inventory turn.

Developing new technology for future engine programmes and enhancing existing products remains a major priority.

Market outlook: We estimate that the global civil engine market will be worth approximately US$1,750 billion over the next 20 years, with US$1,050 billion being for original equipment and US$700 billion of aftermarket services. Over half of this value comprises engines for twin aisle airliners and large business jets, where Rolls-Royce is currently the number one engine supplier in terms of market share. *Our forecasts are based on our own internal forecasting tools, data from Ascend Online Fleets and airline schedules from Official Airline Guide (OAG).*

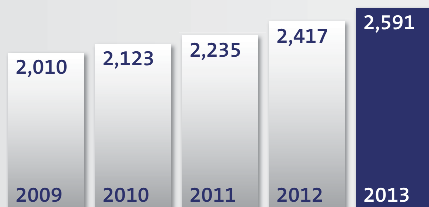
DEFENCE AEROSPACE

We are focused on managing costs to ensure we can effectively compete and win in today's challenging market.

Tom Bell
President – Defence aerospace

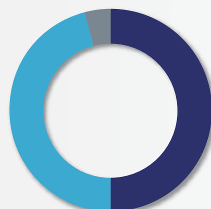
OVERVIEW

Underlying revenue (£m)



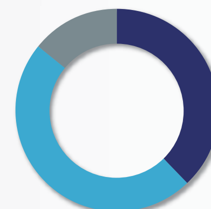
£2,591m
Underlying revenue 2013

Revenue mix 2013



- 50% OE revenue
- 46% Services revenue
- 4% Development

Revenue by sector 2013



- 38% Combat
- 48% Transport
- 14% UAV/trainer

Highlights

- TP400-powered A400M entered service
- MissionCare contract for Saudi Arabian EJ200 engines secured
- 1,500th AE 2100 engine delivered
- Upgraded AE 1107 engines for V-22 Osprey
- T56 enhancement kits gained first sales
- Delivered 40th Rolls-Royce LiftFan for F-35B Lightning II fighter programme
- RTM322 helicopter engine programme sold to Turbomeca

Key financial data

	2009	2010	2011	2012	**2013**
Order book £m	6,451	6,506	6,035	5,157	**4,071**
	+17%	+1%	-7%	-15%	**-21%**
Engine deliveries	662	710	814	864	**893**
Underlying revenue £m	2,010	2,123	2,235	2,417	**2,591**
	+19%	+6%	+5%	+8%	**+7%**
Underlying OE revenue £m	964	1,020	1,102	1,231	**1,385**
Underlying service revenue £m	1,046	1,103	1,133	1,186	**1,206**
Underlying profit before financing £m	253	309	376	395	**438**
	+13%	+22%	+22%	+5%	**+11%**

We are the second largest provider of defence aero-engine products and services globally, with around 16,000 engines in service with over 160 military customers in more than 100 countries.

What we do

Our engines power aircraft in every major market sector including transport, combat, patrol, trainers, helicopters, and unmanned aerial vehicles.

2013 financial review

The Defence order book declined 21 per cent (15 per cent decrease in 2012) reflecting continued budgetary pressures on our major customers. The net order intake of £1.6 billion was five per cent higher than the previous year. Revenue increased seven per cent, reflecting a 13 per cent increase in OE and a two per cent increase in services. Strong OE growth was driven by higher export sales, particularly of our EJ200 and Adour engine programmes. Profit increased 11 per cent due to higher volumes and lower R&D spending.

In 2014, we expect a decline in revenue and profit of between 15-20 per cent before growth resumes in 2015. This one year decline is the consequence of well publicised cuts in defence spending among major customers, and the completion of the delivery phase of a number of major export programmes. After two record years, this re-basing, supported by cost reduction programmes, will position the business well for future growth.

How we are performing

2013 was a challenging year as traditional markets continued to experience unprecedented budgetary pressures. While this environment creates risks for existing business, it also presents opportunities for us to develop innovative solutions to meet the evolving needs of our customers. Nowhere is this more evident than in the area of services where we have the opportunity to help customers manage their budgets and costs more efficiently.

We also continue to pursue new equipment sales opportunities in global markets such as Asia and the Middle East where budgets are less constrained.

MissionCare contracts worth £492 million were secured in 2013. These included the first MissionCare contract for the support of EJ200 engines in Saudi Arabia.

In order to get closer to our customers, we are expanding our presence at operational bases. During 2013, we opened a new support facility at RAF Marham in the UK and announced another at Tinker Air Force Base in the US.

In-service fleets continue to benefit from technology enhancements, with the upgraded AE 1107 now providing 17 per cent more power for the V-22 Osprey aircraft. The latest T56 enhancement kits achieved Federal Aviation Authority (FAA) certification and recorded their first sales in the US, where fuel savings in the US Air Force C-130 fleet could amount to billions of dollars.

Our leading position in transport was underpinned by the entry into service of the A400M powered by TP400 engines, broadening our portfolio in a market where the Rolls-Royce powered C-130 is the leading player. This year we delivered our 1,500th AE 2100 engine for the C-130J.

The Rolls-Royce LiftSystem® continued to perform well as the F-35B Lightning II aircraft expanded its flight test programme and deliveries to the US Marine Corps accelerated. We delivered the 40th Rolls-Royce LiftFan and the 50th 3 Bearing Swivel Module (3BSM).

In order to concentrate our resources on markets where we can add greatest value, we sold our share in the RTM322 helicopter engine programme to Turbomeca, a Safran company, in September 2013. To further improve efficiency, we have reconfigured our organisation to bring us closer to our major customers.

We expect our services business to continue to grow as we continue to provide customers with greater capability.

Future priorities and opportunities

We are focused on managing costs to ensure we maximise our ability to compete and win in an increasingly uncertain market.

Our inclusion in the Hawk Advanced Jet Training System team to pursue the US Air Force T-X training contract provides just one of several paths to growth. Customers also continue to invest in their transport aircraft fleets, where we have a strong position. Defence applications for the Trent 700 should increase as the Airbus A330 tanker aircraft is selected by more military customers. The UK's fleet of tankers continues to expand with Rolls-Royce benefiting both as the engine supplier and as an AirTanker shareholder.

Market outlook: We estimate a business opportunity over the next 20 years of US$155 billion in original equipment and US$260 billion in services. *Source: Forecast International 2014*.

MARINE

Innovation remains an important differentiator in the sector, as technology will address the future challenges related to the environment and the cost of owning and running vessels.

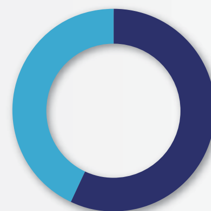
Lawrie Haynes
President – Marine and Nuclear

OVERVIEW

Underlying revenue (£m)

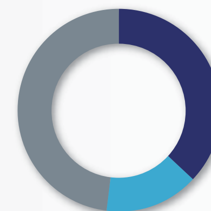
£2,527m
Underlying revenue 2013

Revenue mix 2013



57% OE revenue
43% Services revenue

Revenue by sector 2013



37% Naval
15% Merchant
48% Offshore

Highlights

- A range of world 'firsts' of LNG-powered vessel types delivered
- MT30 selected for the new UK MoD Type 26 Frigate
- £800 million contract agreed with UK MoD for provision of future nuclear submarine propulsion systems
- New UT 830 seismic survey vessel launched
- COSCO ordered new wave-piercing design of offshore vessels
- Third service centre in China opened

Key financial data

	2009	2010	2011*	2012	**2013**
Order book £m	3,526	2,977	2,737	3,954	**3,996**
	-32%	-16%	-8%	+44%	**+1%**
Underlying revenue £m	2,589	2,591	2,271	2,249	**2,527**
	+17%	+0%	-12%	-1%	**+12%**
Underlying OE revenue £m	1,804	1,719	1,322	1,288	**1,438**
Underlying service revenue £m	785	872	949	961	**1,089**
Underlying profit before financing £m	263	332	287*	294	**281**
	+44%	+26%	-14%	+2%	**-4%**

* 2011 figures restated due to transfer of Bergen to Power Systems segment.

The Marine segment has 4,000 customers and equipment installed on over 25,000 vessels worldwide, including those of 70 navies.

What we do

We are leaders in the provision and integration of complex, mission-critical systems for offshore oil and gas, merchant and naval vessels. We are located in 35 countries, and have a global service network supporting our customers' operations around the clock.

Our advanced ship designs combine the latest technologies to offer highly-efficient solutions for ship owners and operators including a range of engines using liquefied natural gas (LNG).

2013 financial review

The order book increased one per cent including new orders of £2.7 billion (£3.3 billion in 2012). In 2013, we saw stable order inflow in our Merchant and Naval businesses. This was offset by weaker order flow in Offshore, where the phasing of projects has slowed growth in some of our key products. Revenue increased 12 per cent, reflecting higher sales in both new equipment and in services. Growth was particularly strong in Offshore and in Naval, offset by further weakening in our Merchant business, which declined 11 per cent. Profit decreased four per cent as volume growth was more than offset by pricing pressure and a less favourable mix. In 2013, profitability was also offset by investments in Marine to better position the business for future growth, including higher spending on R&D and restructuring costs.

In 2014, we expect a modest decline in revenue, with a modest increase in profit. The nuclear submarine business will be reported in the Energy and Nuclear segment going forward.

How we are performing

The global shipbuilding industry has had a challenging year. Important factors driving the market continue to be ship efficiency, environmental performance and value for money.

Merchant: The adoption of LNG as a marine fuel is gaining momentum: the first LNG-powered cargo vessel of our Environship design took to the seas in May; the world's first LNG-powered cruise ferry entered service during the summer; and the world's first LNG-powered tug boat was delivered. We also won our first contract to convert a diesel-powered cargo ship to LNG. Bergen engines using LNG fuel are all provided via the Power Systems business segment.

Naval: Our MT30 gas turbine was successfully installed in the Royal Navy's new aircraft carrier, HMS Queen Elizabeth. The MT30 was also selected by BAE Systems for the UK's new Type 26 Frigate programme and has now been selected by navies in the UK, US and South Korea, across five types of ship. We delivered a new design of water jet to the US Navy's Littoral Combat Ship programme.

This year we opened a new facility in Derby, UK, to support our Submarine business. In February, we agreed an £800 million contract with the MoD for the provision of nuclear propulsion systems for the UK's submarine flotilla. A critical design gate was successfully passed by our new nuclear plant design, PWR 3.

Offshore: We delivered one of our most advanced vessels to date, when a UT 830 seismic survey ship was launched. It features a wealth of Rolls-Royce equipment integrated into our own vessel design. It is now at work identifying oil and gas reserves around the world.

Our wave-piercing hull design was chosen for the first time in Asia, when Chinese customer COSCO announced an order for two UT vessels, with options for four more. These will feature a range of Rolls-Royce equipment, and include MTU diesel gensets from our Rolls-Royce Power Systems AG subsidiary. Several contracts were won to supply our largest azimuth thrusters for drill ships.

We enhanced our technology portfolio through the acquisition of a Norwegian company, SmartMotor AS, a leader in permanent magnet technology.

Services: We offer customers a global service capability through a network of 37 workshops in 28 countries. With more than 1,100 service engineers, we provide round-the-clock support wherever our customers need it and offer not only repair and overhaul but also a growing number of vessel upgrades to improve efficiency. We also train our customers in the operation of our equipment in our training centres in Norway, Singapore and Brazil. This year, we opened our third workshop in southern China.

Future priorities and opportunities

The key priorities for the Marine segment are to increase our competitiveness in a challenging market and continue to develop innovative technologies.

We will continue to develop the synergies between the Marine and Power Systems segments. We are working with a number of oil majors, in developing the availability of LNG. The aftermarket offers growth opportunities as we continue to utilise our growing global network of service engineers and workshops. In Submarines, our focus is on maintaining customer confidence by achieving our savings commitment to the MoD through increased operational efficiency.

Market outlook: We see a business opportunity over the next 20 years of US$270 billion for original equipment and US$125 billion for services (not including nuclear submarine business). *Based on our own forecasting tools.*

ENERGY

We are capitalising on oil and gas demand. We will also grow our Civil Nuclear services globally and support the UK new build programme.

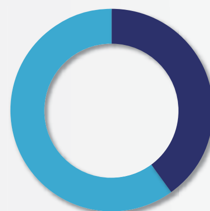
Andrew Heath
President – Energy

OVERVIEW

Underlying revenue (£m)

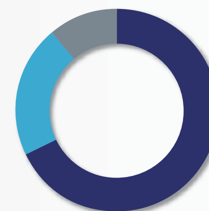
£1,048m
Underlying revenue 2013

Revenue mix 2013



- 40% OE revenue
- 60% Services revenue

Revenue by market sector 2013



- 68% Oil and gas
- 21% Power generation
- 11% Civil Nuclear/other

Highlights

- 33 RB211s ordered for oil and gas applications
- Major service contract secured with Petrobras
- New Santa Cruz, Brazil, assembly plant operational
- Signed tripartite agreement with Rosatom and Fortum to assess nuclear reactor design for UK new build
- Renewed agreement with Westinghouse to provide nuclear inspection services in the US

Key financial data

	2009	2010	2011*	2012	2013
Order book £m	1,262	1,180	1,420	1,290	**1,469**
	+1%	-6%	+20%	-9%	**+14%**
Engine deliveries	87	95	48	49	**56**
Underlying revenue £m	1,028	1,233	1,083	962	**1,048**
	+36%	+20%	-12%	-11%	**+9%**
Underlying OE revenue £m	558	691	527	344	**415**
Underlying service revenue £m	470	542	556	618	**633**
Underlying profit before financing £m	24	27	16	19	**26**
	+1300%	+13%	-41%	+19%	**+37%**

* 2011 figures restated due to transfer of Bergen to Power Systems segment.

Energy has sold 4,600 gas turbines with 180 million operating hours recorded.

Rolls-Royce has over 50 years of experience in the nuclear industry.

What we do

Our Energy segment supplies customers with aero-derivative gas turbines, compressors and related services.

In Civil Nuclear, we provide products and services spanning the nuclear reactor life-cycle from concept design and installation to obsolescence management and plant life extension. We have a strong position in nuclear instrumentation and control systems.

2013 financial review

The order book increased by 14 per cent with new orders of £1.1 billion (£0.8 billion in 2012). The business saw a strong recovery in order intake in oil and gas. Power generation markets remain suppressed. In Civil Nuclear, we continue to extend the suite of products and services that we offer to nuclear utilities to enable them to achieve safe, efficient and reliable lifetime reactor operations. Revenue increased nine per cent, driven by higher OE volumes in our oil and gas business. Profit increased by £7 million, reflecting higher volumes, partially offset by strong pricing pressure and continued investment in our Civil Nuclear business. We continue to work to improve the financial performance of the business. In 2014, Energy will include nuclear submarines to form our Energy and Nuclear business. We expect good growth in revenue and profit, with further improvement in the return on sales.

How we are performing

Oil and gas: In total, 33 RB211 gas turbines were ordered for oil and gas applications, 22 of which were for pipeline compression projects. This includes a US$175 million contract from Asia Gas Pipeline for 12 units.

Our new purpose-built packaging, assembly and test facility in Santa Cruz, Brazil, became operational and the first units were delivered to Petrobras for use in its deepwater offshore production activities.

Power generation: Demand continued to be subdued for new power generation capacity in mature economies. Seven Trent 60 units were ordered, including five for the SARB offshore oilfield project in the UAE.

We released enhanced power ratings for the Trent 60 gas turbine, consolidating its position as the most powerful aero derivative available.

Services: We continue to strengthen both our aftermarket products and services capability as well as our penetration of the installed fleet, resulting in a six per cent year-on-year increase in aftermarket revenue.

Currently 24 per cent of the core engine fleet is under long-term service agreements. During the year we received several new major service contracts including a US$138 million five-year contract from Petrobras to support 15 of its RB211 industrial gas turbine power generation units installed on four oil platforms operating in the Campos Basin.

Civil Nuclear: We strengthened our strategic relationships during the year with AREVA, Westinghouse, Hitachi, EDF and Rosatom.

Our acquisition of PKMJ Technical Services in the US means we now provide services to every nuclear utility in the US and Canada.

We continued to deliver the instrumentation and control (I&C) upgrade for EDF's fleet of 1,300MW nuclear reactors in France and provided I&C systems and components for seven new nuclear reactors currently under construction in China.

Future priorities and opportunities

Our focus is on growing our market position in oil and gas, including opportunities in pipelines and LNG. In power generation, we will benefit from any recovery in industrial demand for electricity.

In Civil Nuclear our priorities will continue to be satisfying our customers, winning new orders and high-quality delivery. Improving operational efficiency will be a key feature for the Nuclear business during 2014.

We will assess potential investments in high-value manufacturing in order to contribute positively to a successful new build programme for the UK.

In international markets, we will extend the suite of products and services that we offer to nuclear utilities to enable them to achieve safe, efficient and reliable lifetime nuclear reactor operations.

Market outlook: In the oil and gas, and power generation sectors, the Group's 20-year forecast values demand for total aero-derivative gas turbine and compressor systems at more than US$60 billion and associated services at around US$60 billion. *Sources: McCoy Power reports, LEK Consulting, Booz & Co., IEA, Infield Systems and our own forecasting tools.* We estimate a demand for nuclear mission-critical equipment, systems, engineering and support services of US$610 billion over the next 20 years. *Based on nuclear capacity forecasts from the International Energy Agency, the World Nuclear Association, the International Atomic Energy Agency and the US Department of Energy.*

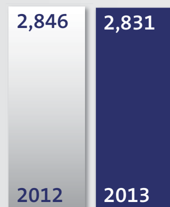
POWER SYSTEMS

2013 proved a challenging year. However, in 2014 we expect most markets to stabilise.

John Paterson
President – Marine and Industrial Power Systems

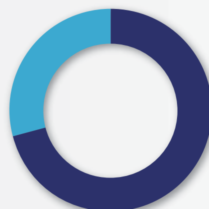
OVERVIEW

Underlying revenue (£m)



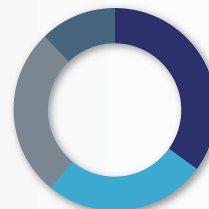
£2,831m
Underlying revenue 2013

Revenue mix 2013



- 71% OE revenue
- 29% Services revenue

Revenue by market sector 2013



- 35% Marine
- 26% Industrial
- 27% Energy
- 12% Defence and other

Highlights

- MTU Powerpacks ordered for UK Intercity Express Programme
- Fjord Line ordered Bergen engines for cruise ferries
- Upgraded Series 1163 engines introduced
- UK MoD selects MTU gensets alongside MT30 gas turbine
- Polish partnership to be created to supply and maintain cogeneration plants
- Mining trucks powered by MTU delivered to Rio Tinto in Australia

Key financial data

	2012	2013	Change
Order book £m	1,823	**1,927**	+5.7%
Underlying revenue £m	2,846	**2,831**	-0.5%
Underlying OE revenue £m	1,938	**2,004**	+3.4%
Underlying services revenue £m	908	**827**	-8.9%
Underlying profit before financing £m	293	**294**	+0.3%

The table above shows a trading comparison as if both Tognum and Bergen Engines had been fully consolidated in 2012 as well as in 2013.

Rolls-Royce and Daimler AG each has a 50 per cent shareholding in Rolls-Royce Power Systems Holding GmbH.

Power Systems is based in Friedrichshafen in Southern Germany and, together with its worldwide subsidiaries, employs around 11,000 people. It specialises in reciprocating engines, propulsion systems and distributed energy systems. The company previously operated under the name of Tognum AG. In 2013, Bergen Engines AS, including its subsidiaries, was contributed to the business.

What we do

The product portfolio includes MTU-brand high-speed engines and propulsion systems for ships, for heavy land, rail and defence vehicles, and for the oil and gas industry. Under the MTU Onsite Energy brand, the company markets diesel and gas gensets for applications such as emergency, base load, peak load or cogeneration. Bergen Engines AS manufactures medium-speed engines for marine and power generation applications. L'Orange completes the portfolio, producing fuel injection systems for large engines.

2013 financial review

The order book increased 6 per cent, with new orders of £2.7 billion (£2.8 billion in 2012). The final quarter of 2013 saw strong sales, driven by the pre-purchase of engines for industrial, including agricultural, applications ahead of the introduction of tighter environmental standards in Europe. Marine revenue is well supported by demand from navies in Asia and the US. In defence, major programmes to power military tanks provide stability despite continued pressure on government spending. Revenue decreased 0.5 per cent with good growth in the Marine and Industrial divisions offset by lower revenue in oil and gas, medium-speed engines and lower aftermarket sales. Profit increased 0.3 per cent, reflecting a strong second half.

In 2014, we expect modest growth in revenue and good growth in profit driven by growth in marine and land power systems markets.

How we are performing

2013 proved a challenging year. Headwinds confronting the business included the Eurozone crisis, US fiscal challenges and slowing of growth in emerging countries. General nervousness about the global economic environment led to constrained order activity within the market.

Despite these adverse market conditions, a number of significant orders and contracts were achieved.

As outlined in the Marine segment review, Power Systems also benefited from contracts awarded by Chinese customer COSCO and from the UK MoD for the generator sets of the Royal Navy's future Type 26 Frigate. The Type 26 propulsion system will consist of a combination of four MTU diesel gensets and a Rolls-Royce MT30 gas turbine. These examples highlight the synergies and benefits of complementary product portfolios.

MTU introduced the upgraded Series 1163 marine engines for IMO Tier II and IMO Tier III emission standards. These are cleaner and more fuel-efficient than the previous generation and offer a better power-to-weight ratio.

For the British Intercity Express Programme, MTU received orders of rail Powerpacks with Series 1600 engines. The Powerpacks will drive Hitachi's future high-speed trains which are scheduled to go into service from 2017 on Great Western Main Line and East Coast Main Line routes. Twenty locomotives built by Chinese manufacturer, Dalian Locomotive & Rolling Stock and powered by MTU engines went into service in Argentina.

China-based Xiangtan Electric Manufacturing Corporation shipped its first ever export of mine dump trucks to the Pilbara mine site in Australia for Rio Tinto. Each of the 230 metric-ton trucks is powered by an MTU mining engine.

The Fjord Line shipping company ordered Bergen gas-powered engines. Its Stavangerfjord and Bergensfjord cruise ferries, both 170 metres long, are each to be equipped with four Bergen B-gas engines. The engines ensure that these ships already meet future IMO Tier III limits as well as satisfying mandatory EU regulations projected for 2015, for sulphur emissions from ferries.

In addition to these contract wins, we continue to build capacity through joint ventures and partnerships. L'Orange has established a consortium with Hoerbiger, for the supply of equipment for large-scale diesel and dual-fuel engines for the Asian market. Onsite Energy and regional Polish energy supplier Kogeneracja Zachód intend to form a partnership for the supply and maintenance of cogeneration plants. Over the coming years, both companies plan on working exclusively with each other to supply small- to medium-sized Polish cities with environmentally-friendly energy from CHP plants.

Future priorities and opportunities

Our long-term growth relies on five pillars: power; propulsion; services; regional expansion and, the product portfolio.

In 2014, we expect most markets to stabilise. although some segments are expected to remain difficult. This leads us to expect continued volatility in revenues. Overall we expect to see a positive performance primarily driven by marine applications.

We will invest in future technologies to maintain our technological leadership. We are configuring our different engine series to meet tougher emission standards. At the same time we will improve efficiency and keep a focus on costs and cash in all other areas.

Market outlook: We estimate the total market opportunity for high-speed engine original equipment over the next ten years to be €280 billion. *The forecast data is taken from a range of sources including: Global Insight; Oxford Economics, Diesel and Gas Turbine Worldwide, Clarkson Research and our own internal forecasting tools.*

ENGINEERING AND TECHNOLOGY

We continued our commitment to recruit and develop the very best engineers and scientists.

Colin Smith CBE
Director – Engineering and Technology

In 2013, we invested £1,118 million in gross research and development (R&D) of which £746 million was funded by the Group, prior to receipts from risk and revenue sharing arrangements.

We continually pursue innovation that will improve the performance of our power systems and benefit our customers.

We have developed and actively deployed a new innovation portal to improve the exchange of ideas around the world as we invest to improve the efficiency of our global R&D footprint.

People

We have an engineering resource inside the Group of around 16,600 engineers. Many work as integrated teams across borders on our major programmes and a number of our top engineers, or Rolls-Royce Fellows, are recognised as world-renowned experts in their fields.

We continued our commitment to recruit and develop the very best engineers and scientists, and the first cohort of our evolving internal Specialist Academy has graduated in October 2013. The Academy has been designed for technologists who have the potential to join the Rolls-Royce Fellowship at the very top of our specialist career ladder.

Research and technology

World-class technology gives us competitive product performance. We generate the largest number of patents of any UK company, 549 new patent applications were approved for filing in 2013 (including Rolls-Royce Power Systems AG). To further expand our capabilities, we acquired Hyper-Therm HTC, a US-based specialist in ceramic materials; and SmartMotor, a world leader in permanent-magnet machines and drives technology, headquartered in Norway. In addition, we acquired from GKN the 49 per cent of Composite Technology and Applications Limited (CTAL) that we did not already own, giving us 100 per cent ownership. CTAL is engaged in the development of composite fan blades and containment cases for the next generation of advanced turbofan engines.

In 2013, we further increased our investment in early-stage research and technology to about 20 per cent of the net R&D spend. We have good visibility of stable, long-term government match-funding for research investments in aerospace technologies following the creation in the UK of the Aerospace Technology Institute, and in the EU through the Clean Sky 2 Joint Technology Initiative in Horizon 2020 and continuous German support via Luftfahrtforschungsprogramm (LuFo) V.

University Technology Centres

In addition to our significant in-house R&D capability, we pursue advanced technologies via a global network of 29 University Technology Centre (UTC) partnerships. Each centre is part-funded by the Group and works closely with our engineering teams, undertaking specialist work led by world-class academics. In 2013, Nanyang Technological University joined this network with the launch of the Rolls-Royce@NTU Corporate Lab, a joint investment of SGD$75 million (£38.5 million) between Rolls-Royce, Nanyang University and the National Research Foundation (NRF) of Singapore.

Our model of developing technology through collaboration with academia and other partners was recognised by the German Fraunhofer Institute for Production Technology which benchmarked 160 European companies: Rolls-Royce was one of five companies to receive the 'Successful Practices' award in technology management in 2013.

Research and development

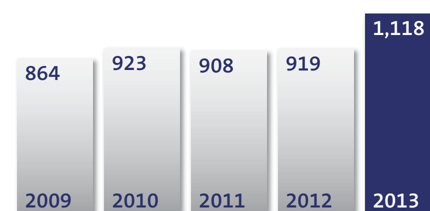
Flight test results have shown the Trent XWB to be the world's most efficient large, civil, aero engine.

The Trent 1000 Package C received EASA certification in September and a few weeks later powered the newest version of the Dreamliner, the Boeing 787-9 on its first flight from Seattle, USA.

The Joint Strike Fighter F-35B, with short take -off and vertical landing (STOVL) capability provided by the Rolls-Royce LiftSystem®, successfully completed its second set of carrier trials aboard the USS Wasp in August 2013. In September, the T56 engine Series 3.5 technology enhancement program received FAA approval and has now been chosen to power the 'Hurricane Hunter' aircraft of the US National Oceanic and Atmospheric Administration.

In 2013, we received the Green Ship Technology Award for our Environship concept – a design for cargo ships that reduces CO_2 emissions by up to 40 per cent compared to similar diesel powered vessels.

Gross research and development (£m)



OPERATIONS

Record levels of investment continue to drive improvements in product and operational performance.

Alain Michaelis
Operations Director

Our teams around the world focus on improvement in all the classical operational metrics – safety, quality, cost, on-time delivery, inventory – while at the same time ensuring that the next generation of advanced products and processes are successfully industrialised.

Our operations employ 25,000 people in 17 countries at 85 Rolls-Royce facilities. In addition, 33 joint venture facilities, seven manufacturing technology partnerships and over 70 significant suppliers help us to meet customer demand.

Developing our capacity

This year we have extended our own capacity and capability. This included our new turbine blade factory in Rotherham, UK and our new 17,000 square metre, state-of-the-art discs manufacturing facility in Washington, UK, that has now started production. When fully operational later this year, it will have the capacity to manufacture over 2,000 fan and turbine discs annually. We are also taking steps to adjust capacity where market segments are contracting or demanding a lower price point. Although our diverse portfolio helps us balance growing and shrinking segments, we do expect an ongoing need to adjust capacity through plant renewal and closures.

Advanced manufacturing

We apply advanced technologies, methods and processes to deliver 'best in class' manufacturing performance through our Rolls-Royce Production System and the Advanced Manufacturing network, which has developed over the past five years.

The advanced centres in this network bring together university, government and industrial partners to provide a realistic testing ground for new industrial techniques that improve yield and reduce costs. These have proved to be successful both for Rolls-Royce and our supplier partners.

The Advanced Forming Research Centre in Glasgow, UK, the National Composites Centre in Bristol, UK and the Manufacturing Technology Centre in Coventry, UK, are expanding their facilities and the new Commonwealth Centre for Advanced Manufacturing in Richmond, USA, is now fully operational.

Our future Advanced Remanufacturing and Technology Research Centre in Singapore and High Temperature Components Centre of Excellence in the UK will ensure we lead in high-performance, low-emission turbine technology.

Our processes will increasingly include powder-based manufacturing, additive layer manufacturing technologies and ultra-high temperature materials. 'Knowledge-based manufacturing' is another developing area. Here, we will use dynamic computer models to design and verify processes. These approaches will increase design flexibility, speed of manufacture and performance.

Suppliers

Strong relationships with our suppliers are critical to our performance. We work closely to align our strategies as well as assessing performance through our Supplier Advanced Business Relationship (SABRE) requirements.

Rolls-Royce has taken a leading role in the establishment of the Aerospace Engine Supplier Quality Committee. Through this body, gas turbine engine makers and their suppliers – with input from regulatory agencies – aim to agree a set of common industry-wide standards. These will help remove variability and waste, enabling the aerospace supply chain to be leaner and more competitive.

To support UK suppliers in the global aerospace market, Rolls-Royce is sponsoring the UK Government-backed Sharing in Growth programme. It is a £110 million programme of intensive supplier development training and is expected to secure at least 5,000 high-value manufacturing jobs in aerospace. We are also supporting a £76 million Sharing in Growth programme in the nuclear industry.

We continue to seek new capabilities in emerging markets across the world through our supplier development groups. These help drive competition with our existing internal plants and suppliers, and also allow us to develop new markets – Brazil (Energy) and China (Marine) being good examples. We expect the proportion of our supplier spend in emerging markets to increase.

Information technology

In 2013, we invested over £100 million in IT, continuing with the modernisation of our IT infrastructure and also launching our Shop Floor IT modernisation programme. We have launched an Integrated Production Systems programme to address the need for simplified, globally scalable and secure systems. The programme will improve delivery to the customer whilst improving efficiency and reducing operating costs. We are also investing in our customer systems to improve the customer experience through the use of portals and digital workflow.

£687 million

Expenditure in 2013 on property, plant and equipment.

We are delivering customer and business benefits as we continue to invest at record levels and transform our industrial infrastructure.

SUSTAINABILITY

Our strategy is to create a sustainable business, through our focus on customer, innovation and profitable growth. Our commitment is to continually improve the environmental performance of our products and services. With our customer at its heart, our strategy will deliver 'Better power, a Better future and a Better business'.

Sustainability

Better power
Helping our customers do more using less.

Better future
We are committed to innovation: powering better, cleaner, economic growth that creates value for customers, employees, investors, suppliers and wider society.

Better business
We invest in technology, people and ideas to improve all aspects of our performance and to drive profitable growth. Building on today's achievements to meet the business challenges of the future.

Better power

Helping our customers do more using less.

Each of our customer-facing segments provides services and customer operation solutions to improve the effectiveness of our equipment. In each of our markets, we are focused on reducing fuel consumption and emission levels. Find out more by visiting www.rolls-royce.com.

Improving the environmental performance of our products

Rolls-Royce has a strong track record of reducing emissions through significant investment in technology. In 2013, we invested £1,118 million in R&D, of which around two-thirds is aimed at reducing the environmental impact of our products and services.

In Civil aerospace, The Advisory Council for Aviation Research and Innovation in Europe (ACARE) has set challenging goals for aviation to meet by 2050. These include reducing aircraft CO_2 emissions by 75 per cent (per passenger kilometre); reducing noise by 65 per cent; and reducing oxides of nitrogen (NO_x) by 90 per cent, all relative to a typical new aircraft produced in 2000.

The Trent XWB is the world's most efficient turbofan aero engine flying today. The low noise technology built into the Trent 1000 makes it the quietest engine on the Boeing 787 Dreamliner, which itself has half the noise level of the corresponding previous generation aircraft.

In Defence aerospace, we have worked with the US Air Force to complete the final testing of the Series 3.5 enhancement of the T56 engine, providing fuel savings of up to ten per cent in addition to improved performance and reliability.

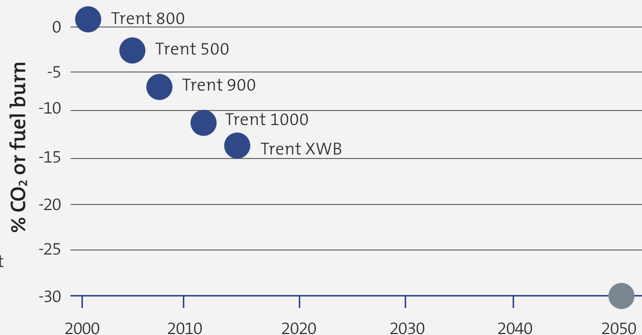
In Marine, our Environship design together with our advanced propulsion systems can reduce CO_2 emissions by up to 40 per cent compared to conventional diesel-powered vessels. The Environship concept was awarded the Green Ship Technology Award this year.

Our Civil Nuclear portfolio makes a significant contribution to future low carbon electricity generation. We are strongly positioned to support growth in this industry.

CO_2 (Engine)

ACARE Target:
75% overall reduction in CO_2 per passenger kilometre 30% engine contribution (Rolls-Royce engine long-term goals).

Trent family
ACARE flightpath 2050 target



Carbon Disclosure Project
The Rolls-Royce 2013 carbon disclosure score of 85 is our highest score to date. This, along with our performance band 'B' rating, demonstrates our commitment to continually improving our environmental performance.

MEMBER OF
Dow Jones Sustainability Indices
In Collaboration with RobecoSAM

Dow Jones Sustainability Index
Rolls-Royce has been listed for the 12th consecutive year. We achieved an overall score of 67 in 2013, above average in all areas within the aviation and defence sector.

Left to right: Sarah Armstrong (Rolls-Royce), Ella Jakubowska and Sir Trevor McDonald at the TARGETjobs Female Undergraduate of the Year 2013 awards.

Better future

We are committed to innovation: powering better, cleaner economic growth that creates value for customers, employees, investors, suppliers and wider society.

Our people

Our culture fosters innovation, collaboration and continuous improvement. Developing strong people management and leadership skills alongside our technical expertise helps ensure that our employees are engaged and understand the wider role they play in the Group's success. We work actively to attract young people to Science, Technology, Engineering and Mathematics (STEM) subjects.

Content and figures do not include Rolls-Royce Power Systems AG, unless indicated.

In 2013, we recruited 2,530 experienced professionals to support the growth of our business. Our graduate programme is expanding, we recruited 379 graduates through our global programmes, an increase of 21 per cent from 2012. Our graduate population is becoming more representative of the diverse and global company we are working in, with this year's graduates representing 32 nationalities and coming from 97 universities. Our apprenticeship programme has been running for over 100 years. At any one time we have over 1,000 apprentices around the world.

Average number of employees	2012	2013*
By region		
United Kingdom	22,800	**24,800**
Rest of the world	20,000	**30,400**
Total	42,800	**55,200**
By sector		
Civil aerospace	21,500	**23,400**
Defence aerospace	7,800	**7,900**
Marine	8,800	**9,200**
Energy	3,700	**4,000**
Power Systems	1,000	**10,700**
Total	42,800	**55,200**

* Includes Rolls-Royce Power Systems AG.

We retained our title as 'The most popular graduate recruiter – Engineering, Designs and Manufacture' in the UK TARGETjobs Awards for the fourth year running. Our position has also risen in the 'Times Top 100 Graduate Employers' rankings and in the 'Guardian UK 300' survey.

Employee involvement

Employee engagement is critical to our success. We use a variety of channels to communicate with our employees. We have well-established frameworks for managing employee and trade union/employee representative participation which include formal information and consultation arrangements. Our incentive schemes and all-employee share plans make sure that every employee has the opportunity to share in our success. We encourage our employees to improve their knowledge and enhance their careers by providing meaningful training and development. In 2013, we supported 49,600 employees, customers and suppliers through our learning management system. Learning investment for 2013 was £39.7 million and a total of 272,000 training course completions were delivered during the year.

Human rights

Our human rights policy sets out our commitment to respect the human rights of our employees through core labour standards regarding employee involvement, diversity and equality, pay and benefits, working hours, forced labour and child labour. We set equivalent standards for our supply chain through our Supplier Code of Conduct.

Diversity and inclusion

A diverse workforce will help ensure our continued success as a global business and contribute towards a better future. We continue to face challenges in increasing diversity across the organisation and are working with our leadership teams to raise awareness of the need for change. Over recent years we have seen increased levels of diversity in both our early career pipeline and high potential pool, with females making up 26 per cent of our UK graduate intake in 2013 and 29 per cent of our graduate intake into countries outside the UK. Females are 24 per cent of our high potential population as compared to 15 per cent of our general population.

This year, Rolls-Royce sponsored the UK Female Undergraduate of the Year 2013 awards. The winner, Ella Jakubowska, accepted a place on our Customer Management Graduate Programme.

Headcount by gender*	Full-time equivalents at 31 December 2013
Male	46,975
Female	8,225
Total	**55,200**

* Includes Rolls-Royce Power Systems AG.

Senior managers by gender*	
Male	188
Female	11

* Includes Rolls-Royce Power Systems AG.

Board directors by gender	
Male	10
Female	2

We give full and fair consideration to applications for employment made by disabled people and also support employees who become disabled during employment, helping them make the best use of their skills and potential.

SUSTAINABILITY

Community investment

We are committed to conducting business to the highest standards and building positive relationships within the communities where we operate. In 2013, our total contribution was £8 million. We actively work with schools and universities to increase interest and encourage diversity amongst those taking STEM subjects, and to broaden the career aspirations of individuals from under-represented groups.

Working with governments

National governments are often our customers and we aim to build strategic relationships with governments in our key markets.

National governments and the EU also set the legislative and policy framework for doing business and they are a potential source of funding and support for research and technology (R&T), R&D, manufacturing, education and training initiatives, as well as for certain capital projects.

We engage in dialogue to align our own business needs with the political, social, economic, industrial and commercial requirements of national governments and the EU.

In 2013, we have worked with the UK Government on the development and implementation of the Aerospace Growth Partnership; in EU Affairs, we have focused on the Horizon 2020 EU funding programme; and in North America we focused on defence appropriations and policy issues.

Globally, we are members of national industry bodies and trade associations that represent our sector and Group interests. In the UK we are members of the Confederation of British Industry (CBI) and AeroSpace, Defence and Security (ADS); in North America the Aerospace Industries Association, Organisation for International Investment and the US Chamber of Commerce; in Brussels on EU affairs we belong to The AeroSpace and Defence Industries Association of Europe (ASD) and EU Turbines, amongst others; and globally we are members of local Chambers of Commerce in our countries of operation.

Rolls-Royce does not make corporate contributions or donations to political parties or to any organisations, think-tanks, academic institutions or charities closely associated to a political party or cause, as outlined in our Global Code of Conduct.

Better business

We invest in technology, people and ideas to improve all aspects of our performance and to drive profitable growth. Building on today's achievements to meet the business challenges of the future.

Ethics

We have made a strong commitment to improving our ethical performance in line with building a better business.

You will have read in the Chief Executive's review on pages 6 and 7, about Lord Gold's review, the SFO investigation, and the publication of our new Global Code of Conduct. We have also introduced a confidential Ethics Line which is available 24 hours a day, where individuals can ask questions or raise concerns. You can read more on these topics in the ethics committee report on pages 49 and 50. We are also refreshing our Supplier Code of Conduct for deployment in 2014. Compliance with the code will continue to be monitored through our regular supplier audits.

The Group continues to be an active participant in ethical initiatives of the European and US aerospace and defence business sectors. We are a signatory to the 'Common Industry Standards' which were drawn up by ASD and aim to promote and enhance integrity practices among its members.

The Group is also a member of the International Forum on Business Ethical Conduct's (IFBEC) Steering Committee. This organisation includes leading US and European companies in the aerospace and defence sectors and aims to promote responsible and ethical business behaviours through the Global Principles of Business Ethics.

Improving operational performance

Improving the environmental performance of our operations contributes to profitable growth. We have set a three-year target to reduce energy consumption by ten per cent by the end of 2015, with 2012 as the baseline year excluding product test and development and normalised by revenue.

Our energy use increased slightly in 2013, reflecting our increased levels of activity, but we are on track to reduce our overall emissions of greenhouse gases. We continue to invest in improvements to our facilities. Our total spend in 2013 amounted to almost £3 million on projects, including upgrades to compressed air systems, lighting systems and controls, and additional energy monitoring capability in our plants and offices. We are seeking to make wider use of more sustainable energy sources, where cost effective and practical to do so.

Our business segments have third-party accredited certification to the environmental management systems standard ISO 14001. In addition, we have maintained our focus on requiring key suppliers to become certified to ISO 14001. For further information on how we work with suppliers please visit www.rolls-royce.com/sustainability.

UK Prime Minister David Cameron meets Colin Smith CBE, Director – Engineering and Technology, and some of our apprentices at the Apprentice Academy, Derby, UK.

We are helping to lead the way on REACH (Registration, Evaluation and Authorisation of Chemicals) regulations and have submitted the first ever REACH Authorisation application. This is in the final stages of the approval process with the European Chemicals Agency and European Commission. Additionally, we continue to work with our suppliers to assist them in meeting their own obligations with a focus on the managed reduction and phase out of the use of targeted substances that are hazardous to health and dangerous to the environment.

Through our active participation in the International Aerospace Environment Group we are also helping to introduce new standards to facilitate efficient data sharing across the aerospace supply chain. This focuses on the uses of hazardous substances (in both manufacturing processes and included in our products) and related substitution and phase out programmes.

Greenhouse gas emissions

In 2013, our total greenhouse gas (GHG) emissions from our facilities, processes, product test and development was 520 kilotonnes carbon dioxide equivalent (ktCO₂e). This represents a reduction of nine per cent compared with 572 ktCO₂e in 2009 (see table). This reduction has been achieved, despite a growth in our global facilities footprint. We have introduced a longer term GHG target over ten years, aimed at reducing emissions by 17 per cent by the end of 2022 (baselined at 2012), excluding product test and development.

The figures in the table do not include emissions associated with Rolls-Royce Power Systems AG. We expect to integrate this subsidiary into our reporting process during 2014. Power generation relates to the operation of commercial gas-fired power stations.

Total GHG emissions ($ktCO_2e$)	2009	2010	2011	2012	**2013**
Direct emissions – facilities, processes, product test and development (Scope 1)	215	236	229	213	**218**
Indirect emissions – facilities, processes, product test and development (Scope 2)	357	365	346	337	**302**
Total for facilities, processes, product test and development	572	601	575	550	**520**
Direct emissions – power generation to grid (Scope 1)					**56**
Indirect emissions – power generation to grid (Scope 2)					**3**
Total for facilities, processes, product test and development, and power generation to grid					**579**
Normalised (by revenue) emissions ratio for facilities, processes, product test and development ($ktCO_2e$/£m)					**0.04**

We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) data gathered to fulfil our requirements under the Carbon Reduction Commitment (CRC) Energy Efficiency scheme, and the UK Government's GHG reporting guidance as the basis of our methodology and source of emissions factors for Company reporting for 2013. Further details on our methodology can be found within our 'Basis of Reporting', available at www.rolls-royce.com/sustainability.

Safety

We are committed to continually improving the standards of health and safety in the workplace. We have steadily improved performance over previous years. In 2013, there were no fatalities or significant injuries and we achieved a 17 per cent reduction in the Total Reportable Injury (TRI) rate from 0.54 in 2012 to 0.45 TRIs per 100 employees. Over the longer term, we have reduced the TRI rate by 37 per cent since 2009. We have set a new target to reduce TRIs per 100 employees by 15 per cent by 2015 (baselined at 2012).

We continue to analyse high-potential incidents and each of them is investigated at business segment level, with some also included in Group level assessment. The number of high-potential incidents has declined slightly from previous years and the number of 'near misses' reported has significantly increased. The increased level of near miss reporting reflects greater risk awareness, overall proactive reporting, risk based investigation and other improvements. These contribute to both TRI and high potential incident reductions.

Throughout the year, we continued several global safety improvement plans. The Electrical and Process Safety programmes included site reviews and training and tools for ensuring efficient implementation of control measures. Reviews have also been carried out on the use and control of exposure to a number of chemicals newly-regulated under the REACH regulations. These reviews confirmed that our controls are suitable and that they ensure occupational exposures and releases to the environment are within limits set by the new requirements.

Health

The current incidence of occupational illness stands at 0.86 cases per 1,000 employees. The leading causes of illness are noise-induced hearing loss, work-related upper limb disorders and stress. This reflects our global health risk profile and provides the focus for our health improvement activities.

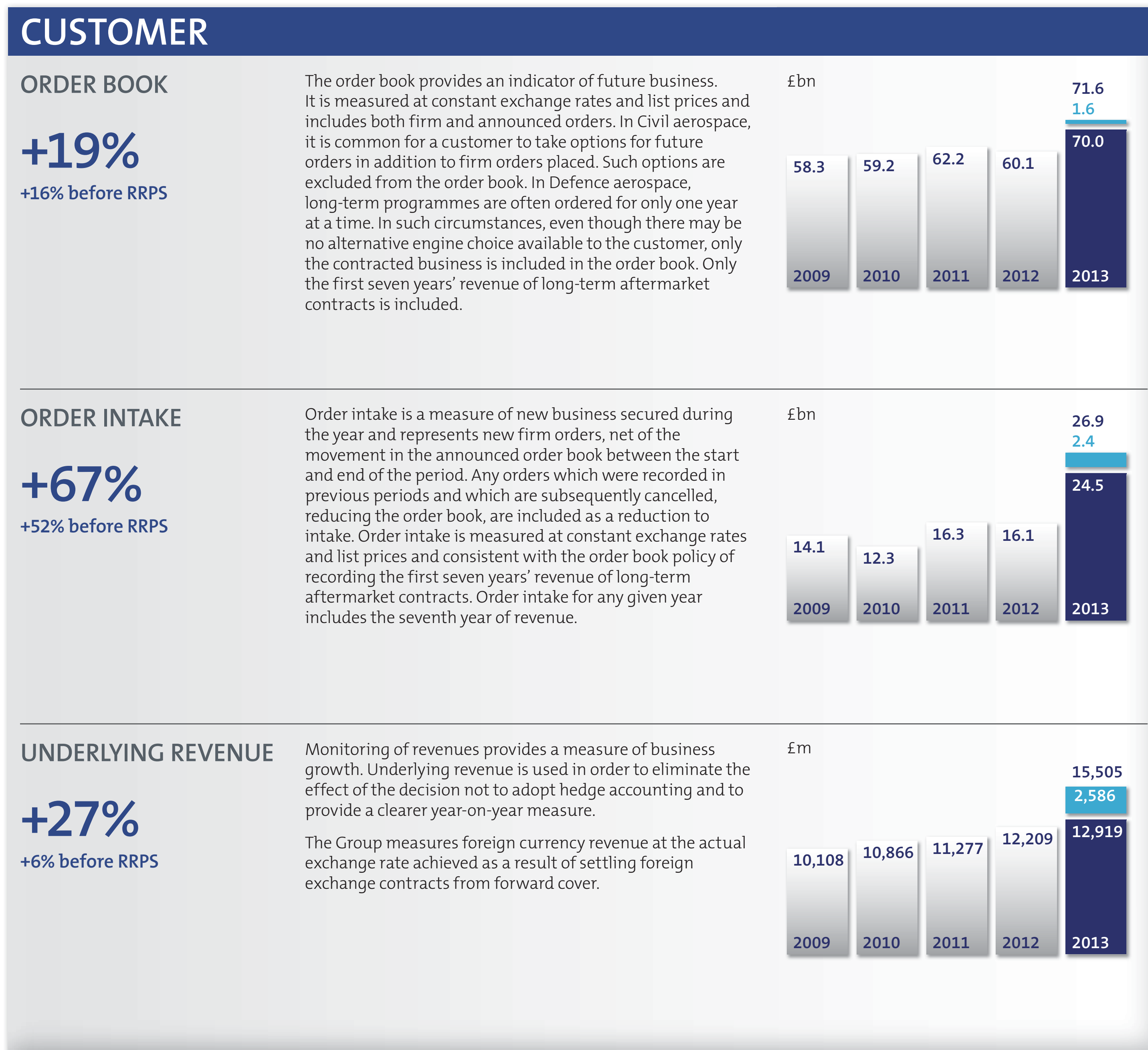
Following a prosecution in the UK by the Health and Safety Executive for one case of Hand-Arm Vibration Syndrome (HAVS), independent advice was sought from the UK Health and Safety Laboratory and we are continuing to strengthen our management of HAVS.

KEY PERFORMANCE INDICATORS

The Board uses a range of financial and non-financial indicators to monitor Group and segmental performance in line with the strategy.

Financial indicators are shown below. The key objectives of the Board and its committees are described on pages 39 to 54 and non-financial key performance indicators are shown in the sustainability section on pages 26 to 29.

Rolls-Royce Power Systems AG (RRPS), formerly Tognum AG, was fully consolidated from 1 January 2013. To aid understanding, the impact on 2013 of consolidation has been displayed separately below.



INNOVATION

NET R&D EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE

+4.5% before RRPS

R&D is measured as the self-funded expenditure both before amounts capitalised in the year and amortisation of previously-capitalised balances. The Group expects to spend approximately five per cent of revenues on R&D although this proportion will fluctuate depending on the stage of development of current programmes. This measure reflects the need to generate current returns as well as to invest for the future.

CAPITAL EXPENDITURE

+40%

+20% before RRPS

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. Annual capital expenditure is measured as the cost of property, plant and equipment acquired during the period.

PROFITABLE GROWTH

UNDERLYING PROFIT BEFORE FINANCING

+22%

+10% before RRPS

Underlying profit before financing is presented 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.

AVERAGE CASH/DEBT

+£380m before RRPS

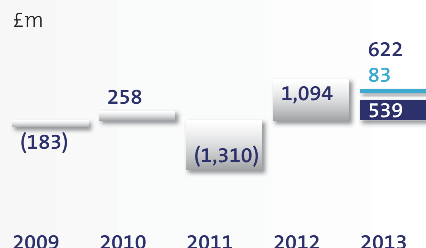
The Group reports the balance of net funds/debt on a weekly basis and average cash is therefore the average of these weekly net balances. These balances are reported at prevailing exchange rates and in recent periods, year-on-year movements in average cash balances reflect the significant acquisitions and disposals which have taken place, most notably RRPS in 2011 and IAE restructuring in 2012. The impact on average cash balances will depend on when these transactions took place during the year.

CASH FLOW

+£539m before RRPS

In a business requiring significant investment, the Board monitors cash flow to ensure that profitability is converted into cash generation, both for future investment and as a reward for shareholders. The Group measures cash flow as the movement in net funds/debt during the year, after taking into account the value of derivatives held to hedge the value of balances denominated in foreign currencies.

The figure for 2011 includes investment of £1,496 million in RRPS.



PRINCIPAL RISKS AND UNCERTAINTIES

The Group places great importance on the identification and effective management of risks. Our approach to enterprise risk management helps us to deliver our objectives and maximise the returns of the Group.

The following table describes the risks that the risk committee, with endorsement from the Board, considers to have the most material potential impact on the Group. They are specific to the nature of our business notwithstanding that there are other risks that may occur and may impact the achievement of the Group's objectives.

The risk committee discussions have been focused on these risks and the actions being taken to manage them.

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 • Our engineering design and validation process is applied from initial design, through production and into service • The safety committee reviews the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards (see safety committee report on page 52) • A safety management system (SMS) has been established by a dedicated team. This is governed by the Product Safety Review Board and is subject to continual improvement based on experience and industry best practice. Product safety training is an integral part of our SMS • Crisis management team led by the Director – Engineering and Technology or General Counsel as appropriate
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.	• Continued investment in adequate capacity and modern equipment and facilities (see operations section on page 25) • Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and our people skills • Selection and development of stronger suppliers (see operations section on page 25) • Developing dual sources or dual capability • Developing and testing site-level incident management and business recovery plans • Crisis management team led by the Director – Engineering and Technology or General Counsel as appropriate • Customer excellence centres provide improved response to supply chain disruption
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 engineering and technology section on page 24) • 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 pages 6 and 7 and Chief Financial Officer's review on page 10) • Protecting credit lines (see additional financial information on pages 137 and 138) • Investing in innovation, manufacturing and production (see operations section on page 25) • Understanding our competitors

Risk or uncertainty and potential impact	How we manage it
INTERNATIONAL TRADE FRICTION Geopolitical factors that lead to 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 in politically stable countries and/or ensuring that we maintain dual capability • Diversifying global operations to avoid excessive concentration of risks in particular areas • Network of regional directors proactively monitors local situations • Maintaining a balanced business portfolio in markets with high technological barriers to entry and a diverse customer base • Understanding our supply chain risks • Proactively influencing regulation where it affects us (see sustainability on page 28)
MAJOR PRODUCT PROGRAMME DELIVERY Failure to deliver a major product programme on time, to specification or technical performance falling significantly short of customer expectations would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation.	• Major programmes are subject to Board approval (see additional financial information on page 137) • Major programmes are reviewed at levels and frequencies appropriate to their performance against key financial and non-financial deliverables and potential risks throughout a programme's life cycle (see additional financial information on page 137) • Technical audits are conducted at pre-defined points performed by a team that is independent from the programme • Programmes are required to address the actions arising from reviews and audits and progress is monitored and controlled through to closure • Knowledge management principles are applied to provide benefit to current and future programmes
COMPLIANCE Non-compliance by the Group with legislation or other regulatory requirements in the regulated environment in which it operates (for example: export controls; offset; use of controlled chemicals and substances; and anti-bribery and corruption legislation) compromising our 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.	• An uncompromising approach to compliance is now, and should always be, the only way to do business • The Group has an extensive compliance programme. This programme and the Global Code of Conduct are promulgated throughout the Group and are updated and reinforced from time-to-time, to ensure their continued relevance, and to ensure that they are complied with both in spirit and to the letter. The Global Code of Conduct and the Group's compliance programme are supported by appropriate training (see ethics committee report on pages 49 and 50) • A legal and compliance team has been put in place to manage the current specific issue (see ethics committee on pages 49 and 50) through to a conclusion and beyond • Lord Gold has reviewed the Group's current compliance procedures and an improvement plan is being implemented

PRINCIPAL RISKS AND UNCERTAINTIES

Risk or uncertainty and potential impact	How we manage it
MARKET SHOCK The Group is exposed to a number of market risks, some of which are of a macro-economic nature, for example, foreign currency exchange rates, and some which are more specific to the Group, for example 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 credit worthiness. 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 138) • The portfolio effect from our business interests, both in terms of original equipment to aftermarket split and our different segments provide a natural shock absorber since the portfolios are not correlated • Deciding where and what currencies to source in, where and how much credit risk is extended or taken and hedging residual risk through the financial derivatives markets (foreign exchange, interest rates and commodity price risk – see additional financial information on page 137)
IT VULNERABILITY Breach of IT security causing controlled data to be lost, made inaccessible, corrupted or accessed by unauthorised users.	• Establishing 'defence in depth' through deployment of multiple layers of software and processes including web gateways, filtering, firewalls, intrusion, advanced persistent threat detectors and integrated reporting • Security and network operations centres have been established • Active sharing of information through industry, government and security forums (see risk committee report on page 51)

The strategic report was approved by the Board on 12 February 2014.

By order of the Board
Nigel T Goldsworthy
Company Secretary

DIRECTORS' REPORT

CHAIRMAN'S INTRODUCTION

We will regularly review and develop our governance arrangements to ensure that the right decisions are made by the right people.

Ian Davis
Chairman

As Chairman, I am responsible for leading the Board and for ensuring its effectiveness in all aspects of its role. Strong governance is vital to this and I was reassured, when I joined Rolls-Royce, to find a robust governance foundation already in place. The challenge ahead is to build upon this foundation and ensure that the Group's values 'trusted to deliver excellence' apply not just to our products but also to the way that we conduct and govern our business.

Governance structure

In November, I led a discussion on governance with the non-executive directors. We will regularly review and develop our governance arrangements to ensure that the right decisions are made by the right people.

My instinct from my discussions to date is to allow as much time as possible at Board meetings for discussion on strategic and operational issues. With regard to committees, I have concluded that merging the work of the separate safety and ethics committees into one broader-based safety and ethics committee will give greater focus to our sustainability agenda.

I agree with the Association of British Insurers (ABI) that good governance enhances a company's sustainable performance and so helps underpin long-term economic growth. Sustainability has to be part of everything we do if our business is to endure in the long term. Further details on sustainability are on pages 26 to 29. We must provide excellent products which are safe, reliable, kinder to the environment and provide the right solutions for our customers at the right price. We can only endure if we are trusted by the world to deliver excellence in everything we do.

Board changes

During the year, Sir Simon Robertson retired as Chairman and Peter Byrom and Ian Strachan retired as non-executive directors at the conclusion of the AGM on 2 May 2013. I was appointed as a non-executive director on 1 March 2013 and was appointed Chairman on 2 May 2013. Lee Hsien Yang and Warren East were appointed as non-executive directors on 1 January 2014. Having served for nine years as a non-executive director, Iain Conn has decided to retire and will not be standing for re-election at the AGM on 1 May 2014.

Business ethics

In January 2013, we appointed Lord Gold to lead a review of our compliance procedures. Lord Gold presented an interim report to the Board in July 2013, having spent time immersing himself in the culture and systems of the Company.

We require high standards of ethical behaviour wherever we do business and for that behaviour to be second nature for every employee. With over 55,000 employees operating in many business sectors, regions and cultures across the world, we are well aware that this is not something that can be achieved overnight but only by relentless pursuit over time. Further details on ethics related matters can be found in the ethics committee report on pages 49 and 50.

Remuneration

Our remuneration report reflects the new reporting regulations. At the 2014 AGM shareholders shall, for the first time, have the right to vote on the policy section of the remuneration report separately and that vote is binding. The remuneration report can be found on pages 53 to 69.

At the 2014 AGM, we will be proposing to renew our long-term incentive plan, the Performance Share Plan (PSP). We are also taking the opportunity to ask shareholders to approve our Deferred Share Bonus Plan. Further details are set out in the remuneration report.

I believe that Rolls-Royce benefits from a strong Board though we will continue to look for opportunities to further strengthen and diversify, as discussed in the nomination committee report on page 47. I look forward to continuing to work with and support my colleagues at Rolls-Royce as we face the challenges and opportunities ahead.

Ian Davis
Chairman

BOARD OF DIRECTORS

1. Ian Davis [2*]
Chairman, appointed March 2013

Skills and experience: Ian spent his early career at Bowater, moving to McKinsey & Company in 1979. He was managing partner of McKinsey's practice in the UK and Ireland from 1996 to 2003. In 2003, he was appointed as Chairman and worldwide Managing Director of McKinsey, serving in this capacity until 2009. During his career with McKinsey, Ian served as a consultant to a range of global organisations across the private, public and not-for-profit sectors. He retired as senior partner of McKinsey & Company on 30 July 2010.

External appointments: Ian serves as a non-executive director on the boards of Johnson & Johnson Inc, BP p.l.c. and as a non-executive member of the Cabinet Office Board. He is also senior adviser to Apax Partners LLP.

2. John Rishton [5*]
Chief Executive, appointed March 2011

Skills and experience: John began his career in 1979 at Ford Motor Company where he held a variety of positions in the UK and in Europe. In 1994 he joined British Airways Plc, where he was Chief Financial Officer from 2001 to 2005. In 2006, he was appointed CFO at Royal Ahold and became CEO in 2007. John was appointed as a non-executive director of Rolls-Royce in 2007 and served as chairman of the audit committee and a member of the ethics and nomination committees until his appointment as Chief Executive. He is a former non-executive director of Allied Domecq.

External appointments: John was appointed as a non-executive director of Unilever NV and Unilever plc in May 2013.

3. Iain Conn [1,2,4*,6]
Senior Independent Director, appointed January 2005

Skills and experience: Iain joined the BP group in 1986 and has held a number of executive positions within the BP group worldwide.

External appointments: Iain is Chief Executive of Refining and Marketing, BP p.l.c. He is a member of The Imperial College Council and of the CBI's Energy and Climate Change Board. He is also a member of the Development Advisory Board of the RAE and of the advisory boards of the Centre for European Reform, the Centre for China in the World Economy at Tsinghua University and of the Schwarzman School at Tsinghua University.

4. Dame Helen Alexander [2,3*,4]
Non-executive director, appointed September 2007

Skills and experience: Dame Helen was Chief Executive of the Economist Group until 2008 which she joined in 1985. She was President of the CBI until 2011; she has also been a non-executive director of Northern Foods plc, BT Group plc and Centrica plc. She was awarded a DBE in 2011 for services to business.

External appointments: Dame Helen is Chairman of UBM plc, the Port of London Authority and Incisive Media. She is also deputy chairman of esure Group plc and senior adviser to Bain Capital. Dame Helen is Chancellor of the University of Southampton and she is involved with a number of other not-for-profit organisations in media, the internet, the arts and education.

5. Lewis Booth CBE [1*,2,4]
Non-executive director, appointed May 2011

Skills and experience: Lewis is the former Executive Vice President and Chief Financial Officer of Ford Motor Company, a position he held for over three years until his retirement from the company in April 2012. During his 34-year career at Ford he held a series of senior positions in Europe, Asia, Africa and the United States. Lewis began his career with British Leyland, before joining Ford in 1978. He was awarded a CBE in June 2012 for services to the UK automotive and manufacturing industries.

External appointments: Lewis is a director of Mondelez International, Inc., Gentherm Inc. and of University of Liverpool in America Inc.

6. Sir Frank Chapman [2,3,6*]
Non-executive director, appointed November 2011

Skills and experience: Sir Frank has worked in the oil and gas industry for 38 years including appointments within Royal Dutch Shell plc and BP p.l.c. He was Chief Executive of BG Group plc for 12 years until December 2012. Sir Frank is a Fellow of the Royal Academy of Engineering, the Institution of Mechanical Engineers and the Energy Institute.

7. Warren East CBE [1,2]
Non-executive director, appointed January 2014

Skills and experience: Warren joined ARM Holdings in 1994 and was appointed Chief Executive in 2001. Under his leadership the company became the world's leading semiconductor IP licensing company. He retired from ARM Holdings in 2013. He is a Fellow of the Institute of Engineering and Technology, a Fellow of the Royal Academy of Engineering and a Distinguished Fellow of the BCS. He was awarded a CBE in 2014 for services to the technology industry.

External appointments: Warren is a non-executive director and chairman of the audit committee of De La Rue plc, and a non-executive director of Dyson Ltd, BT Group plc and Micron Technology Inc.

8. Lee Hsien Yang [2,4,6]

Non-executive director, appointed January 2014

Skills and experience: Hsien Yang was Chief Executive of Singapore Telecommunications Limited for 11 years. He served as Chairman and non-executive director of Fraser and Neave Limited from 2007 until February 2013.

External appointments: Hsien Yang serves as a Special Advisor of General Atlantic LLC. He is Chairman of the Civil Aviation Authority of Singapore, General Atlantic Singapore Fund Pte Ltd. and The Islamic Bank of Asia Private Limited, The Australian and New Zealand Banking Group Ltd. and the Lee Kuan Yew School of Public Policy. He is also President of the INSEAD South East Asia Council.

9. John McAdam [2,3,6]

Non-executive director, appointed February 2008

Skills and experience: John was the Chief Executive of ICI plc until ICI's acquisition by Akzo Nobel. He has held a number of positions at Unilever, within its Birds Eye Walls and Unichema International businesses and is a former non-executive director of Severn Trent plc and Sara Lee Corporation.

External appointments: John is Chairman of United Utilities Group PLC and Rentokil Initial plc and the Senior Independent Director of J Sainsbury plc.

10. John Neill CBE [1,2]

Non-executive director, appointed November 2008

Skills and experience: John is a member of the Council and Board of Business in the Community, is Vice President of the Society of Motor Manufacturers and Traders, BEN, the automotive industry charity and The Institute of the Motor Industry. He was formerly a director of the Bank of England and a non-executive director of Royal Mail and Charter International plc. He was awarded a CBE in June 1994.

External appointments: John is the Chairman and Group Chief Executive of the Unipart Group of Companies Limited and was appointed Chairman of Atlantis Resources Limited in December 2013.

11. Jasmin Staiblin [2,4]

Non-executive director, appointed May 2012

Skills and experience: Jasmin is the CEO of Alpiq Holding AG and was CEO of ABB Switzerland Ltd until December 2012. She has lived and worked in Switzerland, Sweden and Australia.

External appointments: Jasmin is a non-executive director of Georg Fischer AG and a member of the board of the Federal Institute of Technology, the ETH Domain.

12. James Guyette [5]

President and Chief Executive Officer of Rolls-Royce North America Inc. appointed January 1998

Skills and experience: Before joining the Company, Jim was Executive Vice President, Marketing and Planning of United Airlines.

External appointments: Jim is Chairman of PrivateBancorp Inc., of Chicago, Illinois and he is lead independent director of priceline.com Inc of Norwalk, Connecticut. He is also Chairman Emeritus of the Smithsonian National Air & Space Museum, Washington DC.

13. Mark Morris [5]

Chief Financial Officer, appointed January 2012

Skills and experience: Mark joined Rolls-Royce in 1986. He has held a number of senior positions throughout the Company and before his appointment as Chief Financial Officer was Group Treasurer from 2001.

14. Colin Smith CBE [5]

Director – Engineering and Technology, appointed July 2005

Skills and experience: Colin joined Rolls-Royce in 1974. He has held a variety of key positions within the Company, including Director – Research and Technology and Director of Engineering and Technology – Civil aerospace. Colin is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers. He is also a Member of the Council for Science and Technology. In June 2012 he was awarded a CBE for services to UK engineering.

15. Nigel T Goldsworthy

Company Secretary & Head of Legal, appointed December 2012

Skills and experience: A solicitor, Nigel has held a number of senior legal and company secretary roles within the Company and, before his appointment as Company Secretary & Head of Legal, was Deputy General Counsel from 2008. Before joining Rolls-Royce in 2004, Nigel was a partner in the banking group of Lovells (now Hogan Lovells).

INTERNATIONAL ADVISORY BOARD (IAB)

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

Lord Powell of Bayswater (Chairman of the IAB)
Former Foreign Affairs and Defence Adviser to Prime Ministers Baroness Thatcher and Sir John Major

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

Sir Rod Eddington
Chairman of JP Morgan (Australia & New Zealand) and former Chief Executive of British Airways Plc

Dr Fan Gang
Professor at China's Academy of Social Sciences and Director of National Economic Research Institute

Mustafa Koç
Chairman of Koç Holding, A.Ş.

Akio Mimura
Senior Advisor, Honorary Chairman Nippon Steel & Sumitomo Metal Corporation

Lubna Olayan
CEO and Deputy Chairperson of the Olayan Financing Company

Ratan Tata
Former Chairman of Tata Sons Limited

Ambassador Robert B. Zoellick
Chairman of Goldman Sachs International Advisors, Senior Fellow at the Belfer Center at Harvard University, former President of World Bank Group, US Deputy Secretary of State and US Trade Representative

THE EXECUTIVE LEADERSHIP TEAM (ELT)

During 2013, John Rishton chaired meetings of the ELT, an executive forum at which his first line reports (the Group's most senior business and functional leaders) review, communicate and agree on issues and actions of group-wide significance. In addition to John Rishton, its other members are:

Miles Cowdry
Corporate Development Director

Kath Durrant
Human Resources Director

James Guyette
President and Chief Executive Officer – Rolls-Royce North America Inc.

Lawrie Haynes
President – Marine and Nuclear

Andrew Heath
President – Energy

Alain Michaelis
Operations Director

Mark Morris
Chief Financial Officer

John Paterson
President – Marine and Industrial Power Systems

Colin Smith
Director – Engineering and Technology

Robert Webb
General Counsel

Tony Wood
President – Aerospace

CORPORATE GOVERNANCE REPORT

Board members and attendance

There are currently 14 directors on the Board comprising the non-executive Chairman, the Chief Executive, three other executive directors and nine non-executive directors.

	Attendance in 2013
Ian Davis (Chairman) (appointed 1 March 2013)	7/7
Dame Helen Alexander	8/9
Lewis Booth CBE	9/9
Peter Byrom (retired 2 May 2013)	4/4
Sir Frank Chapman	8/9
Iain Conn	8/9
Warren East CBE (appointed 1 January 2014)	n/a
James Guyette	9/9
Lee Hsien Yang (appointed 1 January 2014)	n/a
John McAdam	8/9
Mark Morris	9/9
John Neill CBE	9/9
Sir Simon Robertson (retired 2 May 2013)	3/4
John Rishton	9/9
Colin Smith CBE	9/9
Jasmin Staiblin	4/9
Ian Strachan (retired 2 May 2013)	4/4

The General Counsel and the Company Secretary are also invited to attend meetings. Jasmin Staiblin who is based in Switzerland was unable to attend two scheduled meetings during pregnancy and three due to unavoidable diary clashes in respect of commitments entered into before her appointment to the Board.

Key objective:

- create long-term success for the Group within an acceptable risk profile and provide value for the long-term investor.

Responsibilities:

- ensure the safety of its products and people;
- ensure the development of strategy;
- monitor implementation of the strategy;
- ensure necessary resources are in place;
- ensure controls exist to manage risk;
- safeguard values, brand and reputation;
- oversee performance of management;
- ensure effective succession planning;
- agree remuneration policy; and
- maintain effective governance.

Governance principle: leadership

Board membership

The directors biographical details are on pages 36 and 37 which demonstrate the skills and experience of the Board. The experience and knowledge of each of the directors gives them the ability to constructively challenge strategy and scrutinise performance.

On 12 February 2014, the Board noted that Iain Conn intended to retire as the Senior Independent Director and as a non-executive director and would therefore not seek re-election at the AGM on 1 May 2014. The Board has resolved that Lewis Booth, subject to re-election at the AGM, will succeed Iain Conn as the Senior Independent Director at the conclusion of the AGM.

UK Corporate Governance Code (the Code)

This report explains how the Company discharges its corporate governance responsibilities. In the year to 31 December 2013, the revised principles and provisions of the Code (published in September 2012 by the Financial Reporting Council (FRC) applied to the Company.

Throughout the 2013 financial year, the Company did not fully comply with the provisions of the Code for the following reasons:

Code provision	Explanation
C.3.5 – The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters.	The Board considered it appropriate that this provision of the Code be the primary responsibility of the ethics committee. The ethics committee is, however, required to refer concerns about possible improprieties in matters of financial reporting to the audit committee.
C.3.7 – The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years.	The audit committee has considered the requirement to put the audit out to tender every ten years. In line with the FRC's transitional arrangements, the committee will do so during the tenure of the current lead partner which expires in 2017. The committee concluded that, in order to ensure that a potential change in auditor is managed effectively, it would not be in the Company's interests to put the audit out to tender in 2013. More detail can be found in the audit committee report on page 46.

CORPORATE GOVERNANCE REPORT

In accordance with the Code and the Company's Articles of Association, all directors will retire and put themselves forward for election or re-election at the AGM in 2014 with the exception of Iain Conn who is not seeking re-election and will retire from the Board at the conclusion of that meeting.

The process for succession planning is discussed in the nomination committee report on page 47.

The work of the Board in 2013

During 2013, the Board held nine meetings, eight of which were scheduled and a further one called at short notice. In addition, two formal resolutions were passed by consent of all directors using electronic means. Non-executive directors communicate directly with executive directors and senior management between formal Board meetings. At each scheduled meeting, executive directors supplied reports on business and financial performance including the usual approval of financial statements and budgets. The Board also received regular updates on health, safety and environment (HS&E) and employee and legal issues, including a review of its governance arrangements. In addition, the chairman of each of the Board committees provided reports on matters discussed by that committee since the previous Board meeting.

The Board holds an annual day-long strategy meeting, which provides a forum for directors to challenge strategy and help develop it for the future. The strategy meeting held in September 2013 included discussions on the ten-year financial plan and the strategic context including market structure, competitor positioning, cost challenges, technology and with a focus on the Civil aerospace and the Marine and Industrial Power Systems businesses.

In addition to its routine business, matters considered by the Board in 2013 included:

- Marine strategy focused on markets, costs, supply chain, product development and alignment with the Rolls-Royce Power Systems and Bergen engines businesses;
- the closure of the proposed joint venture with Pratt & Whitney;
- updates on the referral to the Serious Fraud Office;
- discussion on Lord Gold's interim findings, the adoption of a new Global Code of Conduct and the roll-out of a comprehensive ethics training programme to all employees;
- relocation to new Group headquarters;
- the effect of sequestration on US defence spending;
- Civil Nuclear business strategy;
- investors' view on our AGM business;
- restructuring of the Aerospace business;
- liquidity and additional funding;
- the renewal of the Euro Medium Term Note programme;
- preliminary discussions with Wärtsilä regarding a possible offer for the company; and
- cyber security.

Board committees

The Board has established a number of committees, the principal ones being audit, remuneration, nomination, ethics, risk and safety. Terms of reference for each committee are available on the Group's website at www.rolls-royce.com. Reports by committee chairmen on the activities of each of the principal committees are on pages 44 to 54. The Chairman's introduction provides more detail on page 35 of changes to the committee structures.

Senior management and advisers are invited to attend Board and committee meetings where appropriate to contribute to discussions and advise members of the Board and committees on relevant matters. The involvement of senior management additionally helps strengthen the relationship between the Board and senior management and helps to provide the Board with a greater understanding of operations and strategy.

Internal control

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. Our risk management process is a key element of the Group's 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 processes we use to identify and manage risk are set out in the risk committee report on page 51. The Board's report on the Group's principal risks and actions taken to mitigate them is on pages 32 to 34.

Turnover from joint ventures constitutes an increasingly large part of our reported group activity. Responsibility for internal control procedures in joint ventures where we do not have a control agreement lies with the managers of those operations. We seek to exert influence over such ventures by board representation and regularly review the activities of these ventures.

The audit committee has reviewed the effectiveness of the systems of internal control for the year under review. Further information can be found in the audit committee report on page 45. The Board confirms that the processes and systems currently in place ensure that the Group continues to be compliant with the 'Turnbull guidance' as contained in 'Internal Control: Revised Guidance for Directors on the Combined Code' issued by the Financial Reporting Council in 2005.

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.

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.

Roles and responsibilities

The Board has a written remit for the Chairman, Ian Davis, who has responsibility for the running of the Board and ensuring its effectiveness, and the Chief Executive, John Rishton, who has responsibility for running the business. This division of responsibility ensures that no one individual has unfettered powers of decision.

In addition, the Board has agreed a set of guiding principles to govern the relationship between the Chairman and Chief Executive which, for example, requires that the two roles are structured in a complementary manner and demands that the relationship between the two be based on mutual respect and trust and be frank and open.

The Senior Independent Director, Iain Conn, acts as a sounding board for the Chairman and can act as an intermediary for other directors. He led the nomination committee in the process which resulted in the appointment of Ian Davis as Chairman in May 2013.

Each year, the Senior Independent Director leads a separate meeting of the Board excluding the Chairman to review the Chairman's performance.

Role and operation of the Board

The principal role of the Board is to ensure that the Group's strategy creates long-term success for the Group within an acceptable risk profile and provides value for the long-term investor.

To achieve its long-term success the Board must:

- ensure the safety of its products and its people;
- oversee and approve the development of the Group's strategy, monitoring both its achievement and the Group's risk appetite;
- uphold the values of the Group, including its brand and corporate reputation;
- oversee the quality and performance of management and ensure it is maintained at world-class standards, through effective succession planning and remuneration policies; and
- maintain an effective corporate governance framework, with transparent reporting.

The Board has established a formal schedule of matters reserved for its approval, generally being those items which affect the shape and risk profile of the Group, as well as items such as the annual budget and performance targets, the financial statements, payments to shareholders, major capital investments, substantial changes to balance sheet management policy and the strategic plan. This schedule of matters reserved is reviewed annually.

John Rishton, as the Chief Executive, is responsible for the day-to-day leadership, operational and performance management of the Group within the confines of the strategy, business plans and budgets agreed by the Board. The delegation of responsibilities to the executive team is set out in a detailed schedule approved by the Chief Executive.

Information is supplied to directors in a manner which enables them to fulfil their responsibilities. This includes the circulation of papers to be discussed, generally one week before meetings. Presentations are made by senior management at Board meetings on business, financial and operating issues. Directors are expected to attend all meetings of the Board and the committees on which they sit and to devote sufficient time to the Company's affairs to enable them to fulfil their duties as directors. If directors are unable to attend a meeting, their comments on the papers to be considered are discussed in advance with the Chairman so that their contribution can be included in the wider Board discussion.

Executive Leadership Team (ELT)

The ELT is the senior decision-making executive committee and met 26 times during the year. Its membership is described on page 38. It developed detailed strategic options for the Group culminating in approval of strategy by the Board in September. It reviewed HS&E performance, customer relations, governance, financial and operational performance. It also reviewed acquisitions and disposals and recommended them to the Board where required.

Each business segment holds executive meetings to review operational performance of its business, assisting the business president in taking such decisions as fall within his remit and reviewing proposals before presentation to the ELT or the Board for approval as appropriate.

Governance principle: effectiveness

Board evaluation

The Code requires that the Board undertakes an annual evaluation of its own performance and that of its committees and individual directors and to do so externally at least every three years. In 2013, the evaluation process was again conducted internally, full external reviews having been carried out by Jan Hall Associates in 2010 and 2011.

Initially, directors were asked to complete a confidential survey covering the areas set out as best practice published by the Financial Reporting Council's 'Guidance on Board Effectiveness'. The Company Secretary then produced a report which consolidated the responses following which the Chairman conducted one-to-one interviews with each director and the Senior Independent Director interviewed the Chairman. The findings were considered by the Board and actions to be taken were agreed.

The evaluation concluded that the Board was proving to be effective under the leadership of Ian Davis and John Rishton and that relationships and Board discussions work well. The principal recommendation was that succession planning for senior executive positions could be improved. Other areas for improvement identified included risk processes, mitigation plans, Board papers and governance.

Directors' terms of appointment

Executive directors are employees who have day-to-day responsibilities as executives of the Group in addition to their duties as directors. Each executive director receives a service contract on appointment (see pages 60 and 61 for further information).

Non-executive directors are generally independent of the Company, are not employees and do not participate in the daily business management of the Group. On appointment, each non-executive director receives a letter setting out the conditions of his or her appointment. Non-executive directors are appointed for an initial term of three years, which may be extended with the agreement of the Board, although reappointment is not automatic. Their term of office is also subject to annual re-election by shareholders at the AGM and will terminate without compensation if they fail to be re-elected (see page 60 for further information).

CORPORATE GOVERNANCE REPORT

Director training
Newly appointed directors participate in a structured induction programme as detailed in the table below and receive a comprehensive data pack providing detailed information on the Group. An existing executive director can act as a mentor to each newly appointed non-executive director, giving guidance and advice as required.

Issues	Facilitated by
Operation of the Board and governance	Chairman and Company Secretary
Group strategy development and current issues	Chief Executive
Financial structure	Chief Financial Officer
Risk strategy	General Counsel
Operational strategy	Operations Director
Technology and engineering issues	Director – Engineering and Technology
Key site visits	Company Secretary
Committee technical requirements	Committee chairmen, internal or external experts

Further training is available for directors, including presentations by the executive team on particular aspects of the business. In 2013, the Board received training in ethics conducted by our Head of Business Ethics. In December 2013, our corporate lawyers, Slaughter and May, held a seminar immediately following the Board meeting to update the Board on developments in corporate law and regulation. In addition, there is a procedure for directors to take independent professional advice at the Company's expense and every director has access to the General Counsel and to the Company Secretary who is responsible to the Board on corporate governance. All directors are advised of changes in legislation, regulation and changing risks with the assistance of the Company's advisers where necessary. In-house training is provided to directors of the Company's subsidiaries and joint ventures.

Independence of the non-executive directors
The Board conducts a rigorous review of the independence of the non-executive directors every year, based on the criteria in the Code. This review was undertaken in November 2013 and the Board concluded that all the non-executive directors remained independent in character and judgement. The Chairman met the Code's independence criteria upon his election as Chairman in May 2013. His other external commitments are described on page 36.

Non-executive directors are advised of the time required to fulfil the role and are asked to confirm that they can make the required commitment before the appointment is made. The Board is satisfied that each of the non-executive directors is able to devote sufficient time to the Company's business.

The Board believes it can be appropriate for executive directors to take non-executive positions in other companies and organisations, as such appointments should broaden their experience. The appointment to such positions is subject to the approval of the Chairman and the Board and must not conflict with a director's duties and commitments to the Company.

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

Governance principle: accountability

The directors consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

Investor relations
Communications with shareholders regarding business strategy and financial performance are co-ordinated by a dedicated Investor Relations department that reports to the Chief Financial Officer. Communications regarding the general administration of shareholdings are co-ordinated by the Company Secretary.

The Group conducts a dedicated investor relations programme with institutional investors which includes various formal events during the year, as well as a regular series of one-to-one and group meetings. The purpose of these events is to highlight a particular issue, theme or announcement that the Group believes warrants further explanation or clarification. The events also provide opportunities for shareholders to meet members of the senior management team. Examples of these events in 2013 were: the preliminary and half-year results announcements; the AGM; the update given at the Paris Air Show on trends in the Civil and Defence aerospace businesses; visits to certain of the Group's sites; and industry conferences. The one-to-one and group meetings provide additional context around the Group's business strategy and financial performance.

In 2013, over 380 meetings took place with over 340 separately identifiable institutional investors. The majority of meetings took place in the UK (273), 81 meetings were in the USA and Canada, and a further 26 meetings took place in Europe. The Chairman also meets institutional investors from time-to-time.

Shareholder communications

Information about the Group is available on the Group's website (www.rolls-royce.com) and in the published annual report, an online version of which is also available on the website. The website contains financial and other information about the Group including current business strategy, historical financial data, and recent presentation materials together with information on the Group's businesses, products and services.

Over 20,000 Rolls-Royce shareholders have registered their email addresses with etree so that they benefit from immediate communication of the posting of our preliminary results and of the publication of our notice of meetings and our online annual report. This reduces our printing and mailing costs as well as our carbon footprint. We would encourage other shareholders to register for this service by following the instructions on the etree website at www.etreeuk.com/rolls-royce.

Annual general meeting (AGM)

All holders of ordinary shares are invited to attend the Company's AGM. The Chief Executive gives a presentation highlighting key business developments during the year and shareholders have an opportunity to ask questions. All directors normally attend the AGM and the chairmen of the audit, nomination, remuneration, ethics, safety and risk committees are available to answer any questions from shareholders on the work of their committees.

The Company sends the AGM notice and relevant documentation to all shareholders at least 20 working days before the date of the AGM. For shareholders who have consented to receive communications electronically, notice is given by email or by written notice of the availability of documents on the Group's website.

This year's AGM will be held at 11.00am on Thursday, 1 May 2014 at the QEII Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE. The AGM notice and the annual report will be available to view on the Group's website. Shareholders unable to attend the AGM can vote on the business of the meeting either by post or online.

Shareholders and share capital

Information on shareholders and share capital, which also forms part of the Corporate Governance report, is detailed on pages 70 and 71.

Change of control

Contracts and joint venture agreements

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

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At 31 December 2013 these facilities were less than 35 per cent drawn (2012 30 per cent).

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

Employee share plans

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

- PSP – awards would vest pro rata to service in the performance period, subject to remuneration committee judgement of Group performance;
- APRA deferred shares – the shares would be released from trust immediately;
- ShareSave – options would become exercisable immediately. The new company might offer an equivalent option in exchange for cancellation of the existing option; and
- Share Incentive Plan (SIP) – consideration received as shares would be held within the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.

Payment to shareholders

At the AGM on 1 May 2014, the directors will recommend an issue of 134 C Shares with a total nominal value of 13.4 pence for each ordinary share. The final issue of C Shares will be made on 1 July 2014 to shareholders on the register on 25 April 2014 and the final day of trading with entitlement to C Shares is 22 April 2014. Together with the interim issue on 2 January 2014 of 86 C Shares for each ordinary share with a total nominal value of 8.6 pence, this is the equivalent of a total annual payment to ordinary shareholders of 22 pence for each ordinary share.

The payment to shareholders will, as before, be made in the form of redeemable C Shares which shareholders may either choose to retain or redeem for a cash equivalent. The Registrar, on behalf of the Company, operates a C Share Reinvestment Plan (CRIP) and can, on behalf of shareholders, purchase ordinary shares from the market rather than delivering a cash payment. Shareholders wishing to redeem their C Shares or else redeem and participate in the CRIP must ensure that their instructions are lodged with the Registrar, Computershare Investor Services PLC, no later than 5.00pm on 2 June 2014. Redemption will take place on 3 July 2014.

AUDIT COMMITTEE REPORT

Our committee is focused on ensuring the integrity of the Group's financial reporting and improving the financial controls framework.

Lewis Booth CBE
Chairman of the audit committee

Committee members and attendance

The audit committee consists exclusively of independent non-executive directors and met four times in 2013.

	Attendance in 2013
Lewis Booth CBE (Chairman)	4/4
Iain Conn	4/4
Warren East CBE (appointed 1 January 2014)	n/a
John Neill CBE	4/4
Ian Strachan (retired 2 May 2013)	2/2

The external auditors KPMG Audit Plc (KPMG), the Director of Internal Audit, the General Counsel, the Director of Risk, the Company Secretary, the Chairman of the Board, the Chief Executive and the Chief Financial Officer are also invited to attend meetings. Other Board members, including the remuneration committee chairman and senior executives attended meetings during the year at the invitation of the committee chairman.

Key objective:

- to assist the Board in ensuring the integrity of its financial statements.

Responsibilities:

- to review the financial results announcements and financial statements, monitoring compliance with relevant regulations;
- to review the appropriateness of accounting policies and the supporting key judgements and estimates;
- to assess the scope and effectiveness of the systems to identify, manage and monitor financial and non-financial risks;
- to review the procedures for detecting, monitoring and managing the risk of fraud;
- to oversee the relationship with the external auditor and make recommendations to the Board regarding the external auditor's appointment; and
- to review the scope, resources, results and effectiveness of Internal Audit.

I am pleased to present the report of the audit committee for the year. I would like to thank committee members, the executive management team and KPMG for the open discussions that take place at our meetings and the importance they all attach to its work.

Work of the committee in 2013

At our meetings during 2013, we focused on financial reporting, internal control, internal audit and external audit. We received presentations from senior executives from the Civil aerospace, Defence aerospace and Civil Nuclear businesses. These presentations covered key accounting judgements and estimates, internal control and risk management.

We also reviewed the committee's own terms of reference.

Financial reporting

In addressing our key objective, which is to assist the Board in ensuring the integrity of its financial statements, we reviewed financial announcements and financial statements with both management and the external auditor, concentrating on:

- compliance with financial reporting standards and governance reporting requirements;
- areas requiring significant judgements to be made in applying accounting policies;
- the appropriateness of accounting policies;
- the procedures and controls around estimates that are key in applying accounting policies;
- whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's business model, strategy and performance; and
- any relevant correspondence from regulators.

Our committee is focused on ensuring integrity of the Group's financial reporting and improving the financial controls framework, including the restructuring of business audit committees which now report directly to this committee. During the year, we encouraged and supported the development of an enhanced business audit committee process. Under this process, management of each of the Group's businesses consider the appropriateness and related governance of accounting policies, judgements and estimates and the control environment relating to their businesses including internal audit findings and the robustness of the processes used to execute their risk management responsibilities. We receive reports on the results of these reviews.

Our business is complex; in particular the development of gas turbines for use in civil aircraft applications requires large upfront investments, a long period of sale of original equipment, and a very long period over which we generate profits and cash flows from the aftermarket by the sale of spare parts and engine maintenance work. The in-service period could be longer than 25 years for any engine, and the total life cycle of an engine could be more than 40 years from initial concept, through production, and then through the in-service life. Much of the aftermarket repair and overhaul is provided through long-term service agreements. Given this long exposure, the amount of revenue and profit recognised during any period requires a significant number of accounting judgements and estimates, supported by engineering and business assessments. Consequently, one of our primary responsibilities is to ensure that the bases for these judgements and estimates are robust.

In 2013, our work focused on:

- carrying values of the principal intangible assets in Civil aerospace – we considered the business plans for the relevant engine programmes, including the key assumptions on which they are based, and which support the value in use assessments for the intangible assets. We were satisfied that no impairments were required;
- long-term contractual arrangements in Civil aerospace – we reviewed the forecasts of future contract performance on which the accounting is based. We also considered performance to date against these forecasts and the results of a detailed review of certain aspects of the processes supporting these forecasts. Where the accounting results in a contract asset, we assessed the recoverability of the asset against agreed criteria. We were satisfied that the forecasts have been prepared on an appropriate and consistent basis;
- risk and revenue sharing arrangements (RRSAs) in Civil aerospace – (as described in the Chief Financial Officer's review on page 11), during the year and following discussions with the Conduct Committee of the Financial Reporting Council (FRC), the Group has reassessed its accounting policy for entry fees received from workshare partners. Adopted IFRS does not contain requirements that are specific to arrangements of this type and we assessed possible alternative policies developed by management. We reviewed the revised policy, considered the FRC's and KPMG's views and I attended a meeting with the FRC. On balance, we agreed with management's view that the revised policy fairly reflects the nature of the transaction and that it should be adopted retrospectively;
- we reviewed the contractual arrangements that resulted in the Group consolidating Rolls-Royce Power Systems AG from 1 January 2013. We also reviewed the accounting for the business combination, based on a third-party valuation of the intangible assets acquired, and the valuation of the Daimler put option on the non-controlling interest. We were satisfied that appropriate judgements and estimates have been made;
- customer financing liabilities in Civil aerospace – we considered the adequacy of provisions for these liabilities. We considered the likelihood of the liabilities crystallising, based on an assessment of customers' fleet plans and their creditworthiness. We also considered the value of any security held, based on third-party valuations. We were satisfied that provisions have been made on an appropriate basis;
- contingent liabilities – we considered the adequacy of the disclosures. In particular, we considered legal advice in respect of the possible outcome of the SFO enquiries. We were satisfied that the disclosures appropriately reflect the current position; and
- segmental reporting – we considered the changes in management structure and internal reporting described on page 10 and the implications for reporting in accordance with IFRS 8. We were satisfied with the appropriateness of the revised segmental reporting from 1 January 2014.

Since the year end, we have reviewed the form and content of the Group's 2013 annual report. The committee has reported to the Board that it considers the annual report, taken as a whole, to be fair, balanced and understandable.

Internal control

The Director of Internal Audit provided a report setting out an overview of the Group's control environment and we reviewed the processes by which the control environment is assessed and any identified weaknesses resolved. We considered control weaknesses identified by the auditors in accounting for Civil aerospace long-term aftermarket contracts, and management's plans to address these. We also received reports of any identified frauds that are significant or demonstrate significant weakness in internal control.

We also reviewed a report on compliance with the Group's policies in respect of expenses incurred by the directors and other senior executives, which did not identify any significant issues.

Internal Audit

The Director of Internal Audit presented two updates on audit activities and findings covering six-month periods, the resolution of control weaknesses, progress against the agreed plan and the resourcing of the department. We are continuing to develop with him a simplified metrics-driven approach to the reporting, focusing on the closure of open items on a timely basis and the identification of recurring themes. We were satisfied that the scope, extent and effectiveness of Internal Audit are appropriate for the Group.

I meet the Director of Internal Audit in private before each meeting and the committee as a whole has a private meeting with him at least once a year.

External auditor

The external audit is a continuous process. At the start of the audit cycle, KPMG presented their audit strategy, identifying their assessment of the key risks for the purposes of the audit and the scope of their work.

For 2013, these risks were: the implementation of a new consolidation system; the business combination and Daimler's put option in respect of Rolls-Royce Power Systems Holding GmbH; impairment of intangible assets; long-term contractual arrangements; warranties and guarantees; RRSAs; customer financing arrangements; contingent liabilities; valuation of derivatives; valuation of pension liabilities; recoverability of tax assets and adequacy of tax provisions; the adjustments between the reported results and the Group's underlying performance; and the form and content of the annual report. More detail is set out in KPMG's report on pages 130 to 135.

AUDIT COMMITTEE REPORT

KPMG reports to the committee at both the half and full-year setting out their assessment of the Group's judgements and estimates in respect of these risks and the adequacy of the reporting. I meet the lead audit partner in private before each meeting and the whole committee meets with KPMG in private at least once a year.

Non-audit services provided by KPMG

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

Excluding Rolls-Royce Power Systems (see below), the main non-audit related services provided by KPMG during the year were in respect of grant claims and tax compliance and were 11 per cent of the audit fee. The nature and level of all services provided by the external auditor is a factor taken into account by the audit committee in its annual review of the external auditor.

All proposed services must be pre-approved in accordance with an agreed policy. We review the non-audit fees charged by KPMG at each meeting and annually review the approval limits.

Following the consolidation of Rolls-Royce Power Systems on 1 January 2013, we took the decision to allow the completion of engagements already in progress. As a result, Rolls-Royce Power Systems incurred fees on non-audit services provided by KPMG in 2013 of £2.1 million, 210 per cent of its audit fee. This will reduce in 2014.

Reappointment of auditor

Following the completion of the audit, we reviewed the effectiveness and performance of KPMG with feedback from committee members, senior finance personnel and Internal Audit, covering overall quality, independence and objectivity, business understanding, technical knowledge, quality and continuity of personnel, responsiveness and cost effectiveness. We also considered the reports on KPMG by the FRC's Audit Quality Review Team. The audit of Rolls-Royce was not subject to their review in 2013. KPMG were appointed as auditors in 1990 and this appointment has not been subject to a tender process since that date.

The lead audit partner is required to rotate every five years and other key audit partners are required to rotate every seven years. Jimmy Daboo took over as lead audit partner in 2013 and has had no previous involvement with Rolls-Royce in any capacity. No contractual obligations restrict our choice of external auditors. We concluded that KPMG provides an effective audit and the committee and the Board have recommended their reappointment at the 2014 AGM.

Audit tendering

The Group is a complex and technologically advanced business with a long cycle from the development of an engine to its eventual retirement. We believe that KPMG's knowledge of this, built up over a number of years, enhances the effectiveness of the audit and that the existing professional requirements, such as the rotation of audit personnel, maintain independence. However, the UK Corporate Governance Code now requires the external audit contract be tendered at least every ten years. The FRC has proposed non-binding transitional arrangements with respect to audit tendering, including a suggestion that tendering should normally fit the five-yearly cycle with respect to the lead partner.

We plan to recommend a tender of the audit during the tenure of the current lead partner which, subject to KPMG's annual reappointment, is due to end following the 2017 audit. This will also satisfy the requirements proposed by the Competition Commission. However, before we make such a recommendation, we will satisfy ourselves that, if the tender resulted in a change of auditor: (i) it would not be unnecessarily disruptive, taking account of any other activities; and (ii) appropriate plans are in place to ensure audit effectiveness is maintained. During the year, we approved a tender plan prepared by management to be used when the audit is tendered but we do not plan to tender the audit during 2014. The EU is also finalising requirements which would require mandatory rotation of auditors. the draft proposals would require us to appoint a different firm by 2020 at the latest. Once finalised, we will take account of the EU requirements in our assessment of when to recommend an audit tender.

Lewis Booth CBE

Chairman of the audit committee

NOMINATION COMMITTEE REPORT

We must continue to appoint the best candidates but we will show an increasing emphasis on recruiting candidates from more diverse backgrounds.

Ian Davis
Chairman of the nomination committee

Committee members and attendance

The nomination committee consists of all of the non-executive directors and met six times in 2013.

	Attendance in 2013
Ian Davis (Chairman) (appointed 1 March 2013)	4/4
Dame Helen Alexander	6/6
Lewis Booth CBE	5/5
Peter Byrom (retired 2 May 2013)	2/2
Sir Frank Chapman	4/6
Iain Conn	5/6
Warren East CBE (appointed 1 January 2014)	n/a
Lee Hsien Yang (appointed 1 January 2014)	n/a
John McAdam	6/6
John Neill CBE	6/6
John Rishton	2/2
Sir Simon Robertson (retired 2 May 2013)	2/2
Jasmin Staiblin	4/6
Ian Strachan (retired 2 May 2013)	2/2

The committee decided on July 2013 that the committee should only consist of non-executive directors and John Rishton therefore ceased to be a member.

Key objective:

- to lead the process for appointments to the Rolls-Royce Board.

Responsibilities:

- monitor the composition and performance of the Board and its committees;
- evaluate the balance of skills and experience on the Board and the diversity of its members;
- consider and recommend the appointment and removal of directors;
- monitor executive development and succession planning;
- evaluate any conflicts of interest that directors might have; and
- evaluate the independence of the non-executive directors and their time commitments.

I am pleased to present my first report as chairman of the nomination committee.

During the year, the committee continued to develop its succession plans for new non-executive directors taking into account their respective tenures of office, analysing the skills which were either missing or could be missing in future and how different personalities would fit around the Board table. We are very clear that we must continue to appoint the best candidates but we will show an increasing emphasis on recruiting candidates from more diverse backgrounds and with international experience.

We are pleased that Lee Hsien Yang has joined the Board as a non-executive director. Hsien Yang was already known to the Board as a valued member of the IAB (a role that he has relinquished upon his appointment to the Board). The committee did not therefore engage search consultants in connection with his appointment.

Hsien Yang will bring to our Board a wealth of business experience in the Asian marketplace. His biography can be found on page 37.

The Board has been further bolstered by the appointment of Warren East as a non-executive director. Warren has extensive experience in the global technology sector and an outstanding record of business achievement that will be of great value to Rolls-Royce. His biography can be found on page 36. Both Warren and Hsien Yang took up their posts from 1 January 2014. Sciteb was engaged as search consultant for Warren's appointment. The firm has no other connection with the Company.

The topic of boardroom diversity has received much attention over the past two years. In September 2011, we issued our response to the Davies Report on women on boards stating that we expected to make demonstrable progress in this area by 2015. Maintaining the right balance on the Board and getting the succession policy right is high on my agenda and the Board is clear that purposeful diversity is a valuable goal. Gender diversity is an important part of that although we do not consider it appropriate to fix a specific target.

We continue to participate in the FTSE 100 Cross-Company Mentoring Programme, the objective of which is to increase the pool of eligible senior female candidates for UK board positions and we have comprehensive programmes in place to increase the diversity of our internal pipeline of future leaders. We have also issued guidance to executive search companies outlining the importance of diverse candidate short lists. Further details of our gender representation can be found in sustainability on page 27.

NOMINATION COMMITTEE REPORT

During the year, the committee reviewed the use of executive search consultants and concluded that the existing agency relationships were working well and should continue. The overarching brief is to find candidates of international stature, with international mindsets and relevant experience who could demonstrate sound judgement and board skills with an emphasis towards greater diversity.

MWM Consulting was engaged in the search for the vacant chairman's post earlier in 2013. A detailed brief was approved by the Board covering both the responsibilities of the role and the desired profile which formed the blueprint against which candidates were identified and assessed. The search was broad and global in outlook, constrained only by the requirements of the brief. Seventy candidates from ten different countries were actively considered. MWM Consulting has no other connection with the Company.

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

- considered time commitments and potential conflicts faced by directors who wished to take up non-executive positions on the boards of other companies;
- authorised John Rishton's acceptance of a non-executive role at Unilever;
- reviewed its own terms of reference;
- considered the independence of the non-executive directors;
- considered the standing schedule of directors' conflicts of interest and recommended to the Board that the schedule be approved;
- recommended the appointment of a new Chairman and two new non-executive directors and renewed terms of office for Dame Helen Alexander, John McAdam and Iain Conn;
- discussed governance arrangements for the Group and the Board evaluation process;
- reviewed the Board's diversity policy; and
- since the year end, the committee has reviewed and approved the form of this report.

Ian Davis
Chairman of the nomination committee

ETHICS COMMITTEE REPORT

The Board has a firm belief that the only way we can succeed as a Group is by applying sound and ethical business practices wherever we operate.

Iain Conn
Chairman of the ethics committee

Committee members and attendance

The ethics committee consists exclusively of independent non-executive directors and met four times in 2013.

	Attendance in 2013
Iain Conn (Chairman)	3/3
Dame Helen Alexander	4/4
Lewis Booth CBE	4/4
Peter Byrom (retired 2 May 2013)	1/1
Lee Hsien Yang (appointed 1 January 2014)	n/a
Jasmin Staiblin	3/4
Ian Strachan (retired 2 May 2013)	1/1

The Chairman of the Board, the Chief Executive, the General Counsel, the Director of Risk and the Head of Business Ethics are also invited to attend meetings on a regular basis.

Key objective:

- review compliance with Rolls-Royce ethics policies.

Responsibilities:

- review compliance with and recommend changes to the Global Code of Conduct;
- monitor evolving practice and requirements of regulatory bodies and recommend how they should be applied in the Group;
- establish bribery prevention policies and procedures;
- review arrangements by which staff may raise concerns and ensure such concerns are handled effectively; and
- ensure that ethical policies and practices are subject to an appropriate level of independent internal scrutiny.

The ethics committee was formed in 2008 in response to the publication of the Woolf Committee report. It is responsible, on behalf of the Board, for reviewing compliance with the Group's Global Code of Conduct, for improving bribery and corruption prevention policies and for reviewing arrangements by which staff may raise ethical concerns in confidence. It considers recommendations on ethical matters made by external regulatory authorities or other bodies and makes recommendations to the Board on how they should be applied in Rolls-Royce. I would like to thank Ian Strachan for his chairmanship of this committee from November 2008 to May 2013.

Referral to Serious Fraud Office (SFO)

On 6 December 2012, we announced that we had passed information to the SFO relating to concerns in overseas markets. Since that date we have continued our investigations and are engaging with the SFO and other authorities in the UK, the USA and elsewhere. In December 2013, we announced that we had been informed by the SFO that it had commenced a formal investigation. The consequence of these disclosures will be decided by the regulatory authorities. It remains 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 (including debarment from government contracts, suspension of export privileges and reputational damage) 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. We continue to demand the highest standards of behaviour from our people. John Rishton has stated unequivocally that neither he nor the Board will tolerate improper business conduct of any sort and all necessary action will be taken to ensure compliance.

Lord Gold's review

The Group has taken significant further action to strengthen and enhance its ethics and compliance programme. In January 2013, the Group appointed Lord Gold to review its ethical and compliance procedures and make recommendations. Lord Gold began his work in 2013 reporting directly to the ethics committee and attending its meetings. In July 2013, he presented an interim report, having interviewed over 80 senior managers across the Group. In addition to a number of detailed recommendations, the report drew attention to the need for further strengthening of the Group's ethics and compliance function in the following three areas: develop and implement an integrity and values communication strategy; provide integrity and values training for all employees; and reorganise the compliance function. The ethics committee, the Board and the ELT have all reviewed and accepted Lord Gold's interim report and the recommendations made in it and the Group has started to implement those recommendations. The Group has

ETHICS COMMITTEE REPORT

developed an holistic ethics and compliance improvement programme, overseen by a newly appointed Director of Risk, clarifying, with a new Global Code of Conduct, what is expected from all individuals in the Group, defining processes to combat bribery and corruption and strengthening oversight and review of the Group's performance in these areas. The following is a summary of some of the Group's major activities undertaken in 2013:

Global Code of Conduct (Global Code)

In July 2013, the Board and the ELT approved a revised version of the Group's Global Code of Conduct which is a condensed, updated and more readable version of the previous Global Code of Business Ethics. The Global Code is being used as a platform for the Group's enhanced ethics and compliance programme and its rollout is being supported by manager-led face-to-face awareness briefings for all employees and a detailed programme of training which will continue. The Board and the ELT received the awareness briefing and supporting ethics training in July 2013 and provided feedback and input into the materials. The Board agreed that the training programme would be compulsory for all employees.

The rollout programme started in September 2013 and will be delivered to all employees and all new starters. All employees are being asked to certify they have: received a copy of the Global Code; read and understood it; will comply with it; and have received a management briefing. In future years, periodic refresher training will continue and will also be compulsory.

Ethics Line

Since 2008, employees have been able to access a confidential reporting line to report any concerns they might have. In 2013, the Group has reviewed, updated and re-launched its confidential reporting line (now known as the Ethics Line). Today we have contact numbers in 48 countries in addition to a web-based reporting tool which enables employees to ask questions or raise concerns 24 hours a day wherever they are based in the world. The ethics committee receives reports and questions raised through the Ethics Line. In July 2013, it was agreed that an oversight committee would be established to monitor the detailed operation of the Ethics Line and ensure it remains effective and efficient.

Anti-bribery and corruption policies (ABC policies)

Much progress has been made in developing policies to govern the use of intermediaries since the formation of the ethics committee in 2008. The number of intermediaries used by our businesses has continued to fall dramatically during the year. Businesses now have greater ownership and direct responsibility for the marketing, sales and support of the Group's products and services. An updated and simpler version of the Global Gifts and Hospitality Policy was introduced in October 2012 and work has continued in the year to capture data, develop a reporting regime and develop key metrics.

In July 2013, following the issue of Lord Gold's interim report, the Director of Risk undertook to carry out a further thorough review of all ABC policies, taking account of Lord Gold's recommendations. This review is underway and the Group has started the process of updating and modifying its suite of anti-bribery and corruption policies so that they are robust, simpler, meet the current needs of the business and are embedded as a core part of the Group's processes for winning new business. All revised and enhanced ABC policies and procedures will meet the recommendations made by Lord Gold and will be supported by a training programme.

ABC compliance team

The ABC compliance organisation's remit is to embed the ABC policies in the businesses, take the ABC programme into a 'business as usual' mode and make compliance a central part of the Group's processes for winning new business. The ABC compliance team has been reorganised during the year to ensure team members remain independent of the businesses they are policing. The team has been strengthened with the creation of several new roles and broader areas of responsibility including offset compliance. A new role of Head of Risk Training has been created to ensure that there is a robust and effective training programme to support all risk policies including compliance and ethics. In response to Lord Gold's recommendations, a protocol is being developed which will ensure that the Group's Legal, HR, Compliance and Ethics functions work in a co-ordinated manner when investigating potential ethics and compliance breaches, ensuring that any proposed disciplinary action is reported to the Director of Risk.

Ethics team

The ethics team manages the Global Code and the reporting Helplines. It works closely with the compliance team. The team has been strengthened by the creation of the new role of Group Ethics Officer responsible for establishing and co-ordinating a network of trained ethics officers across all business sectors to act as a local point of contact for ethical issues.

Conclusion

When I took up the post of chairman of the ethics committee in 2013, I was well aware of the huge amount of effort and resource that this Group had already dedicated to improving the way our employees conduct our business. The Board has a firm belief that the only way we can succeed as a Group is by applying sound and ethical business practices wherever we operate. We are equally aware that there will always be more to do and we must always seek to improve.

Iain Conn
Chairman of the ethics committee

RISK COMMITTEE REPORT

We have benefited from the work we did in 2012 to concentrate our focus on a smaller number of risks.

John Rishton
Chairman of the risk committee

Committee members and attendance

The risk committee consists of all of the executive directors and met three times in 2013.

	Attendance in 2013
John Rishton (Chairman)	3/3
Jim Guyette	3/3
Mark Morris	3/3
Colin Smith CBE	2/3

Other members of the Executive Leadership Team, the Director of Risk, the Company Secretary and the Head of Enterprise Risk Management are also invited to attend meetings.

Key objective:

- to assist the Board in determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives.

Responsibilities:

- develop and implement the Company's Risk Management strategy and policy;
- review reports on key risks and monitor the total level of risk across the Group; and
- assess the adequacy of management plans to address the risks.

Introduction

Each of the Group's principal risks are owned by specific members of my executive team. We continually review and challenge ourselves as to whether these continue to be our principal risks and whether our management of those risks remains effective. This year, in addition to executive directors, all members of my executive team were invited to attend the meetings to ensure there was enhanced visibility of the principal risks affecting the business and good communication of the outcomes of our discussions to each of the businesses and functions.

Work of the committee in 2013

The committee discussed all of the key risks in depth in advance of the annual and half-year results process and produced a report on principal risks for the Board's approval. It also discussed the work of the Crisis Management Team and agreed to hold more frequent crisis management exercises. During the year, work continued on the development of meaningful indicators to measure the principal risks. More focus was given to our key business continuity risks and the committee considered and assessed each of the key business continuity risks identified by the businesses and their mitigation plans. Our discussion on IT vulnerability led us to have an in-depth review of our IT Operations Centre and give detailed consideration to how IT security risks, including the growing global threat of cyber attack, are managed. We also reviewed the committee's own terms of reference.

Risk process

The Director of Risk leads our risk team across the Group which is responsible for implementing risk policy and processes. Line ownership for risk management is devolved to our business units and functions, supported by a network of risk champions and risk managers.

Each business maintains a risk register which comprises those risks that it considers are material to its objectives and operations. The businesses regularly review the effectiveness and consistency of risk management activity via their assurance framework and the application of the risk management process, all of which are subject to review by the business audit committees. Each business formally reviews their risks at least twice yearly taking account of work carried out by the underlying business units, programmes and functions. Business continuity plans are put in place by the businesses to mitigate continuity risks.

Every six months, as part of the full- and half-year results process, the risk committee reviews the key risks that the businesses and functions report in accordance with our enterprise-wide risk management system. The committee cross-checks the risks identified by the business with those risks it has identified from its own assessments and concludes a list of principal risks. During the year, the committee discusses how the risks have changed and how each risk is managed, identifying where further action is required.

We have benefited from the work we did in 2012 to concentrate our focus on a smaller number of risks. I am particularly pleased with the way the quality of discussion at these meetings has improved as a result of this focus. The attendance of business presidents at meetings has provided greater visibility across the Group of the principal risks and has enabled the Group to better manage and mitigate such risks.

John Rishton
Chairman of the risk committee

SAFETY COMMITTEE REPORT

The safety of our products and our people will always remain a central pillar of our business.

Sir Frank Chapman
Chairman of the safety committee

Committee members and attendance

The safety committee consists exclusively of independent non-executive directors and met twice in 2013.

	Attendance in 2013
Sir Frank Chapman (Chairman)	2/2
Iain Conn	2/2
Lee Hsien Yang (appointed 1 January 2014)	n/a
John McAdam	2/2

The Chairman of the Board, the Chief Executive, the General Counsel, the Director – Engineering and Technology, the Company Secretary, the Technical and Quality Director and the Head of Product Safety Assurance are also invited to attend meetings.

Key objective:

- review and assure the Board on all safety policies, practices and procedures and ensure that these operate reliably and to appropriate industry standards.

Responsibilities:

- keep product safety, HS&E, and personnel security policies under review;
- make recommendations as to content and communication of those policies;
- measure and review safety performance; and
- review external issues which relate to safety policies and practices.

Product safety

In all sectors, the Group supplies high value capital products that are strictly regulated with regard to safety. Civil aerospace products are required to meet relevant airworthiness authority standards, whilst defence operators define their own standards for military aerospace and naval products. Our Marine and Energy businesses need to meet industry specific standards with our Nuclear business being particularly highly regulated.

In June 2013, the committee reviewed a Trent case study which demonstrated how the Company's product safety process operates in practice both in the design stage and during the operational life of an engine. The committee found this product safety process to be very thorough and of a very high standard.

At its meeting in July 2013, the committee considered how the Group applied judgements in product safety beyond the levels defined in legislation. It received an update on the product safety management system and on recent developments in safety in the aerospace industry. It also examined the findings of the Australian Transport Safety Bureau in respect of the Qantas QF32 event and the actions taken by the Group.

In September, the committee was briefed by senior manufacturing and quality managers from the supply chain units (SCUs), the Technical and Quality Director and the Head of Product Safety Assurance on the Rolls-Royce Management System as it applies to safety. This was followed by an in-depth look at the compressor SCU and the design to manufacture process for wide-chord fan blades as well as the process for monitoring on-going blade production.

At our meeting in December, the committee reviewed how the Director – Engineering and Technology executes his accountability for product safety on behalf of the Chief Executive through the Company Product Safety Review Board and the Quality System. The committee also reviewed its own terms of reference.

Health, safety and environment

In July, the committee considered how the As Low as Reasonably Practical (ALARP) approach is applied to HS&E risks, and received updates on the global improvement programmes being implemented in relation to process safety management and electrical safety.

In December, we received an update on 2013 HS&E activity, including briefings on the global improvement programmes related to process safety, electrical safety and occupational health.

Further information on our HS&E performance can be found in sustainability on pages 28 and 29.

Overall the committee made good progress in 2013, particularly in relation to examining the processes that manage product safety. Alongside this central theme, the areas of asset integrity, occupational safety, occupational health, environmental performance and personnel security arrangements for staff working in difficult environments were reviewed. In 2014, we intend to establish a framework for a structured cyclical review of all HS&E and personnel security matters.

This is a Company built on a brand promise of being 'trusted to deliver excellence' and the safety of our products and our people will always remain a central pillar of our business.

Sir Frank Chapman
Chairman of the safety committee

REMUNERATION COMMITTEE REPORT

We believe that our remuneration policy is aligned with our strategy to enhance long-term value for our stakeholders.

Dame Helen Alexander
Chairman of the remuneration committee

Committee members and attendance

The remuneration committee consists exclusively of independent non-executive directors and met five times in 2013.

	Attendance in 2013
Dame Helen Alexander	5/5
Sir Frank Chapman	4/5
John McAdam	5/5

The Chairman, the Chief Executive, the Director – Human Resources, the HR Director – Reward & Pensions, the Company Secretary and the Chief Financial Officer are also invited to attend meetings. None of these executives were present during any discussion of their own remuneration packages.

Key objective:

- to develop a remuneration policy capable of attracting and retaining individuals necessary for business success.

Responsibilities:

- to consider and make recommendations to the Board on the policy for the remuneration of the executive directors, members of the Executive Leadership Team and other direct reportees to the Chief Executive (collectively the Senior Executives) and the Chairman;
- to determine the whole remuneration package for Senior Executives and recommend to the Board the whole remuneration package for the Chairman;
- to determine the terms and conditions of service contracts for Senior Executives;
- to determine the design, conditions and coverage of any annual and long-term incentive schemes for Senior Executives and to approve total and individual payments under these schemes;
- to determine targets for any annual and long-term incentive schemes;
- to determine the issue and terms of all share-based plans available to all employees;
- to determine compensation (if any) in the event of termination of service contracts of any of the Senior Executives; and
- to approve the appointment of former executive directors by the Company as consultants.

On behalf of the Board, I am pleased to present our directors' remuneration report that has been prepared in accordance with the new reporting regulations which became effective on 1 October 2013.

The report is divided into two sections. A policy report which sets out the approach to remuneration, and a remuneration report which details what has been paid to the directors during 2013. Each report will be proposed as a separate resolution at the AGM. The vote on the policy report is a binding vote.

The remuneration policy must be approved at least every three years if it remains unchanged, or sooner in the event the policy needs revising. The policy will become effective on 1 May 2014 subject to shareholder approval at the AGM.

We have a clearly defined strategy to win in competitive markets through our focus on the customer, innovation and profitable growth. Our remuneration policy supports the delivery of this strategy and aligns the interests of our directors with that of our shareholders. This is achieved by short-term and long-term incentive plans which focus on delivering business objectives, profitable growth and strong shareholder returns. Annual incentives are also based on personal performance which will include the progress made on longer-term strategic objectives. An important principle of the annual bonus plan is that no bonus can be paid unless the entire Group has achieved a base level of business performance.

For the first time, the bonus and PSP targets we set in 2014 will include both profit and cash contributions from Rolls-Royce Power Systems. We believe this is appropriate now that Rolls-Royce Power Systems is being integrated into the Rolls-Royce business.

Our overall remuneration policy remains relatively conservative which has served us well in recent years. There will be no increase in basic pay for most of the senior leadership team in 2014. We remain satisfied that the existing remuneration arrangements continue to align with the Group's strategy and there are no plans to change the current arrangements significantly. The committee will continue to monitor our market competitiveness in order to ensure we are able to attract and retain the best talent.

Annual bonus

For executive directors and all senior managers, a proportion of any annual bonus is made in deferred shares. The committee has agreed to allow flexibility to allot new shares to satisfy awards and this provision will be part of the new Rolls-Royce plc Deferred Share Bonus Plan which will be proposed at this year's AGM.

REMUNERATION COMMITTEE REPORT

Performance Share Plan
The current Performance Share Plan (PSP), approved by shareholders ten years ago, expires in 2014. A new PSP will be put forward for approval at the AGM. This will be broadly unchanged with the following two exceptions which we believe increase the link to shareholder interests:

- the new plan will contain malus and clawback provisions to enable the withdrawal or amendment of share grants before vesting and the right to reclaim awards that have vested or their proceeds in the case of serious non-compliance with the Group's Global Code of Conduct, reputational damage or gross misconduct; and
- the directors will be obliged to retain half of all PSP shares released to them until a multiple of salary is reached. The shareholding requirement has been increased to 250 per cent of salary for the Chief Executive and 200 per cent of salary for the other executive directors. The share retention policy is explained on page 66.

Annual bonus outcome
This year's bonus reflects on-target performance. Group underlying profit was £1,500 million which met the base level performance, and there was a net cash inflow of £312 million which resulted in an annual bonus outcome of 60 per cent. The targets and results exclude Rolls-Royce Power Systems AG (previously named Tognum AG).

PSP outcome
Over the three-year performance period for the 2011 PSP grant, earnings per share growth was 60 per cent, which exceeded the OECD index of consumer prices of six per cent, and cash flow per share was 86p. This resulted in 100 per cent of the shares conditionally granted being released. The Company's Total Shareholder Return (TSR) performance was ninth in the FTSE 100 over the three-year performance period which resulted in a 50 per cent increase in the number of shares released to executive directors.

Summary of activity during 2013
During 2013, amongst other things, the committee:

- endorsed the out-turn of the 2012 annual bonus and 2010 PSP;
- reviewed executive directors' base salary levels;
- set 2013 annual bonus targets and performance targets for the PSP 2013 – 2015;
- recommended the approval of the 2012 remuneration report to the Board;
- approved PSP grants to certain senior management;
- considered the structure of the annual bonus for 2014;
- considered the new BIS regulations in respect of drafting the remuneration report;
- considered the projected out-turns for the 2013 annual bonus, All-Employee Bonus Scheme and the 2011 PSP;
- considered a benchmarking report for the executive salary review in 2014; and
- reviewed its own terms of reference.

We believe our current remuneration practices are in line with the new reporting regulations and we welcome the structure and transparency introduced by the new requirements. Overall, we believe that our remuneration policy is aligned with our strategy to enhance long-term value for our stakeholders.

Dame Helen Alexander
Chairman of the remuneration committee

DIRECTORS' REMUNERATION POLICY

Remuneration policy framework

The Group is committed to achieving sustained improvements in performance and this depends crucially on the individual contributions made by the executive team and by employees at all levels. The Board believes that an effective remuneration strategy plays an essential part in the future success of the Group.

Accordingly, the remuneration policy will continue to reflect the following broad principles:

- the remuneration of executive directors and other senior executives should reflect their responsibilities and contain incentives to deliver the Group's performance objectives without encouraging excessive risk taking;
- remuneration must be capable of attracting and retaining the individuals necessary for business success;
- remuneration policy must be sufficiently flexible to take account of changes in the Group's business environment and market practices;
- total remuneration should be based on Group and individual performance, both in the short and long term;
- the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the senior executives to acquire shares in the Company. Therefore a significant proportion of senior executive remuneration will comprise share-based long-term incentives; and
- when determining remuneration, the committee will take into account pay and employment conditions elsewhere in the Group.

Policy report

The policy will start on 1 May 2014, subject to shareholder approval at the AGM.

Executive directors' remuneration policy

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
Salary	It is essential that the Company provides competitive salaries, suitable to attract and retain individuals of the right calibre to develop and execute the business strategy.	Salary levels are set using careful judgement, taking into account the scope of the role and responsibilities, performance, experience, potential, retention issues and salaries elsewhere in the Group. Judgement will be informed, but not led, by reference to companies of a similar size, complexity and internationality. Salaries are reviewed annually and normally fixed for 12 months from 1 March each year. However, salary increases are not automatic. Exceptionally, salaries may be increased on other dates in the year. Executive directors may be appointed at salaries below the target level to enable pay progression commensurate with growth in the new role.	Annual salary increases will not normally exceed average increases for employees in other appropriate parts of the Group. On occasion, increases may be larger where the committee considers this to be necessary. Circumstances where this may apply include: growth into a role; to reflect a change in scope of role and responsibilities; where market conditions indicate a level of under competitiveness and the committee judges that there is a risk in relation to attracting or retaining executives. Where the committee exercises its discretion to award increases above the average for other employees, the resulting salary will not exceed the competitive market range.	None, although individual performance is the primary consideration in setting salary alongside overall Company affordability and market competitiveness.

DIRECTORS' REMUNERATION POLICY

Executive directors' remuneration policy

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
Benefits	To provide market-competitive benefits sufficient to recruit and retain, and to support the executive to give maximum attention to their role.	Benefits provided include a car or car allowance, contribution to the cost of fuel, use of a driver, financial planning assistance, life assurance and medical insurance. Other appropriate benefits may be provided from time-to-time at the discretion of the committee. Certain benefits, such as accommodation or use of a driver, are to enable an executive to devote maximum time and attention to their role. Club membership fees may also be provided. The Group may pay any tax due on these benefits. The Group offers relocation for executives to be located within reasonable reach of their place of work. Where relocation is not practical or a preferred option, or where work is mainly split between two locations, support for accommodation and travel may be provided. Relocation support may include items such as transaction and legal fees, removals, disturbance allowance and temporary travel and subsistence costs. International relocation support may include items such as school fees, tax equalisation and home visits.	Benefits will be market competitive taking into account the role and the local market. Benefits excluding any accommodation, relocation and associated tax costs will not exceed £100,000 per annum. The value of benefits provided for international and domestic relocation and any ongoing accommodation and travel support will be appropriate to the individual circumstances of the executive and only expenses that the committee considers necessary and appropriate will be supported.	None.
Pension	To provide market-competitive pensions sufficient to recruit and retain.	New executives to the Company are offered membership of a defined contribution pension plan. Pension contributions are based on base salary only. There are a number of legacy pension arrangements, including defined benefit plans, which were in place before 27 June 2012 and have not changed since. Commitments to these arrangements will be honoured. Executives may opt to receive a cash allowance in lieu of pension.	The maximum employer contribution to defined contribution pension arrangements is 38% of base salary. Under the Group's legacy defined benefit arrangements, the pension due is the higher of a pension based on the executive's final salary, with a maximum annual accrual rate of 2.5%, or based on career average salary with a maximum annual accrual rate of 3.3%. The resulting pension is limited so that the maximum pension at normal retirement age is two thirds of the executive's final remuneration. The benefits under these arrangements include a lump sum payable on death in service and pensions for surviving spouses, civil partners and certain dependants.	None.

Executive directors' remuneration policy

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
Pension continued			Executives may opt to receive a cash allowance in lieu of pension. The cash allowance is calculated to be equivalent to the employer's defined contribution pension contributions, reduced to allow for the additional National Insurance cost incurred by the employer. James Guyette participates in qualified and non-qualified defined benefit and defined contribution pension arrangements in the US. Under these various arrangements combined it is expected that the benefits provided by the Company will be equivalent in value to a pension of two thirds of salary, with post retirement increases similar to those required by statute in the UK.	
Annual bonus	To incentivise and reward execution of the business strategy, delivery of financial performance targets and achievement of personal objectives. Compulsory deferral of part of any bonus encourages retention and provides alignment with shareholders.	The committee sets Group financial targets and agrees personal objectives for each executive director at the start of the financial year. At the end of the year, business performance determines the Company bonus payout level and the committee considers whether any adjustment to the payout level is appropriate. Each executive director's bonus is also dependent on the achievement of their personal objectives and wider contribution to the Group. The committee may apply an uplift of up to 20% or a reduction, potentially to zero, as appropriate. A portion of the bonus paid, in a range 30% to 50%, is compulsorily deferred into the Company's shares for a period of two years and is subject to continued employment (with early release in certain circumstances). There are no further performance conditions. Deferred shares may receive a bonus issue of C Shares or equivalent during the deferral period. The bonus plan is non-contractual and may be offered on a year-by-year basis. The committee has the right to apply the malus provision on an individual or group basis and amend or withdraw the bonus before payment. From 2014, the same right over deferred shares will apply as will the right to clawback bonuses paid or vested shares on an individual basis if it can be demonstrated that individuals have acted in an improper manner. Malus and/or clawback provisions may apply in exceptional cases such as: material misstatement of results; a material failure of risk management; serious reputational damage; serious individual wrongdoing such as non-compliance with the Company's Code of Conduct; or gross misconduct.	The current maximum annual bonus, linked to business performance, is 135% of salary for the Chief Executive and 125% for other executive directors. This is based on achieving the highest targets set for business performance. However, the committee may adjust the bonus to reflect personal performance as described in the previous column, giving an overall maximum of 162% and 150% respectively. The committee has the discretion to increase the overall maximum bonus level to 200% of salary for the Chief Executive and 175% for other executive directors, subject to this not being above the competitive market range.	The bonus payout level is determined primarily by Group financial performance but the committee may introduce non-financial metrics and/or adjust the payout level to reflect other factors as appropriate. The final bonus awarded to each director is also linked to their personal performance. Any non-financial metrics used in the annual bonus plan will be linked to the Group's strategy and will not be weighted more than 50% of the whole bonus. A principle applies that no bonus is payable unless the base financial targets are achieved and this also applies if non-financial measures are introduced. Based on the current bonus opportunity: **Chief Executive:** Bonus generated by business performance is 40% of salary for achieving the base level targets and 135% of salary for achieving the highest level of targets. Bonus may then be adjusted for personal performance in a range 0-120% at committee discretion with 100% typically applying for good performance and a 20% uplift available for outstanding personal performance. **Other executive directors:** Bonus generated by business performance is 37% of salary for achieving the base level targets and 125% of salary for achieving the highest level of targets. Bonus may then be adjusted for personal performance as above.

DIRECTORS' REMUNERATION POLICY

Executive directors' remuneration policy

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
Performance Share Plan (PSP) **Post 2014 AGM onwards**	To incentivise and reward development and execution of the business strategy over the longer term. The plan provides alignment with shareholder interests through the performance measures chosen and a retention element through the plan timescale. A shareholding requirement is linked to the PSP in order to further provide alignment with shareholders. The link between the performance measures and the Company's strategy is explained in the notes to this table on page 59.	Executive directors are granted awards over shares annually at the start of a three-year performance period. The proportion of the those awards that vest is determined at the end of the period according to a set of Company performance measures. Vesting of awards is subject to continued employment until vesting date with the exception of certain leaver circumstances, in which case vesting is subject to Company performance and pro-rating for service. The plan rules contain malus and clawback provisions. The committee has the right to amend and withdraw share grants before vesting for individuals and groups and the right to reclaim vested shares or their proceeds from individuals where it has been demonstrated that they acted in an improper manner. Situations where the provisions will apply are as described in the bonus section on page 57. Executive directors are required to hold a level of shareholding as described on page 66.	The Chief Executive is granted awards each year over shares to the value of 120% of salary. Other executive directors are granted 100% of salary. Subject to the earnings per share (EPS) condition being met, these shares vest at the end of the performance period if the Company has achieved the maximum target set for cash flow per share (CPS). The number of shares vesting can be increased by 25% for above median TSR ranking rising to 50% increase for upper quartile TSR ranking. Maximum face values of annual awards are therefore 180% of salary for the Chief Executive and 150% of salary for other executive directors.	The three corporate performance measures are: 1. EPS – condition. The increase in EPS over the three-year period must exceed an appropriate index of consumer prices for the same period. If this condition is not met share vesting is zero. 2. CPS – prime measure. The aggregate CPS over the performance period will determine the number of shares which vest. Achieving a base target of CPS will result in 30% of the shares vesting and achieving a maximum CPS target will cause 100% of the shares to vest. The number of shares which may vest is determined on a straight-line basis between the 30% and 100% level. 3. Total Shareholder Return (TSR) relative to FTSE 100 or other appropriate index. The number of shares vesting will be increased by 25% if the Company's TSR is ranked above the median of the FTSE 100, or other appropriate index, over the same periods and by 50% if ranked at or above the upper quartile of the same group. Intermediate TSR ranking will increase the number of shares released on a straight-line basis.
Performance Share Plan (PSP) **Legacy awards – 2004 plan**	The purpose of the 2004 share plan is fully consistent with the purpose of the 2014 plan described above.	The operation of the 2004 plan is as described above with the exception of malus and clawback elements which will apply for 2014 grants.	As above.	As above.
ShareSave Plan	This savings-related share option plan provides all employees worldwide an interest in the performance of Rolls-Royce shares.	Executive directors may participate on the same terms as other employees. The option price may be discounted by up to 20%. Accumulated savings may be used to exercise an option to acquire shares.	The maximum savings amount is currently £250 per month over a three- or five-year period. This may be increased in accordance with changes to UK legislation.	No performance measures are permitted by UK legislation applicable to this type of plan.
Share Incentive Plan (SIP)	UK employees may elect to receive part of any annual bonus in shares. UK employees may elect to make regular monthly purchases of shares from pre-tax income.	UK-based executive directors may participate on the same terms as all other UK employees. Shares held in the SIP for five years will vest free from income tax and National Insurance contributions.	Currently, up to £3,000 of the annual cash bonus can be applied to purchase shares. The maximum monthly amount of £125 may be used to purchase shares. The above limits may be increased in accordance with changes to UK legislation.	The award of any bonus will depend on performance conditions (see page 57) but no further conditions apply once the employee elects to participate in the SIP.

Non-executive directors' remuneration policy

Element	Purpose and link to strategy	Operation	Maximum opportunity	Performance measures
Fees	To reward individuals for fulfilling the relevant role and to attract individuals of the skills and calibre required.	The committee makes recommendations to the Board on the remuneration of the Chairman. The Chairman and the executive directors determine the remuneration for the non-executive directors. The level of remuneration is set within a limit approved from time-to-time by shareholders. The Chairman is paid a single consolidated fee. Other non-executive directors are paid a base fee covering Board and committee membership. Committee chairmen and the Senior Independent Director receive an additional fee.	The Articles of Association require the Company to set a maximum ceiling on the total remuneration payable to non-executive directors including the non-executive Chairman. A resolution to increase this to £1,400,000 will be proposed at the 2014 AGM. Fees are set at a level appropriate for the role and are reviewed regularly, taking in to account fees payable to non-executive directors of companies of a similar size and complexity.	None
Benefits	To devote maximum time and attention to the requirements of the role.	The Chairman has occasional use of chauffeur services. Travel, hotel and subsistence expenses incurred in attending Board meetings and committee meetings or otherwise required to attend the Company's offices are reimbursed by the Company. The Group may pay any tax due on such benefits. Where a non-executive director is based outside the UK and has to file a UK tax return, the Company may pay towards tax advice and filing.	The maximum value for chauffeur services will not exceed £25,000 per annum. The maximum contribution towards tax advice and filing is £5,000 per annum.	None

Performance measures and targets

The annual bonus measures are primarily based on Group financial performance but may contain non-financial measures as detailed in the above table.

The committee will set the Group financial targets with reference to the prior year and to the budgets and business plans for the coming year, ensuring the levels to achieve base, on-target and maximum bonus payout are appropriately challenging.

The PSP performance measures set out in the policy table support the Group's strategy as follows:

- the EPS growth hurdle ensures any payout is supported by sound profitability;
- the aggregate CPS measure incentivises the generation of cash flow in line with the Group's strategy. This measure is set in line with the principles described for the annual bonus; and
- the TSR performance measure aligns interests with shareholders by rewarding TSR out-performance. The TSR is measured with reference to constituents of an appropriate index such as the FTSE 100.

In accordance with the rules of the PSP, the performance condition may be replaced or varied if an event occurs or circumstances arise which cause the committee to determine that the performance conditions have ceased to be appropriate. If the performance condition is varied or replaced, the amended performance conditions must, in the opinion of the committee, be fair, reasonable and materially no more or less difficult than the original condition when set.

Shareholders' views

This statement of remuneration policy is largely a consolidation of policies which have enjoyed the support of shareholders for many years. We have considered the guidance provided by the GC 100 and shareholder advisory groups in preparing this policy and have followed this insofar as it is appropriate in the context of our business. Prior to finalising the policy, we have shared it with a selection of major shareholders. Looking ahead, we welcome an open dialogue with shareholders and intend to continue to consult with major shareholders before implementing any significant change.

Group employee considerations

When setting remuneration for executive directors the committee takes into account contextual information about pay and conditions within the Group, including the following:

- salary increases for the all-employee population;
- bonus awards for the all-employee population; and
- pay ratios between executive directors and other employees.

DIRECTORS' REMUNERATION POLICY

Rolls-Royce employs over 55,000 people in more than 50 countries. Inevitably remuneration arrangements differ to reflect local markets, but some common themes apply to employees at all levels worldwide:

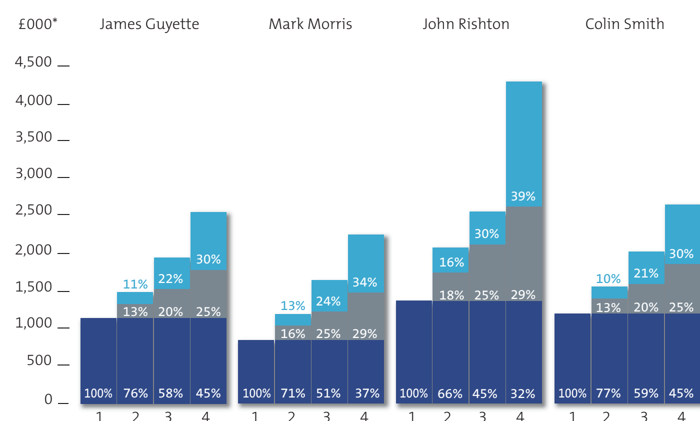
- we aim to offer competitive levels of remuneration, benefits and incentives to attract and retain employees;
- all employees participate in bonus arrangements where the bonus is determined by the same financial measures as that applicable to executive directors; and
- all employees have the opportunity to participate in a savings related share option plan.

At more senior levels, remuneration is increasingly long term and larger proportions are dependent on both Group and individual performance and paid in the form of shares.

Given the scale of the employee population, the committee considered that it would be impractical to consult all employees when drawing up the policy.

Illustrations of remuneration policy application

The bar chart below illustrates projected executive remuneration for 2014 at four different levels of performance showing payments from minimum to maximum. The table below the chart explains performance levels one to four and the associated remuneration.



* Salary values are as at 31 December 2013

- Salary, plus pension and benefits
- Potential value of bonus depending on the performance scenario
- Potential value of PSP depending on the performance scenario

Remuneration achieved for key levels of performance are:

1. Minimum	Fixed remuneration only. No bonus or PSP paid.
2. Base level	Bonus and PSP resulting from base level of business performance. Bonus at 30% of maximum payment assuming no adjustment for personal performance. PSP vesting at 30% of maximum from achieving base CPS target with no TSR multiplier.
3. On-target	Bonus and PSP resulting from performance in line with Company expectations. Bonus at 60% of maximum assuming no adjustment for personal performance. PSP vesting mid-way between base and maximum levels with 25% TSR multiplier.
4. Maximum	Maximum annual bonus based on achieving the highest targets set for business performance and outstanding individual performance: PSP vesting from achieving maximum CPS target and with maximum 50% TSR multiplier.

Service contracts

UK-based executive directors' contracts include the following provisions:

- 12 months' notice of termination from Rolls-Royce;
- 6 months' notice of termination from the executive; and
- reimbursement of reasonable business expenses.

The committee recognises that in the case of appointments to the Board from outside the Group, it may be necessary to offer a longer initial notice period, which would subsequently reduce to 12 months after that initial period.

The policy on exit payments is set out in the next section. The following table summarises the terms of the executive directors' service contracts:

	Date of contract	Notice period Company	Notice period individual
James Guyette	29 Sep 1997	30 days	30 days
Mark Morris	1 Jan 2012	12 months	6 months
John Rishton	10 Mar 2011	12 months	6 months
Colin Smith CBE	1 July 2005	12 months	6 months

James Guyette has a contract with Rolls-Royce North America Inc., drawn up under the laws of the State of Virginia, US. This provides that, on termination without cause, he is entitled to 12 months' severance pay without mitigation and, in addition, appropriate costs incurred in relocating household and personal effects. The contract also provides for the payment of club membership fees and for tax and financial planning up to a maximum of US$15,000 per annum and the Group will gross up any amounts to cover any applicable taxes arising.

All contracts also include the entitlement to paid holidays, sick pay and other standard employee terms.

The Chairman and the non-executive directors have letters of appointment rather than service contracts. No compensation is payable to the Chairman or to any non-executive director if the appointment is terminated early or if they fail to be re-elected at an AGM.

	Appointment date	Current letter of appointment end date
Dame Helen Alexander	1 Sep 2007	31 Aug 2016
Lewis Booth CBE	25 May 2011	24 May 2014
Sir Frank Chapman	10 Nov 2011	9 Nov 2014
Iain Conn	20 Jan 2005	19 Jan 2015
Ian Davis	1 Mar 2013	29 Feb 2016
Warren East CBE	1 Jan 2014	31 Dec 2016
Lee Hsien Yang	1 Jan 2014	31 Dec 2016
John McAdam	19 Jan 2008	18 Feb 2017
John Neill CBE	13 Nov 2008	12 Nov 2014
Jasmin Staiblin	21 May 2012	20 May 2015

Policy on exit payments

The notice period the Company is required to give to executive directors under their contracts of employment is 12 months. Payment in lieu of notice will not exceed the value of 12 months' salary, benefits and pension contributions. Both mitigation and the staggering of payments through the notice period will be considered by the committee where appropriate, as will the funding of reasonable outplacement and other professional fees. Should additional compensation matters arise, such as a settlement or compromise agreement, the committee will exercise judgement and will take into account the specific commercial circumstances.

Pension benefits on early retirement should be payable in accordance with the normal rules of the relevant pension plan. Under legacy UK defined benefit pension arrangements, accrued pension is reduced to reflect early receipt in accordance with factors set by the trustees from time-to-time and is limited to a maximum pension of two thirds of the executive's final remuneration, pro-rated by actual service to potential service.

The committee has the discretion to preserve incentive awards pro-rated to service and to release deferred shares. In exercising this discretion, the committee will have regard to performance and the circumstances of leaving. For deferred shares these are usually released in cases such as retirement, death, injury, ill-health and redundancy.

For PSP, the rules state that unvested awards may be preserved at the committee's discretion according to the circumstances. In such cases vesting will be at the normal date, subject to the established performance conditions, and pro rata to employment in the performance period. In cases such as death and terminal illness, the committee also has the discretion to vest the awards immediately using an estimate of future out-turn.

The treatment of leavers in the Company's ShareSave and SIP plans is governed by the plan rules. The UK rules are HMRC approved. An executive director who has ShareSave options who retires or who leaves the Company through ill-health, disability or redundancy will be entitled to exercise their options, pro rata to the savings made, within six months of leaving the Company. An executive director who leaves in any other manner such as dismissal would only be entitled to have their savings returned to them. Participants in the SIP who leave the Company for the same reasons listed above will have their shares released to them free of tax and National Insurance contributions.

In the event of a change of control of the Company, PSP awards will vest based on the extent to which the committee determines the performance conditions have been or would have been met. Pro-rating for service in the performance period will apply. Deferred shares earned under APRA would vest in full. ShareSave options would immediately be exercisable pro rata to savings made. Consideration received as shares would be held in the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.

If awards are made on recruitment (such as buy-outs) the treatment on leaving would be determined at the time at the committee's discretion.

Policy on new appointments

The committee will normally award newly appointed executive directors with a remuneration package which is consistent with the policy and principles as set out in this report. Base salary may be set at a level higher or lower than previous incumbents and in certain circumstances, to facilitate the recruitment of individuals of the required calibre, the committee may use its discretion to make individual additional incentive awards up to a maximum of 100 per cent of annual salary. Incentive levels may also be increased by up to 30 per cent of salary per annum for incentives commencing within two years of joining. This level of discretion is considered appropriate given the current conservative market positioning of Rolls-Royce and our potential need to recruit from other market sectors or countries outside of the UK.

In addition, remuneration forfeited on resignation from a previous employer may be compensated. The form of this compensation would be considered on a case-by-case basis and may comprise either cash or shares. Generally:

- if such remuneration was in the form of shares, compensation will be in the Company's shares;
- if remuneration was subject to achievement of performance conditions, compensation will be subject to Rolls-Royce performance conditions; and
- the timing of any compensation will, where practicable, match the vesting schedule of the remuneration forfeited.

A newly appointed executive director may be provided with reasonable relocation support as set out in the policy table. Internal appointments would receive a remuneration package that is consistent with the remuneration policy. Legacy terms and conditions would be honoured, including pension entitlements and any outstanding incentive awards.

If an executive director is appointed following a merger or an acquisition of a company by Rolls-Royce, of which the executive director was employed, legacy terms and conditions may be honoured.

Legacy commitments

Contractual commitments made before 27 June 2012 and before the policy comes into effect will be honoured. This will include grants made under the old PSP arrangement which will vest, subject to the performance criteria being achieved after the adoption of this policy, as well as previous contractual provisions relating to the defined benefit pension scheme.

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

The remuneration policy report was approved by the Board on 12 February 2014 and signed on its behalf.

Dame Helen Alexander
Chairman of the remuneration committee

DIRECTORS' REMUNERATION REPORT

Single figure of remuneration (subject to audit)

The total remuneration for the directors of the Company for the financial year ending 31 December 2013 is detailed below:

	Salary/fees (a) £000		Benefits (b) £000		Bonus (c) £000		LTIP (d) £000		Other (e) £000		Sub-total £000		Pension (f) £000		Total £000	
	2013	2012	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012
James Guyette	**535**	517	**107**	100	**423**	663	**1,464**	1,399	**–**	–	**2,529**	2,679	**532**	472	**3,061**	3,151
Mark Morris	**506**	482	**159**	189	**383**	464	**445**	333	**6**	–	**1,499**	1,468	**162**	719	**1,661**	2,187
John Rishton	**921**	896	**125**	126	**824**	1,239	**4,055**	1,998	**–**	–	**5,925**	4,259	**303**	318	**6,228**	4,577
Colin Smith CBE	**523**	506	**128**	23	**394**	596	**1,329**	1,194	**–**	–	**2,374**	2,319	**531**	1,034	**2,905**	3,353
Dame Helen Alexander	**75**	75	**–**	–	**–**	–	**–**	–	**–**	–	**75**	75	**–**	–	**75**	75
Lewis Booth CBE	**80**	80	**10**	4	**–**	–	**–**	–	**–**	–	**90**	84	**–**	–	**90**	84
Peter Byrom	**20**	60	**–**	–	**–**	–	**–**	–	**–**	–	**20**	60	**–**	–	**20**	60
Sir Frank Chapman	**75**	75	**3**	–	**–**	–	**–**	–	**–**	–	**78**	75	**–**	–	**78**	75
Iain Conn	**82**	72	**–**	–	**–**	–	**–**	–	**–**	–	**82**	72	**–**	–	**82**	72
Ian Davis	**292**	–	**2**	–	**–**	–	**–**	–	**–**	–	**294**	–	**–**	–	**294**	–
John McAdam	**60**	60	**–**	–	**–**	–	**–**	–	**–**	–	**60**	60	**–**	–	**60**	60
John Neill CBE	**60**	60	**2**	2	**–**	–	**–**	–	**–**	–	**62**	62	**–**	–	**62**	62
Sir Simon Robertson	**126**	370	**2**	7	**–**	–	**–**	–	**–**	–	**128**	377	**–**	–	**128**	377
Jasmin Staiblin	**60**	37	**2**	–	**–**	–	**–**	–	**–**	–	**62**	37	**–**	–	**62**	37
Ian Strachan	**26**	75	**–**	–	**–**	–	**–**	–	**–**	–	**26**	75	**–**	–	**26**	75
Total	**3,441**	3,365	**540**	451	**2,024**	2,962	**7,293**	4,924	**6**	–	**13,304**	11,702	**1,528**	2,543	**14,832**	14,245

Notes to the table

(a) Salary/fees – cash paid in the year. James Guyette was paid in US dollars translated at £1 = US$1.565 (2012 US$1.585).

(b) Benefits – taxable value of all benefits paid in the year. The benefits for the non-executive directors relate to travel and subsistence associated with attending board meetings with the exception of Sir Simon Robertson which was related to the use of a chauffeur.

	James Guyette £000		Mark Morris £000		John Rishton £000		Colin Smith CBE £000	
Benefits	**2013**	2012	**2013**	2012	**2013**	2012	**2013**	2012
Car or car allowance including fuel allowance	**11**	11	**24**	24	**18**	18	**21**	22
Chauffeur services	**–**	–	**–**	–	**13**	8	**–**	–
Financial planning	**19**	16	**–**	–	**–**	–	**–**	–
Medical insurance	**–**	–	**1**	1	**1**	1	**1**	1
Life assurance	**38**	37	**–**	–	**–**	–	**–**	–
Club membership fees	**23**	20	**–**	–	**–**	–	**–**	–
Travel and subsistence	**–**	–	**30**	36	**–**	–	**3**	–
Housing costs	**16**	16	**104**	128	**93**	99	**103**	–
Total	**107**	100	**159**	189	**125**	126	**128**	23

(c) Bonus. This is the total APRA bonus earned in 2013. The bonus, based on Group profit and cash performance, was 60 per cent of the maximum as detailed on page 57. Personal performance is taken into account in determining individual bonuses payable. The awards made to John Rishton and James Guyette included a modification for personal performance of 110 per cent and 105 per cent respectively. 60 per cent of the bonus is paid as cash and 40 per cent is deferred into shares for two years subject to continuous employment with the Group.

(d) Long-term incentives. This is the estimated value of the PSP shares that are due to vest in March 2014 (2013 being the final year of the performance period) and for John Rishton, as well as his PSP shares, the performance related shares he received on joining the Company. It is based on the number of shares that will vest multiplied by the average share price of 1184.52p over the quarter ending 31 December 2013 (as the vesting price is not known at the date of approval of the remuneration report). Performance has already been determined for these awards as detailed on page 64 and 150 per cent of the original award will vest, based on achievement of the EPS growth hurdle, the maximum CPS target and TSR performance in the upper quartile of FTSE 100 companies. The share price at the date of vesting for the PSP in 2013 was 1020.52p. The vesting price for John Rishton's release of the performance related and restricted shares in 2013 was 1048p.

(e) Value of the gain made on the exercise of ShareSave options is the difference between the exercise price of 387p and the mid-market price of 1062p on the date of exercise. ShareSave is not subject to performance conditions and the UK plan rules are HMRC approved.

(f) Pensions. For defined benefit plans, this is the increase in pension benefit net of inflation for the current year and applying the HMRC methodology multiplier of 20. Cash in lieu of pension accrual is also included.

Implementation of remuneration policy

Information on the elements of remuneration and how the Company intends to implement the remuneration policy in 2014 are set out below and on pages 64 to 66.

Base salary

The committee reviewed the salary levels of executive directors and decided not to award any increases for 2014.

Name	Base salary
James Guyette	$840,000
Mark Morris	£510,000
John Rishton	£925,000
Colin Smith CBE	£525,000

Annual bonus

The annual bonus pool is delivered under APRA.

In 2013, executive directors were eligible for award levels as detailed in the policy report on page 57.

APRA 2013 performance measures

The APRA bonus is determined by Group financial performance and personal performance.

For 2013, the Group financial measures were cash-flow performance and profit. Targets for both measures were set as follows:

	% of maximum bonus
Base	15%
Target	30%
Maximum	50%

The Group financial performance is the addition of the cash and profit out-turns, provided a specified minimum level is achieved on both, after deduction of the cost of bonus from profit, otherwise no bonus is payable.

The 2013 financial performance which resulted in the APRA bonus out-turn of 60 per cent was as follows:

Group underlying profit	Group underlying profit* was £1,500 million which matched the base level but fell short of the on-target level of £1,530 million. The profit performance resulted in achievement of 15%.
Cash flow	Cash flow* for the year was £312 million which exceeded both the on-target level of break-even and the maximum target of £200 million. The cash flow performance resulted in the achievement of 50%.
Overall award	The minimum level of profit after the cost of bonus, necessary to enable payment of bonus was £1,500 million. To ensure this was achieved the bonus earned through the separate profit and cash elements was limited to 60% of the maximum.

* Group underlying profit and cash flow excludes the results of Rolls-Royce Power Systems AG (previously named Tognum AG), the impact of acquisitions and disposals in the year and unbudgeted foreign exchange translation effects where material.

The extent of this disclosure reflects the Board's view that APRA profit and cash targets are commercially sensitive. This will be kept under review.

Deferred APRA awards in March 2013 (subject to audit)

For executive directors and other senior executives, 40 per cent of APRA was delivered in deferred shares. As detailed on page 57, ordinary shares held as deferred shares may receive a bonus issue of C Shares during the deferral period.

Name	Number of shares	Face value £000	Vesting date
James Guyette	25,770	264	01/03/2015
Mark Morris	18,057	185	01/03/2015
John Rishton	48,250	494	01/03/2015
Colin Smith CBE	23,207	237	01/03/2015

APRA 2014

The committee have determined that the bonus in respect of 2014 will be operated on similar terms to 2013. There will be no change to the maximum bonus opportunities for executive directors. As described above, bonus targets are not disclosed.

Long-term incentives – PSP

The PSP is designed to reward and incentivise selected senior executives who can influence the long-term performance of the Group.

PSP 2013

In 2013, executive directors received PSP grants in line with the policy report on page 58.

PSP awards made in March 2013 (subject to audit)

The targets were as follows:

Aggregate CPS over the three-year period	% of maximum award released
Less than 56p	0%
56p	30%
94p	100%

Straight line vesting will apply between these points.

	Number of shares awarded	% of salary	Face value (at maximum vesting) £000	Minimum % vesting (as a % of maximum)	Performance period end date
James Guyette	51,714	100	794	20	31/12/2015
Mark Morris	49,838	100	765	20	31/12/2015
John Rishton	108,470	120	1,665	20	31/12/2015
Colin Smith CBE	51,304	100	788	20	31/12/2015

All awards are made as performance shares based on a percentage of salary and the value is divided by the average share price over a three-day period which was 1023.33p before to the date of grant. The face value is the maximum number of shares that would vest (150 per cent of the award) multiplied by the share price at the date of grant. If the base EPS or CPS targets are not achieved, no shares vest.

DIRECTORS' REMUNERATION REPORT

PSP awards vesting in March 2014

The following sets out details in respect of the March 2011 PSP award, for which the final year of performance was the 2013 financial year.

	Targets for 2011 – 2013 period	Performance against targets
EPS growth (hurdle)	Awards may vest if EPS growth exceeds the OECD index of consumer prices. Awards will lapse if hurdle not met.	EPS growth of 60% over the three-year period exceeded the hurdle which was 6%.
Aggregate CPS (100% of award)	Aggregate CPS over three-year period of less than 56p – zero vesting. Aggregate CPS over three-year period of 56p – 30% vesting. Aggregate CPS over three-year period of 83p – 100% vesting. Straight-line vesting between these points.	Aggregate CPS performance over three years of 86p. 100% vesting.
TSR performance (multiplier of up to 50%)	TSR below median of FTSE 100 – no additional vesting. TSR above median of FTSE 100 – 25% increase. TSR at upper quartile of FTSE 100 – 50% increase. Straight-line basis between these points.	TSR performance was ninth best amongst the FTSE 100. 50% increase.
Total		150% of shares will vest during March 2014.

PSP awards to be made in March 2014

The performance targets in respect of the 2014 to 2016 performance period under the Aggregate CPS measure will be as follows:

Aggregate CPS over the three-year period	% of maximum award released
Less than 125p	0%
125p	30%
155p	100%

CPS is calculated as reported cash flow before the cost of business acquisitions or proceeds of disposals, foreign exchange translation effects, special payments into pension schemes and payments to shareholders, divided by the weighted average number of shares in issue.

We believe that the combination of EPS, CPS and TSR targets are challenging and that the performance necessary to achieve awards towards the upper end of the range is stretching. They should not, therefore, be interpreted as providing guidance on the Group's performance over the relevant period.

Non-executive directors' fees paid

The Chairman and the other non-executive directors are not eligible to participate in any of the Group's share schemes, incentive arrangements or pension schemes. A facility is in place which enables non-executive directors to use some or all of their fees, after the appropriate statutory deductions, to make market purchases of shares in the Company on a monthly basis.

Non-executive directors' base fees

	2014[1] £000	2013 £000	2012 £000
Chairman[2]	425	425	370
Other non-executive directors	70	60	60
Chairman of audit committee	25	20	20
Chairman of ethics committee	20	15	15
Chairman of remuneration committee	20	15	15
Chairman of safety committee	20	15	15
Senior Independent Director	15	12	12

1 Subject to approval at the AGM, the base fees will be increased with effect from 1 May 2014.

2 Sir Simon Robertson retired as Chairman on 2 May 2013. The fee was increased on the appointment of the new Chairman, Ian Davis.

Payments to past directors (not subject to audit)

John Cheffins retired from the Board on 30 September 2007. He continued in his role as Chairman of Rolls-Royce Fuel Cell Systems Limited and provided non-executive advice to the Energy business until 28 September 2013. He was paid £35,811 and benefits totalling £2,051 in 2013 (paid in Canadian dollars and translated at £1=CAD$1.612).

Dr Mike Howse retired from the Board on 30 June 2005. Following his retirement, he has continued to be retained by the Company for his expertise in engineering and was paid £23,310 in 2013.

Payments to past directors (subject to audit)

Mike Terrett retired from the Board on 31 December 2012. The PSP award, granted to him on 1 March 2010, for the performance period 1 January 2010 to 31 December 2012 vested on 1 March 2013 at a vesting price of 1020.52p. The value of the PSP released to him was £1.4 million (2012 £2.4 million) before tax and National Insurance contributions. PSP awards that will vest in 2014 and may vest in 2015, subject to meeting the performance criteria, will be pro-rated to the length of service during the performance period.

Loss of office payments (subject to audit)

There were no payments in respect of loss of office during the year.

External directorships

The directors retained the payments detailed below from serving on the boards of these companies:

	Directorships held	Payments received £000
James Guyette [1,2]	PrivateBancorp Inc. and priceline.com	128
John Rishton [3]	Unilever PLC and Unilever N.V.	56

[1] James Guyette was paid in US dollars translated at £1=US$1.565.
[2] James Guyette received 2,548 Restricted Stock Units (RSUs) at US$19.63 per share in PrivateBank, in addition to an annual fee. He also received 359 shares of restricted stock at US$695.62 per share in priceline.com.
[3] John Rishton was appointed as a director of Unilever PLC and Unilever N.V. on 15 May 2013. Part of his fee was paid in Euro's translated at £1 = EUR 1.178.

Pension entitlements (subject to audit)

The Group's UK pension schemes are funded, registered schemes and were approved under the regime applying until 6 April 2006. They include both defined contribution and defined benefit pension schemes. In the defined benefit pension schemes normal retirement age is 62.

John Rishton is a member of one of the Group's UK defined contribution pension schemes and received employer contributions restricted to the annual allowance limits with any excess paid as a cash allowance. The cash allowance is calculated as equivalent to the cost of the pension contributions allowing for National Insurance costs.

Mark Morris opted out of future pension accrual and salary linkage with effect from 16 August 2012 and receives a cash allowance in lieu of future pension accrual.

Colin Smith CBE opted out of future pension accrual with effect from 1 April 2006 and receives a cash allowance in lieu of future pension accrual.

James Guyette participates in pension plans sponsored by Rolls-Royce North America Inc. He is a member of two defined benefit plans in the US, one qualified and one non-qualified. He accrues a retirement lump sum benefit in both of these plans. In addition, James Guyette is a member of two 401(k) Savings Plans in the US, one qualified and one non-qualified, to which both he and his employer, Rolls-Royce North America Inc., contribute. He is also a member of an unfunded non-qualified deferred compensation plan in the US, to which his employer makes notional contributions. Under the defined benefit plans, the earliest age at which benefits can be taken without consent and without actuarial reduction by James Guyette is age 65.

Details of the pension benefits of the executive directors as at 31 December 2013, in the Group's UK and US pensions schemes are given below:

	Total accrued annual pension entitlement at 31 December 2013 £000
Mark Morris	167
Colin Smith	391

	Total accrued retirement lump sum entitlement at 31 December 2013 £000
James Guyette [1]	1,181

[1] Benefits are translated at £1 = US$1.6542.

Details of the defined contribution pension contributions paid by the Group on behalf of the following executive directors are given below:

	2013 £000	2012 £000
James Guyette [1]	**395**	394
John Rishton	**50**	123

[1] Benefits are translated at £1=US$1.565 (2012 US$1.585).

DIRECTORS' REMUNERATION REPORT

Share retention policy (subject to audit)

We believe it is important that the interests of the executive directors should be closely aligned with those of shareholders. The deferred APRA award and the PSP provide considerable alignment. However, participants in the PSP are also required to retain at least one half of the number of after-tax shares released from the PSP, until the value of their shareholding reaches the percentage of salary shown in the table below. When this level is reached it must be maintained until retirement or departure from the Group. The director's total shareholding, for the purposes of comparing it with the minimum shareholding requirement, includes shares held: by their connected persons; in the SIP; APRA deferred shares that have not vested; and PSP shares that have vested but does not included unvested PSP awards. The shareholding requirement will increase in 2014 to 250 per cent of salary for the Chief Executive and 200 per cent of salary for the other executive directors. APRA deferred shares will no longer count towards their minimum shareholding requirement.

As at 31 December 2013, the executive directors each complied with the 2013 minimum shareholding requirement as detailed in the table below:

	Base salary £000	Total shareholding	Minimum shareholding requirement as % of salary	Minimum shareholding requirement[1]	Actual shareholding as % of minimum requirement
James Guyette[2]	508	447,868	150	74,462	601
Mark Morris	510	86,954	150	74,756	116
John Rishton	925	293,947	200	180,782	163
Colin Smith CBE	525	346,466	150	76,954	450

1 Salary divided by the March 2013 PSP grant price of 1023.33p multiplied by percentage of salary.
2 Translated at £1 = US$1.6542.

Directors' interests in shares (subject to audit)

The directors and their connected persons had the following interests in the ordinary shares and C Shares[1] of the Company at 31 December 2013, or at date of retirement if earlier, are shown in the table below:

			Unvested awards			Vested awards
	Ordinary shares	C Shares	Conditional shares not subject to performance conditions (APRA)	Conditional shares subject to performance conditions (PSP)	Options over shares subject to savings contracts (ShareSave)	Vested shares and options exercised in year
James Guyette	393,937	–	53,931	198,503	–	174,265
Mark Morris	62,752	12,676,120	24,202	134,776	541	41,713
John Rishton	201,297	–	92,650	510,681	1,450	190,691
Colin Smith CBE	296,274	–	50,192	189,104	–	150,678
Dame Helen Alexander	2,442	605,377	–	–	–	–
Lewis Booth CBE	12,500	950,000	–	–	–	–
Peter Byrom (retired 2 May 2013)	229,910	–	–	–	–	–
Sir Frank Chapman	4,832	358,759	–	–	–	–
Iain Conn	27,353	11,178	–	–	–	–
Ian Davis	6,595	–	–	–	–	–
Dr John McAdam	2,174	–	–	–	–	–
John Neill CBE	41,426	12,722,692	–	–	–	–
Sir Simon Robertson (retired 2 May 2013)	43,072	–	–	–	–	–
Jasmin Staiblin	–	–	–	–	–	–
Ian Strachan (retired 2 May 2013)	11,500	–	–	–	–	–

1 Non-cumulative redeemable preference shares of 0.1p each.

Changes in interests (subject to audit)

	Ordinary shares		C Shares	
	31 December 2013	Changes from 31 December 2013 to 12 February 2014	31 December 2013	Changes from 31 December 2013 to 12 February 2014
James Guyette	393,937	2,609	–	–
Mark Morris	62,752	6	12,676,120	2,362,936
John Rishton	201,297	1,335	–	–
Colin Smith CBE	296,274	1,951	–	–
Dame Helen Alexander	2,442	204	605,377	(605,377)
Lewis Booth CBE	12,500	–	950,000	(950,000)
Sir Frank Chapman	4,832	534	358,759	354,062
Iain Conn	27,353	580	11,178	–
Ian Davis	6,595	361	–	–
Dr John McAdam	2,174	39	–	–
John Neill CBE	41,426	442	12,722,692	(12,722,692)

Directors' interests in unvested and vested awards

James Guyette

	31 December 2012	Granted during year	TSR uplift at vesting/ dividend enhancement	Vested awards	31 December 2013	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2010	91,383	–	45,692	137,075	–	544.70	01/03/2010	01/03/2013	1020.52
PSP 2011	82,404	–	–	–	82,404	601.50	09/03/2011	09/03/2014	–
PSP 2012	64,385	–	–	–	64,385	809.70	01/03/2012	01/03/2015	–
PSP 2013	–	51,714	–	–	51,714	1023.33	01/03/2013	01/03/2016	–
	238,172	51,714	45,692	137,075	198,503				
APRA 2010	35,595	–	1,595	37,190	–	601.00	11/03/2011	11/03/2013	1048.00
APRA 2011	28,161	–	–	–	28,161	808.80	01/03/2012	01/03/2014	–
APRA 2012	–	25,770	–	–	25,770	1023.33	01/03/2013	01/03/2015	–
	63,756	25,770	1,595	37,190	53,931				

Mark Morris

	31 December 2012	Granted during year	TSR uplift at vesting/ dividend enhancement	Vested awards	31 December 2013	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting/ exercise (p)
PSP 2010	26,085	–	6,522	32,607	–	544.70	01/03/2010	01/03/2013	1020.52
PSP 2011	25,039	–	–	–	25,039	601.50	09/03/2011	09/03/2014	–
PSP 2012	59,899	–	–	–	59,899	809.70	01/03/2012	01/03/2015	–
PSP 2013	–	49,838	–	–	49,838	1023.33	01/03/2013	01/03/2016	–
	111,023	49,838	6,522	32,607	134,776				
APRA 2010	7,881	–	353	8,234	–	601.00	11/03/2011	11/03/2013	1048.00
APRA 2011	6,145	–	–	–	6,145	808.80	01/03/2012	01/03/2014	–
APRA 2012	–	18,057	–	–	18,057	1023.33	01/03/2013	01/03/2015	–
	14,026	18,057	353	8,234	24,202				
ShareSave (options)	872	–	–	872	–	387.00*	01/02/2010	01/02/2013	1062.00
ShareSave (options)	541	–	–	–	541	525.00	01/02/2012	01/02/2015	–
	1,413	–	–	872	541				

* For ShareSave, the share price shown is the exercise price which was 85 per cent of the market price at the date of award.

DIRECTORS' REMUNERATION REPORT

John Rishton

	31 December 2012	Granted during year	TSR uplift at vesting/ dividend enhancement	Vested awards	31 December 2013	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting/ exercise (p)
PSP 2011	164,866	–	–	–	**164,866**	601.50	09/03/2011	09/03/2014	–
PSP 2012	133,383	–	–	–	**133,383**	809.70	01/03/2012	01/03/2015	–
PSP 2013	–	108,470	–	–	**108,470**	1023.33	01/03/2013	01/03/2016	–
	298,249	108,470	–	–	**406,719**				
Performance related shares	76,365	–	38,183	114,548	**–**	601.50	09/03/2011	11/03/2013	1048
Performance related shares	63,397	–	–	–	**63,397**	601.50	09/03/2011	01/03/2014	–
Performance related shares	40,565	–	–	–	**40,565**	601.50	09/03/2011	01/03/2015	–
	180,327	–	38,183	114,548	**103,962**				
APRA 2011	44,400	–	–	–	**44,400**	808.80	01/03/2012	01/03/2014	–
APRA 2012	–	48,250	–	–	**48,250**	1023.33	01/03/2013	01/03/2015	–
	44,400	48,250	–	–	**92,650**				
Restricted shares	76,143	–	–	76,143	**–**	601.50	09/03/2011	01/03/2013	1048
ShareSave (options)	1,450	–	–	–	**1,450**	525.00*	01/02/2012	01/02/2017	–

* For ShareSave, the share price shown is the exercise price which was 85 per cent of the market price at the date of award.

Colin Smith CBE

	31 December 2012	Granted during year	TSR uplift at vesting/ dividend enhancement	Vested awards	31 December 2013	Market price at date of award (p)	Date of grant	Date of vesting	Market price at vesting (p)
PSP 2010	78,025	–	39,013	117,038	**–**	544.70	01/03/2010	01/03/2013	1020.52
PSP 2011	74,813	–	–	–	**74,813**	601.50	09/03/2011	09/03/2014	–
PSP 2012	62,987	–	–	–	**62,987**	809.70	01/03/2012	01/03/2015	–
PSP 2013	–	51,304	–	–	**51,304**	1023.33	01/03/2013	01/03/2016	–
	215,825	51,304	39,013	117,038	**189,104**				
APRA 2010	32,197	–	1,443	33,640	**–**	601.00	11/03/2011	11/03/2013	1048.00
APRA 2011	26,985	–	–	–	**26,985**	808.80	01/03/2012	01/03/2014	–
APRA 2012	–	23,207	–	–	**23,207**	1023.33	01/03/2013	01/03/2015	–
	59,182	23,207	1,443	33,640	**50,192**				

Chief Executive pay, TSR and all-employee pay

This section of the report enables our remuneration arrangements to be seen in context by providing:

- a five-year history of our Chief Executive's remuneration;
- our TSR performance over the same period;
- a comparison of the year-on-year change in our Chief Executive's remuneration with the change in average remuneration across the Group; and
- a year-on-year comparison of the total amount spent on pay across the Group with profit before tax and dividends paid.

Chief Executive pay

Year	Chief Executive[1,2]	Single figure of total remuneration £000	Annual bonus as a % of maximum	PSP as a % of maximum
2013	John Rishton	6,228	55	100
2012	John Rishton	4,577	85	–
2011	John Rishton	3,677	63	–
2011	Sir John Rose	3,832	–	75
2010	Sir John Rose	3,914	100	100
2009	Sir John Rose	2,409	29	93

1 On 31 March 2011, Sir John Rose retired as Chief Executive and John Rishton was appointed.

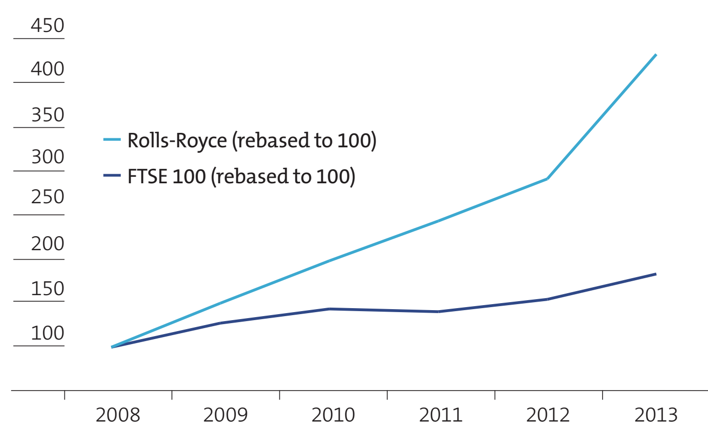
2 The remuneration for Sir John Rose does not include any pension accrual or contribution as he was receiving his pension from 1 February 2008. John Rishton received a special grant of shares on joining the Company on 1 March 2011 to mirror the shares he forfeited on resigning from his previous employer. The share price has increased from 483.50p at the time this grant was made to 1275p at the end of 2013. These are the main reasons why John Rishton's remuneration exceeds that of his predecessor.

Five-year TSR performance

The Company's TSR performance over the previous five years compared to a broad equity market index is shown in the graph opposite. The FTSE 100 has been chosen as the comparator because it contains a broad range of other UK listed companies.

The graph shows the growth in value of a hypothetical £100 holding in the Company's ordinary shares over five years, relative to the FTSE 100 index. The values of the hypothetical £100 holdings at the end of the five-year period were £432.40 and £183.10 respectively.

Rolls-Royce – five year TSR data



Percentage change in Chief Executive remuneration

The following table compares the percentage change in the Chief Executive's remuneration to the average percentage change in remuneration for all UK employees from 2012 to 2013.

	Salary	Benefits	Annual bonus
Chief Executive	2.8%	-0.8%	-33%
UK employees average	3.2%	0.6%	-12%

UK employees were chosen as a comparator group in order to avoid the impact of exchange rate movements over the year. UK employees make up approximately 45 per cent of the total employee population.

Relative spend on pay

The following table sets out the percentage change in payments to shareholders and overall expenditure on pay across the Group.

	2013 £m	2012 £m	Change %
Payments to shareholders (note 17 – financial statements)	**366**	328	11.6
Group employment costs (note 7 – financial statements)	**3,675**	2,762	34.7

Statement of shareholder voting

	For	Against	Votes withheld
Approval of 2012 remuneration report			
Percentage of votes (%)	98.41	1.59	0.58
Number of votes cast	1,297,319,180	20,981,975	7,611,187

We monitor carefully shareholder voting on our remuneration policy and implementation. We recognise the importance of ensuring that our shareholders continue to support our remuneration arrangements.

Advisers to the committee

During the year, the committee had access to advice from Deloitte LLP's executive compensation advisory practice. Total fees for advice provided to the committee during the year by Deloitte were £120,850. Deloitte also advised the Company on tax, assurance, pensions and corporate finance and Deloitte MCS Limited provides consulting services.

Deloitte is a founding member of the Remuneration Consultants Group and adheres to its code in relation to executive remuneration consulting. The committee requests Deloitte to attend meetings periodically during the year. The committee is satisfied that the advice it has received has been objective and independent.

Statutory requirements

The remuneration report has been prepared on behalf of the Board by the remuneration committee.

We adopt the principles of good governance as set out in the UK Corporate Governance Code and comply with the regulations contained in the Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, the Listing Rules of the Financial Conduct Authority and the relevant schedules of the Companies Act 2006.

The Companies Act 2006 and the Listing Rules require the Company's auditor to report on the audited information in their report on page 135 and to state that this section has been properly prepared in accordance with these regulations. The remuneration policy report and the annual remuneration report are subject to shareholder approval at the AGM on 1 May 2014.

The directors' remuneration report was approved by the Board on 12 February 2014 and signed on its behalf.

Dame Helen Alexander
Chairman of the remuneration committee

SHAREHOLDERS AND SHARE CAPITAL

Share capital and voting rights

On 31 December 2013, there were 1,880,301,654 ordinary shares of 20 pence each, 16,286,039,565 redeemable C Shares of 0.1 pence each and one Special Share of £1 in issue. The ordinary shares are listed on the London Stock Exchange.

Payments to shareholders

Payments to shareholders will, as before, be made in the form of redeemable C Shares and at the AGM on 1 May 2014, the directors will recommend an issue of 134 C Shares with a total nominal value of 13.4 pence for each ordinary share. The C Shares will be issued on 1 July 2014. Together with the interim issue on 2 January 2014 of 86 C Shares for each ordinary share with a total nominal value of 8.6 pence, this is the equivalent of a total annual payment to ordinary shareholders of 22 pence for each ordinary share.

You can find out more about payments to shareholders by going to the 'Shareholder information' section of this report on page 139 or by visiting the Group's website www.rolls-royce.com/investors/share_information.

Share class rights

The rights and obligations attaching to the different classes of shares are summarised below. The full rights are set out in the Company's Articles of Association, the latest copy of which can be found on the Group's website at www.rolls-royce.com.

Ordinary shares

Holders of ordinary shares are entitled to receive the Company's annual report. They are also entitled: to 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. They have the right to ask questions at the AGM relating to the business of the meeting and for these to be answered, unless such answer would interfere unduly with the business of the meeting, involve the disclosure of confidential information, if the answer has already been published on the Group's website or if it is not in the interests of the Group or the good order of the meeting that the question be answered. Holders of ordinary shares may receive a bonus issue of C Shares or a dividend and on liquidation may share in the assets of the Company.

C Shares

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

Shareholders can choose to:

- redeem all C Shares for cash;
- redeem all C Shares for cash and reinvest the proceeds in additional ordinary shares using the CRIP operated by the Registrar; or
- keep the C Shares.

Any C Shares retained have limited voting rights and attract a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis. The Company has the option to redeem the C Shares compulsorily, at any time, if the aggregate number of C Shares in issue is less than ten per cent of the aggregate number of all C Shares issued, or on the acquisition or capital restructuring of the Company.

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

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

Special Share

Certain rights attach to the special rights non-voting share (Special Share) issued to HM Government (Special Shareholder). Subject to the provisions of the Companies Act 2006, the Treasury Solicitor may redeem the Special Share at par at any time. The Special Share confers no rights to dividends but in the event of a winding-up it must be repaid at its nominal value in priority to any other shares.

Certain Articles that relate to the rights attached to the Special Share may only be altered with the consent of the Special Shareholder. Such Articles include: (i) the foreign shareholding limit provisions whereby a foreign person cannot hold more than a 15 per cent voting interest in the Company; and (ii) the nationality of directors provisions whereby at least the Chairman or the Chief Executive must be a British citizen and at least half of the number of directors must be British citizens. The Special Shareholder is not entitled to vote at any general meeting or any other meeting of any class of shareholders.

Restrictions on transfer of shares and limitations on holdings

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

Shareholder agreements and consent requirements

There are no known arrangements under which financial rights carried by any of the shares in the Company are held by a person other than the holder of the shares and no known agreements between the holders of shares with restrictions on the transfer of shares or exercise of voting rights. No disposal may be made to a non-Group member which, alone or when aggregated with the same or a connected transaction, constitutes a disposal of the whole or a material part of either the nuclear business or the assets of the Group as a whole, without consent of the Special Shareholder.

Authority to issue shares

At the AGM in 2013, authority was given to the directors to allot new ordinary shares up to a nominal value of £124,821,118, equivalent to one-third of the issued share capital of the Company.

This is called the first section 551 amount. In addition, a special resolution was passed to effect a disapplication of pre-emption rights for a maximum of five per cent of the issued share capital of the Company. These authorities are valid until the AGM in 2014, and the directors propose to renew these authorities at that AGM. It is proposed to seek a further authority, at the AGM in 2014 to allot up to two thirds of the total issued share capital, but only in the case of a rights issue. This is called the second section 551 amount.

The Board believes that this additional authority will allow the Company to retain the maximum possible flexibility to respond to circumstances and opportunities as they arise; and to allot new C Shares up to a nominal value of £500 million as an alternative to a cash dividend. Such authority expires at the conclusion of the AGM. The directors propose to renew the authority to allot new C Shares at the AGM.

Authority to purchase own shares

At the 2013 AGM, the Company was authorised by shareholders to purchase up to 187,231,677 of its own ordinary shares representing ten per cent of its issued ordinary share capital.

The Company did not make use of this authority during 2013. The authority for the Company to purchase its own shares expires at the conclusion of the AGM or 18 months from 2 May 2013, whichever is the earlier. A resolution to renew it will be proposed at the AGM.

Voting rights

Deadlines for exercising voting rights

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

Voting rights for employee share plan shares

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

Major shareholdings

At 31 December 2013, the following companies had notified an interest in the issued ordinary share capital of the Company in accordance with the Financial Conduct Authority's Disclosure and Transparency Rules:

Company	Date notified	% of issued ordinary share capital
BlackRock Inc.	03 Sep 2010	5.02
Invesco Limited	04 Feb 2008	6.91
Capital Research and Management Company	16 May 2013	3.03

The Company had not received any further notifications from 31 December 2013 to 12 February 2014.

OTHER STATUTORY INFORMATION

Political donations

In line with its established policy, the Group made no political donations pursuant to the authority granted at the 2013 AGM. Although the Company does not make, and does not intend to make, donations to political parties within the normal meaning of that expression, the definition of political donations under the Companies Act 2006 is very broad and includes expenses legitimately incurred as part of the process of talking to members of parliament and opinion formers to ensure that the issues and concerns of the Group are considered and addressed. These activities are not intended to support any political party.

A resolution will therefore be proposed at the AGM seeking shareholder approval for the directors to be given authority to make donations and incur expenditure which might otherwise fall within the terms of the Companies Act 2006. The authority sought will be limited to a maximum amount of £25,000 per Group company but so as not to exceed £50,000 for the entire Group in aggregate.

During the year, the business expenses incurred by Rolls-Royce North America Inc. towards the operation of the Rolls-Royce North America Political Action Committee (RRNAPAC) in the US was US$69,430 (2012 US$44,161). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act.

The RRNAPAC is independent of the Group and independent of any political party. The RRNAPAC 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 £25,000 and £50,000 limits for political donations and expenditure for which shareholder approval will be sought at the AGM.

Indemnity

The Company has entered into separate Deeds of Indemnity in favour of its directors, which were in force during the financial year and remain in force at the date of this report. The deeds provide substantially the same protection as that already provided to directors under the indemnity in Article 216 of the Company's Articles of Association. The Company has also reviewed, arranged and maintains appropriate insurance cover for any legal action taken against its directors and officers.

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:

- greenhouse gas emissions on page 29;
- disabled people and employee involvement on page 27;
- the future development, performance and position of the Group throughout pages 1 to 34;
- the financial position of the Group on pages 10 to 13;
- the R&D and net R&D expenditure as a proportion of underlying revenue on pages 24 and 31; and
- the summary of principal risks on pages 32 to 34.

In addition, notes 1, 14, 15 and 17 to the consolidated financial statements include the Group's objectives, policies and processes for financial risk management, details of its cash and cash equivalents, indebtedness and borrowing facilities and its financial instruments, hedging activities and its exposure to counterparty credit risk, liquidity risk, currency risk, interest rate risk and commodity pricing risk.

Going concern

As described on page 138, the Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds and notes. The Group has facilities of £3.6 billion of which £2.4 billion was drawn at the year end. £200 million of these facilities mature in 2014.

The Group's forecasts and projections, taking into account reasonably possible changes in trading performance, show that the Group has sufficient financial resources. If the put option on Rolls-Royce Power Systems Holding GmbH (formerly named Engine Holding GmbH) is exercised by Daimler AG, (estimated cost £1.9 billion), the directors consider that the Group would be able to raise additional resources in the necessary timeframe to meet this commitment. As a consequence, the directors have a reasonable expectation that the Company and the Group are well placed to manage their business risks and to continue in operational existence for the foreseeable future, despite the current uncertain global economic outlook.

Accordingly, the directors continue to adopt the going concern basis (in accordance with the guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' issued by the FRC) in preparing the consolidated financial statements.

Responsibility statements

Statement of directors' responsibilities in respect of the annual report and the financial statements

The directors as listed on pages 36 to 37 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 IFRS as adopted by the EU;
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

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

Under applicable law and regulations, the directors are also responsible for preparing a strategic report and a directors' report (including the directors' remuneration report and corporate governance statement) that comply with that law and those regulations.

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

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 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.

Responsibility statements under the Disclosure and Transparency Rules and the UK Corporate Governance Code

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 issuer and the undertakings included in the consolidation taken as a whole;

ii) the strategic report on pages 1 to 34 and pages 137 to 138 of the directors' report include a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face; and

iii) the annual report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

By order of the Board

Nigel T Goldsworthy
Company Secretary

12 February 2014

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CONSOLIDATED INCOME STATEMENT

For the year ended 31 December 2013

	Notes	2013 £m	Restated* 2012 £m
Revenue	2	**15,513**	12,161
Cost of sales		**(12,197)**	(9,432)
Gross profit		**3,316**	2,729
Other operating income	3	**65**	–
Commercial and administrative costs		**(1,323)**	(993)
Research and development costs	3	**(683)**	(531)
Share of results of joint ventures and associates	11	**160**	173
Operating profit		**1,535**	1,378
Profit on transfer of joint ventures to subsidiaries		**119**	–
Profit on disposal of businesses (2012 IAE International Aero Engines AG restructuring £699 million)	25	**216**	699
Profit before financing and taxation	2	**1,870**	2,077
Financing income	4	**327**	797
Financing costs	4	**(438)**	(108)
Net financing		**(111)**	689
Profit before taxation [1]		**1,759**	2,766
Taxation	5	**(380)**	(431)
Profit for the year		**1,379**	2,335
Attributable to:			
Ordinary shareholders		**1,367**	2,321
Non-controlling interests (NCI)		**12**	14
Profit for the year		**1,379**	2,335
Earnings per ordinary share attributable to ordinary shareholders:	6		
Basic		**73.26p**	125.38p
Diluted		**72.44p**	123.73p
Payments to ordinary shareholders in respect of the year:	17		
Per share		**22.0p**	19.5p
Total		**414**	365
[1] Underlying profit before taxation	2	**1,759**	1,434

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2013

	Notes	2013 £m	Restated* 2012 £m
Profit for the year		**1,379**	2,335
Other comprehensive income (OCI)			
Items that will not be reclassified to profit or loss			
Movements in post-retirement schemes	19	**48**	(305)
Share of OCI of joint ventures and associates	11	**–**	(46)
Related tax movements	5	**10**	105
		58	(246)
Items that may be reclassified to profit or loss			
Foreign exchange translation differences on foreign operations		**(64)**	(118)
Share of OCI of joint ventures and associates	11	**(6)**	(12)
Related tax movements	5	**1**	(1)
		(69)	(131)
Total comprehensive income for the year		**1,368**	1,958
Attributable to:			
Ordinary shareholders		**1,356**	1,945
Non-controlling interests		**12**	13
Total comprehensive income for the year		**1,368**	1,958

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 19, and the change in the accounting policy for RRSAs – see note 1.

CONSOLIDATED BALANCE SHEET

At 31 December 2013

	Notes	2013 £m	Restated* 31 December 2012 £m	Restated* 1 January 2012 £m
ASSETS				
Non-current assets				
Intangible assets	9	**4,987**	2,901	2,882
Property, plant and equipment	10	**3,392**	2,564	2,338
Investments – joint ventures and associates	11	**601**	1,800	1,680
Investments – other	11	**27**	6	10
Other financial assets	17	**674**	592	327
Deferred tax assets	5	**316**	342	387
Post-retirement scheme surpluses	19	**248**	348	520
		10,245	8,553	8,144
Current assets				
Inventories	12	**3,319**	2,726	2,561
Trade and other receivables	13	**5,092**	4,119	4,009
Taxation recoverable		**16**	33	20
Other financial assets	17	**74**	115	91
Short-term investments		**321**	11	11
Cash and cash equivalents	14	**3,990**	2,585	1,310
Assets held for sale		**6**	4	313
		12,818	9,593	8,315
Total assets		**23,063**	18,146	16,459
LIABILITIES				
Current liabilities				
Borrowings	15	**(207)**	(149)	(20)
Other financial liabilities	17	**(1,976)**	(312)	(111)
Trade and other payables	16	**(7,045)**	(6,401)	(6,263)
Tax liabilities		**(204)**	(126)	(138)
Provisions for liabilities and charges	18	**(348)**	(220)	(276)
Liabilities associated with assets held for sale		**–**	–	(135)
		(9,780)	(7,208)	(6,943)
Non-current liabilities				
Borrowings	15	**(2,164)**	(1,234)	(1,184)
Other financial liabilities	17	**(360)**	(418)	(919)
Trade and other payables	16	**(2,138)**	(1,672)	(1,533)
Tax liabilities		**(10)**	–	–
Deferred tax liabilities	5	**(882)**	(584)	(445)
Provisions for liabilities and charges	18	**(385)**	(241)	(226)
Post-retirement scheme deficits	19	**(1,041)**	(793)	(807)
		(6,980)	(4,942)	(5,114)
Total liabilities		**(16,760)**	(12,150)	(12,057)
Net assets		**6,303**	5,996	4,402
EQUITY				
Equity attributable to ordinary shareholders				
Called-up share capital	20	**376**	374	374
Share premium account		**80**	–	–
Capital redemption reserve		**163**	169	173
Cash flow hedging reserve		**(68)**	(63)	(52)
Other reserves		**250**	314	433
Retained earnings		**4,804**	5,185	3,473
		5,605	5,979	4,401
Non-controlling interests		**698**	17	1
Total equity		**6,303**	5,996	4,402

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 19, and the change in the accounting policy for RRSAs – see note 1.

The financial statements on pages 75 to 123 were approved by the Board on 12 February 2014 and signed on its behalf by:

Ian Davis Chairman **Mark Morris** Chief Financial Officer

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2013

	Notes	2013 £m	Restated* 2012 £m
Reconciliation of cash flows from operating activities			
Operating profit		1,535	1,378
Loss/(profit) on disposal of property, plant and equipment		7	(9)
Share of results of joint ventures and associates	11	(160)	(173)
Dividends received from joint ventures and associates	11	99	129
Amortisation and impairment of intangible assets	9	428	231
Depreciation and impairment of property, plant and equipment	10	372	256
Impairment of investments	11	–	2
Decrease in provisions		(17)	(40)
Decrease/(increase) in inventories		119	(158)
Increase in trade and other receivables		(533)	(284)
Increase in trade and other payables		376	242
Cash flows on other financial assets and liabilities held for operating purposes		9	(29)
Net defined benefit post-retirement cost recognised in profit before financing		279	173
Cash funding of defined benefit post-retirement schemes		(315)	(299)
Share-based payments	21	79	55
Net cash inflow from operating activities before taxation		2,278	1,474
Taxation paid		(238)	(219)
Net cash inflow from operating activities		2,040	1,255
Cash flows from investing activities			
Additions of unlisted investments	11	(1)	–
Disposals of unlisted investments	11	1	4
Additions of intangible assets	9	(503)	(250)
Disposals of intangible assets	9	–	1
Purchases of property, plant and equipment		(669)	(435)
Government grants received		21	10
Disposals of property, plant and equipment		7	30
Acquisitions of businesses	25	(37)	(20)
Reclassifications of joint ventures to subsidiaries	25	245	–
Acquisitions of preference shares in subsidiary	25	(34)	–
Restructuring of IAE International Aero Engines AG		–	942
Disposals of businesses	25	273	–
Investments in joint ventures and associates		(43)	(24)
Repayment of loan to Rolls-Royce Power Systems Holding GmbH		–	167
Transfer of subsidiary to associate		–	(1)
Net cash (outflow)/inflow from investing activities		(740)	424
Cash flows from financing activities			
Repayment of loans		(133)	(99)
Proceeds from increase in loans		1,013	221
Net cash flow from increase in borrowings		880	122
Interest received		15	11
Interest paid		(58)	(52)
Increase in short-term investments		(313)	–
Issue of ordinary shares and cash received on share-based payments vesting	20	32	–
Purchase of ordinary shares		(3)	(94)
Dividend to NCI		(60)	–
Redemption of C Shares		(357)	(318)
Net cash inflow/(outflow) from financing activities		136	(331)
Net increase in cash and cash equivalents		1,436	1,348
Cash and cash equivalents at 1 January		2,585	1,291
Exchange losses on cash and cash equivalents		(34)	(54)
Cash and cash equivalents at 31 December		3,987	2,585

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 19, and the change in the accounting policy for RRSAs – see note 1.

CONSOLIDATED CASH FLOW STATEMENT

	2013 £m	2012 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Increase in cash and cash equivalents	1,436	1,348
Cash flow from increase in borrowings	(880)	(122)
Cash flow from increase in short-term investments	313	–
Change in net funds resulting from cash flows	869	1,226
Net funds (excluding cash and cash equivalents) of businesses acquired	(204)	(78)
Exchange losses on net funds	(43)	(54)
Fair value adjustments	105	2
Movement in net funds	727	1,096
Net funds at 1 January excluding the fair value of swaps	1,213	117
Net funds at 31 December excluding the fair value of swaps	1,940	1,213
Fair value of swaps hedging fixed rate borrowings	(1)	104
Net funds at 31 December	1,939	1,317

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

	At 1 January 2013 £m	Funds flow £m	Net funds of businesses acquired £m	Exchange differences £m	Fair value adjustments £m	Reclassifications £m	At 31 December 2013 £m
Cash at bank and in hand	674	333		(25)	–	–	982
Money market funds	408	754		(5)	–	–	1,157
Short-term deposits	1,503	352		(4)	–	–	1,851
Overdrafts	–	(3)		–	–	–	(3)
Cash and cash equivalents	2,585	1,436		(34)	–	–	3,987
Short-term investments	11	313	–	(3)	–	–	321
Current borrowings excluding overdrafts	(149)	133	(4)	–	17	(201)	(204)
Non-current borrowings	(1,233)	(1,013)	(200)	(6)	88	201	(2,163)
Finance leases	(1)	–	–	–	–	–	(1)
Net funds excluding fair value of swaps	1,213	869	(204)	(43)	105	–	1,940
Fair value of swaps hedging fixed rate borrowings	104				(105)		(1)
Net funds	1,317	869	(204)	(43)	–	–	1,939

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the year ended 31 December 2013

		Attributable to ordinary shareholders								
	Notes	Share capital £m	Share premium £m	Capital redemption reserve £m	Cash flow hedging reserve[1] £m	Other reserves[2] £m	Retained earnings[3] £m	Total £m	Non-controlling interests £m	Total equity £m
At 1 January 2012, as previously reported		374	–	173	(52)	433	3,590	4,518	1	4,519
Effect of amendments to IAS 19	19	–	–	–	–	–	67	67	–	67
Effect of change in accounting policy for RRSAs	1	–	–	–	–	–	(184)	(184)	–	(184)
At 1 January 2012, as restated		374	–	173	(52)	433	3,473	4,401	1	4,402
Profit for the year		–	–	–	–	–	2,321	2,321	14	2,335
Foreign exchange translation differences on foreign operations		–	–	–	–	(117)	–	(117)	(1)	(118)
Movement on post-retirement schemes	19	–	–	–	–	–	(305)	(305)	–	(305)
Share of OCI of joint ventures and associates	11	–	–	–	(11)	(1)	(46)	(58)	–	(58)
Related tax movements	5	–	–	–	–	(1)	105	104	–	104
Total comprehensive income for the year		–	–	–	(11)	(119)	2,075	1,945	13	1,958
Issue of C Shares	17	–	–	(328)	–	–	4	(324)	–	(324)
Redemption of C Shares	17	–	–	324	–	–	(324)	–	–	–
Ordinary shares purchased		–	–	–	–	–	(94)	(94)	–	(94)
Share-based payments – direct to equity[4]		–	–	–	–	–	47	47	–	47
Transactions with NCI[5]		–	–	–	–	–	116	116	48	164
Initial recognition of put option on NCI[6]		–	–	–	–	–	(121)	(121)	(45)	(166)
Related tax movements	5	–	–	–	–	–	9	9	–	9
Other changes in equity in the year		–	–	(4)	–	–	(363)	(367)	3	(364)
At 1 January 2013		**374**	**–**	**169**	**(63)**	**314**	**5,185**	**5,979**	**17**	**5,996**
Profit for the year		–	–	–	–	–	1,367	1,367	12	1,379
Foreign exchange translation differences on foreign operations		–	–	–	–	(64)	–	(64)	–	(64)
Movement on post-retirement schemes	19	–	–	–	–	–	48	48	–	48
Share of OCI of joint ventures and associates	11	–	–	–	(5)	(1)	–	(6)	–	(6)
Related tax movements	5	–	–	–	–	1	10	11	–	11
Total comprehensive income for the year		**–**	**–**	**–**	**(5)**	**(64)**	**1,425**	**1,356**	**12**	**1,368**
Arising on issues of ordinary shares	20	2	80	–	–	–	(81)	1	–	1
Issue of C Shares	17	–	–	(366)	–	–	3	(363)	–	(363)
Redemption of C Shares	17	–	–	360	–	–	(360)	–	–	–
Ordinary shares purchased		–	–	–	–	–	(3)	(3)	–	(3)
Share-based payments – direct to equity[4]		–	–	–	–	–	99	99	–	99
Reclassification of Rolls-Royce Power Systems AG	25	–	–	–	–	–	–	–	669	669
Transactions with NCI[7]		–	–	–	–	–	–	–	(45)	(45)
Initial recognition of put option on NCI[6]	17, 25	–	–	–	–	–	(1,477)	(1,477)	45	(1,432)
Related tax movements	5	–	–	–	–	–	13	13	–	13
Other changes in equity in the year		**2**	**80**	**(6)**	**–**	**–**	**(1,806)**	**(1,730)**	**669**	**(1,061)**
At 31 December 2013		**376**	**80**	**163**	**(68)**	**250**	**4,804**	**5,605**	**698**	**6,303**

[1] See accounting policies note 1.
[2] Other reserves include a merger reserve of **£3m** (2012 £3m, 2011 £3m) and a translation reserve of **£247m** (2012 £311m, 2011 £430m).
[3] At 31 December 2013, **11,960,535** ordinary shares with a net book value of **£91m** (2012 20,365,787, 2011 22,541,187 ordinary shares with net book values of £125m and £116m respectively) were held for the purpose of share-based payment plans and included in retained earnings. During the year, **16,603,840** ordinary shares with a net book value of **£118m** (2012 13,533,646 shares with a net book value of £85m) vested in share-based payment plans. During the year, the Company acquired **298,588** of its ordinary shares via reinvestment of dividends received on its own shares. In addition, the Company issued **7,900,000** new ordinary shares to the Group's share trust for its employees share-based payment plans with a net book value of **£81m**.
[4] 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.
[5] On 2 January 2012, the Group contributed its interest in Bergen Engines AS to Rolls-Royce Power Systems Holding GmbH (RRPSH – previously Engine Holding GmbH), a company jointly held by Rolls-Royce and Daimler AG. Under the terms of agreement with Daimler, Rolls-Royce retained certain rights such that Bergen Engines continued to be classified as a subsidiary and consolidated.
[6] As part of the RRPSH shareholders' agreement, Daimler has the option to sell its shares in RRPSH to Rolls-Royce for a period of six years from 1 January 2013. The initial fair value of the exercise price of this option in respect of Bergen Engines AS (£166m) was recognised in 2012 and that amount in respect of RRPS (£1,432m) has been recognised in 2013 and charged to retained earnings. In addition, £45m of the initial recognition of the put option on NCI relating to Bergen Engine AS, recognised in 2012, has been reclassified from NCI to retained earnings. Subsequent movements in the value of this liability are included in the income statement, but excluded from the underlying results.
[7] On 1 January 2013, the Group exercised rights in RRPSH that resulted in Rolls-Royce Power Systems AG (RRPS – formerly Tognum AG) being classified as a subsidiary and consolidated – see note 25.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies

The Company

The consolidated financial statements of Rolls-Royce Holdings plc (the 'Company') for the year ended 31 December 2013 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 2013 (Adopted IFRS).

The Company has elected to prepare its parent company financial statements under UK Generally Accepted Accounting Practices (GAAP). These are set out on pages 124 to 126 and the accounting policies in respect of Company financial statements are set out on page 125.

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 liabilities are valued on the basis required by IAS 19 *Employee Benefits* – and on a going concern basis as described on page 72.

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

The preparation of financial statements in conformity with Adopted IFRS requires management to make estimates and judgements 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; the key areas of judgement and key sources of estimation uncertainty are described below. Actual results could differ from those estimates.

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

Amendment to accounting policy

As explained in the Chief Financial Officer's review on page 11, following discussions with the Conduct Committee of the FRC, the Group has reassessed its policy for the recognition of entry fees received under Risk and Revenue Sharing Arrangements (RRSAs). Whilst the impact on our historical results is not significant, the directors believe that the change represents an improvement in the policy.

In prior years, entry fees were recognised as other operating income when they were received, on the basis that this matched it to the recognition of non-recurring development costs incurred on behalf of the workshare partner. This policy has been revised, to reflect better the fact that some of these non-recurring development costs are capitalised. Under the amended policy, where the relevant costs in the development programme are capitalised (ie development costs incurred between engine certification and entry into service and certification costs and participation fees paid to airframers), an equivalent portion of the entry fee received is deferred and recognised as the related costs are amortised after entry into service. In addition, the amount of entry fees recognised in the year will be presented as a contribution to research and development expenses, rather than other operating income.

As required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, this change has been made retrospectively; the impact of the change in policy in 2012 was to increase profit before tax by £25 million and to reduce net assets at 31 December 2011 and 2012 by £184 million and £170 million respectively. Had the policy not been amended, profit before tax in 2013 would have been £39 million higher and at 31 December 2013 net assets £208 million higher.

The FRC Conduct Committee's 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 pre-determined 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.

As explained in the Chief Financial Officer's review, on page 11, the FRC Conduct Committee has confirmed that, in view of the change to the policy and the additional disclosure the Group has made, it does not intend to pursue its consideration of this accounting policy further.

1 Accounting policies (continued)

Key areas of judgement

The directors consider the potential key areas of judgements required to be made in applying the Group's accounting policies to be:

- Assessing whether or not the Group controls Rolls-Royce Power Systems Holding GmbH (RRPSH) requires judgement. The shares of RRPSH are held equally by the Group and Daimler AG and the rights of each shareholder are encapsulated in shareholder agreements which set out, amongst other things, key matters on which the Group has the casting vote at the Shareholders' Committee of RRPSH. These most important matters subject to casting vote which are relevant to assessing whether RRPSH is controlled include (a) setting the annual budget and operating and financial plan, (b) appointing, removing and setting the remuneration of key management personnel (though removal of the CEO or the CFO requires joint agreement), (c) entering into contracts in the ordinary course of business and (d) establishing management procedures and responsibilities. The Group considers that these provisions are sufficient to give it control over RRPSH. Daimler AG has protective rights covering matters such as: (i) significant changes to the scale, scope and financing of RRPSH's business; (ii) certain significant supplier relationships; and (iii) changes to contractual arrangements between RRPSH and Rolls-Royce. These are not considered sufficient to prevent the Group from directing the activities of RRPSH.
- A large proportion of the Group's activities relate to long-term aftermarket contracts. The determination of appropriate accounting policies for recognising revenue and costs in respect of these contracts requires judgement:
  i) whether a long-term aftermarket contract is linked, for accounting purposes, to the related sale of original equipment – where the long-term aftermarket contract is agreed (or agreed in principle) at the same time as the original equipment contract, these are considered to be linked for accounting purposes and treated as a single contract – or whether it should be treated separately; and
  ii) the appropriate measure of stage of completion of the contract – this will vary depending on the precise nature of the arrangements. Where the service provided is assessed to be continuous, the stage of completion is measured by reference to the flying hours, or equivalent, under the contract. Other aftermarket contracts are overhaul event based and the stage of completion is measured accordingly.
- The Group has significant intangible assets. In deciding whether certain intangible assets should be recognised, judgement is required:
  i) IAS 38 *Intangible Assets* 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 54 per cent of development costs; for these, the criteria are generally satisfied at the time of the initial engine certification;
  ii) on delivery of engines without a linked long-term aftermarket contract, 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. Accordingly the directors consider that these rights meet the definition of an intangible asset in IAS 38. However, the directors do not consider that it is possible to determine a reliable fair value for this intangible asset. Accordingly, an intangible asset (recoverable engine cost or REC) 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 a reliable value.
- 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. The share of development costs borne by the workshare partner and of the revenues it receives reflect a jointly agreed forecast of the proportionate cost of providing its production parts compared to the overall forecast manufacturing cost of the engine.

  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. 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 control 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

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 further, 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 we believe do not conflict with IFRS in this regard).

The resulting accounting policy (described below) 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.

- 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.

Intangible assets arising on consolidation of Rolls-Royce Power Systems AG and put option on Rolls-Royce Power Systems Holding GmbH

The fair value of intangible assets of RRPS at 1 January 2013 involved the use of valuation techniques and the estimation of future cash flows to be generated by RRPS over a considerable period of time. The Group engaged a specialist valuer to assist with these.

For a period of six years from 1 January 2013, the Group is obliged to acquire, at Daimler AG's option, the latter's 50 per cent interest in RRPSH. The estimated exercise price of this option has been recognised as a liability. The exercise price of the option is based on averaging three valuations at the date the option is exercised, which are based on both internal metrics, requiring estimation of future performance of the business, and external metrics.

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 2013 £1,864 million) arising on the consolidation of RRPSH is impaired is dependent of the present value of the future cash flows expected to be generated by the business. These cash flows are based on the business plan jointly agreed by the shareholders.
- The assessment as to whether there are any indications of impairment of development, participation, certification, recoverable engine costs and customer relationships recognised as intangible assets (carrying values at 31 December 2013 **£2,499 million**, 31 December 2012 £1,457 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 (RECs), 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.

1 Accounting policies (continued)

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 was based on assumptions determined with independent actuarial advice, resulted in a net deficit of **£793 million** before deferred taxation being recognised on the balance sheet at 31 December 2013 (31 December 2012 £445 million). The size of the net deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 19.

Provisions

As described in the accounting policy on page 87, the Group measures provisions (carrying value at 31 December 2013 **£733 million**, 31 December 2012 £461 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.

Basis of consolidation

The Group consolidated financial statements include the financial statements of the Company and all of its subsidiary undertakings together with the Group's share of the results of joint ventures and associates made up to 31 December.

A subsidiary is an entity controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of the entity so as to derive benefits from its activities.

A joint venture 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. An associate is an entity, being neither a subsidiary nor a joint venture, in which the Group holds a long-term interest and where the Group has a significant influence. The results of joint ventures and associates are accounted for using the equity method of accounting.

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

Where the Group has issued a put option over shares held by a non-controlling interest, the Group recognises a liability for the estimated exercise value of that option. Movements in the estimated liability after initial recognition are recognised in the income statement.

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

Significant accounting policies

Revenue recognition

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

Sales of products (both original equipment and spare parts) are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured – this is generally on delivery. On occasion, the Group may participate in the financing of OE, most commonly by the provision of guarantees as described in note 18. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing when the significant risks and rewards of ownership have been transferred to the customer. As described on page 81, a sale of OE at a contractual price below its cost of manufacture is considered to give rise to an intangible asset, a recoverable engine cost. In these circumstances, revenue is recognised to the same value as the recoverable engine cost.

Sales of services are recognised by reference to the stage of completion based on services performed to date. As described on page 81, 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

As described on page 81, **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 the list prices. This 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 overall balance is a liability, it is recognised in 'accruals and deferred income'.

Full provision is made for any estimated losses to completion of contracts, having regard to the overall substance of the arrangements.

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

Risk and revenue sharing arrangements (RRSAs)
As described on page 81, 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 deferred tax is also dealt with in equity.

1 Accounting policies (continued)

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax is not recognised on taxable temporary differences arising on the initial recognition of goodwill or for temporary differences arising from the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit.

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

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

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

The trading results of Group undertakings are translated into sterling at the average exchange rates for the year. The assets and liabilities of overseas undertakings, including goodwill and fair value adjustments arising on acquisition, are translated at the exchange rates ruling at the year end. Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are recognised in OCI. The cumulative amount of exchange adjustments was, on transition to IFRS in 2004, deemed to 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, financial RRSAs, put options on NCI and C Shares are classified as other liabilities; and
- derivatives, comprising foreign exchange contracts, interest rate swaps, and commodity swaps are classified as fair value through profit or loss.

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

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

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

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

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

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

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

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

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

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

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

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

All research phase expenditure is charged to the income statement. Development expenditure is capitalised as an internally generated intangible asset only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits. As described on page 81, 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 on a straight-line basis over its useful economic life, up to a maximum of 15 years from the entry into service of the product.

The fair value of research and development recognised during a business combination relate to the acquired company's technology. Amortisation occurs on a straight-line basis over its useful economic life, up to a maximum of 15 years.

Recoverable engine costs
The Group may sell OE to customers at a price below its cost, on the basis that this deficit will be recovered from the profits of highly probable future aftermarket sales. As described on page 81, this sale is considered to give rise to an intangible asset, which, subject to an impairment review, is recognised at the time of delivery and 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 during 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.

1 Accounting policies (continued)

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.

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 24 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 15 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 include cash at bank and in hand, investments in money-market funds and short-term deposits with a maturity of three months or less on inception. The Group considers overdrafts (repayable on demand) to be an integral part of its cash management activities and these are included in cash and cash equivalents for the purposes of the cash flow statement.

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 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

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

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

The cost of shares of Rolls-Royce Holdings plc held by the Group for the purpose of fulfilling obligations in respect of employee share plans is deducted from equity in the consolidated balance sheet. See note 21 for a further description of the share-based payment plans.

Sales financing support

In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers. These arrangements fall into two categories: credit-based guarantees; and asset-value guarantees. In accordance with the requirements of IAS 39 and IFRS 4 *Insurance Contracts*, credit-based guarantees are treated as insurance contracts. The Group considers asset-value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts. As described on page 82, the directors consider the likelihood of crystallisation is 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 2013

With effect from 1 January 2013, the Group has adopted the amendments to IAS 19 *Employee Benefits* issued by the IASB in June 2011. A description of these amendments and their effect is set out in note 19. In summary, the amendments require:

- recognition of certain administrative costs as operating costs rather than being included in net financing;
- net financing to be calculated on the net asset or liability recognised on the balance sheet using an AA corporate bond rate rather than using an expected rate of return for scheme assets; and
- immediate recognition of previously unrecognised past-service credits.

Had these amendments not been adopted, the results would have been affected as follows:

- profit before financing **£15 million** higher (2012 £22 million higher);
- net post-retirement financing **£107 million** higher (2012 £56 million higher); and
- net assets **£73 million** lower (2012 £100 million lower).

Revisions to IFRS not applicable in 2013

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

Under Adopted IFRS, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities* and amendments to IAS 17 *Separate Financial Statements* are effective for 2014. The principal potential effect is 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. If 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.

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 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:

Civil aerospace	– development, manufacture, marketing and sales of commercial aero engines and aftermarket services.
Defence aerospace	– development, manufacture, marketing and sales of military aero engines and aftermarket services.
Marine	– development, manufacture, marketing and sales of marine-power propulsion systems and aftermarket services.
Energy	– development, manufacture, marketing and sales of power systems for the offshore oil and gas industry and electrical power generation and aftermarket services.
Power Systems	– development, manufacture, marketing and sales of diesel engines.

Engineering and technology and Operations, discussed in the strategic report, operate on a Group-wide basis across all the above segments.

The operating results reviewed by the Board are prepared on an underlying basis, which the Board considers reflects better the economic substance of the Group's trading during the year. 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 costs and credits on post-retirement schemes and the effect of acquisition accounting.

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

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

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

Year ended 31 December 2013	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Power Systems £m	Inter-segment £m	Total reportable segments £m
Underlying revenue from sale of original equipment	3,035	1,385	1,438	415	2,004	(72)	8,205
Underlying revenue from aftermarket services	3,620	1,206	1,089	633	827	(75)	7,300
Total underlying revenue	6,655	2,591	2,527	1,048	2,831	(147)	15,505
Underlying operating profit excluding share of results of joint ventures and associates	708	424	281	15	296	2	1,726
Share of results of joint ventures and associates	136	14	–	11	(2)	–	159
Underlying profit before financing and taxation	844	438	281	26	294	2	1,885
Segment assets	9,587	1,437	1,910	1,407	3,927	(744)	17,524
Investments in joint ventures and associates	495	17	6	54	29	–	601
Segment liabilities	(6,243)	(1,660)	(1,312)	(688)	(3,034)	733	(12,204)
Net assets/(liabilities)	3,839	(206)	604	773	922	(11)	5,921
Investment in intangible assets, property, plant and equipment and joint ventures and associates	891	103	37	66	142	–	1,239
Depreciation, amortisation and impairment	349	53	75	51	272	–	800

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis (continued)

Year ended 31 December 2012 (restated – see note 1)	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Power Systems £m	Inter-segment £m	Total reportable segments £m
Underlying revenue from sale of original equipment	2,934	1,231	1,288	344	118	(22)	5,893
Underlying revenue from aftermarket services	3,503	1,186	961	618	169	(121)	6,316
Total underlying revenue	6,437	2,417	2,249	962	287	(143)	12,209
Underlying operating profit excluding share of results of joint ventures and associates	613	382	295	7	32	(11)	1,318
Share of results of joint ventures and associates	130	13	(1)	12	77	–	231
Underlying profit before financing and taxation	743	395	294	19	109	(11)	1,549
Segment assets	8,683	1,434	2,059	1,279	150	(682)	12,923
Investments in joint ventures and associates	440	(22)	4	50	1,328	–	1,800
Segment liabilities	(5,819)	(1,797)	(1,467)	(570)	(282)	671	(9,264)
Net assets/(liabilities)	3,304	(385)	596	759	1,196	(11)	5,459
Investment in intangible assets, property, plant and equipment and joint ventures and associates	581	126	101	94	11	–	913
Depreciation, amortisation and impairment	322	46	55	42	4	–	469

Reconciliation to reported results

Year ended 31 December 2013	**Total reportable segments £m**	**Underlying central items £m**	**Total underlying £m**	**Underlying adjustments £m**	**Group £m**
Revenue from sale of original equipment	**8,205**	**–**	**8,205**	**70**	**8,275**
Revenue from aftermarket services	**7,300**	**–**	**7,300**	**(62)**	**7,238**
Total revenue	**15,505**	**–**	**15,505**	**8**	**15,513**
Operating profit excluding share of results of joint ventures and associates	**1,726**	**(54)**[1]	**1,672**	**(297)**	**1,375**
Share of results of joint ventures and associates	**159**	**–**	**159**	**1**	**160**
Profit on transfer of joint ventures to subsidiaries	**–**	**–**	**–**	**119**	**119**
Profit on disposal of businesses	**–**	**–**	**–**	**216**	**216**
Profit before financing and taxation	**1,885**	**(54)**	**1,831**	**39**	**1,870**
Net financing		**(72)**	**(72)**	**(39)**	**(111)**
Profit before taxation		**(126)**	**1,759**	**–**	**1,759**
Taxation		**(434)**	**(434)**	**54**	**(380)**
Profit for the year		**(560)**	**1,325**	**54**	**1,379**
Ordinary shareholders			**1,224**	**143**	**1,367**
Non-controlling interests			**101**	**(89)**	**12**
Profit for the year			**1,325**	**54**	**1,379**

Year ended 31 December 2012 (restated – see note 1)	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Revenue from sale of original equipment	5,893	–	5,893	41	5,934
Revenue from aftermarket services	6,316	–	6,316	(89)	6,227
Total revenue	12,209	–	12,209	(48)	12,161
Operating profit excluding share of results of joint ventures and associates	1,318	(54)[1]	1,264	(59)	1,205
Share of results of joint ventures and associates	231	–	231	(58)	173
Profit on disposal of businesses	–	–	–	699	699
Profit before financing and taxation	1,549	(54)	1,495	582	2,077
Net financing		(61)	(61)	750	689
Profit before taxation		(115)	1,434	1,332	2,766
Taxation		(317)	(317)	(114)	(431)
Profit for the year		(432)	1,117	1,218	2,335
Ordinary shareholders			1,103	1,218	2,321
Non-controlling interests			14	–	14
Profit for the year			1,117	1,218	2,335

[1] Central corporate costs.

2 Segmental analysis (continued)

Underlying adjustments

	2013				2012*			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**15,505**	**1,831**	**(72)**	**(434)**	12,209	1,495	(61)	(317)
Revenue recognised at exchange rate on date of transaction	**8**	**–**	**–**	**–**	(48)	–	–	–
Realised gains on settled derivative contracts [1]	**–**	**(10)**	**(5)**	**–**	–	(25)	–	–
Net unrealised fair value changes to derivative contracts [2]	**–**	**–**	**250**	**–**	–	–	747	–
Effect of currency on contract accounting	**–**	**(18)**	**–**	**–**	–	(23)	–	–
Put option on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	**–**	**–**	**(251)**	**–**	–	–	11	–
Effect of acquisition accounting [3]	**–**	**(265)**	**–**	**–**	–	(69)	–	–
Profit on reclassification of joint ventures to subsidiaries	**–**	**119**	**–**	**–**	–	–	–	–
Pensions discretionary increase [4]	**–**	**(64)**	**–**	**–**	–	–	–	–
Net post-retirement scheme financing	**–**	**–**	**(26)**	**–**	–	–	(8)	–
Profit on disposal of businesses	**–**	**216**	**–**	**–**	–	–	–	–
Other [5]	**–**	**61**	**(7)**	**–**	–	–	–	–
Related tax effect	**–**	**–**	**–**	**54**	–	–	–	(151)
IAE restructuring	**–**	**–**	**–**	**–**	–	699	–	37
Total underlying adjustments	**8**	**39**	**(39)**	**54**	(48)	582	750	(114)
Reported per consolidated income statement	**15,513**	**1,870**	**(111)**	**(380)**	12,161	2,077	689	(431)

1 Realised gains on settled derivative contracts include adjustments to reflect (gains)/losses 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; 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 Discretionary increase of £64m on unindexed pensions – see Chief Financial Officer's review on page 12.
5 Other includes the exclusion of other operating income of £63m and the revaluation of preference shares in RRPS, which have now been acquired.

The reconciliation of underlying earnings per ordinary share is shown in note 6.

		Restated*	
	2013 £m	31 December 2012 £m	1 January 2012 £m
Reportable segment assets	**17,524**	12,923	12,425
Investments in joint ventures and associates	**601**	1,800	1,680
Cash and cash equivalents and short-term investments	**4,311**	2,596	1,321
Fair value of swaps hedging fixed rate borrowings	**47**	104	106
Income tax assets	**332**	375	407
Post-retirement scheme surpluses	**248**	348	520
Total assets	**23,063**	18,146	16,459
Reportable segment liabilities	**(12,204)**	(9,264)	(9,463)
Borrowings	**(2,371)**	(1,383)	(1,204)
Fair value of swaps hedging fixed rate borrowings	**(48)**	–	–
Income tax liabilities	**(1,096)**	(710)	(583)
Post-retirement scheme deficits	**(1,041)**	(793)	(807)
Total liabilities	**(16,760)**	(12,150)	(12,057)
Net assets	**6,303**	5,996	4,402

* Restated – see note 1.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis (continued)

Geographical segments

The Group's revenue by destination is shown below:

	2013 £m	2012 £m
United Kingdom	**1,803**	1,641
Norway	**520**	446
Germany	**977**	319
Switzerland	**871**	63
Spain	**178**	177
Italy	**236**	151
France	**259**	182
Russia	**114**	165
Rest of Europe	**670**	613
USA	**3,972**	3,999
Canada	**507**	351
South America	**393**	303
Saudi Arabia	**547**	308
Rest of Middle East	**426**	389
India	**244**	148
China	**1,087**	1,117
South Korea	**452**	194
Japan	**244**	158
Malaysia	**292**	322
Singapore	**558**	333
Rest of Asia	**772**	376
Africa	**139**	123
Australasia	**174**	240
Other[1]	**78**	43
	15,513	12,161

[1] Other revenue mainly originates from Central America.

In 2012, revenue (included in all reportable segments other than Power Systems) of £1,203 million was received from a single customer. In 2013, no single customer represented ten per cent 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:

	2013 £m	2012 £m
United Kingdom	**3,649**	3,139
North America	**872**	723
Nordic countries	**823**	889
Germany	**2,739**	2,023
Other	**924**	497
	9,007	7,271

3 Other income and expenses

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 (120–230 passenger) aircraft. In September 2013, the parties agreed not to proceed with the partnership. Other operating income includes £63 million received by the Group as a result of this.

Research and development costs

	2013 £m	2012* £m
Expenditure in the year	(750)	(572)
Capitalised as intangible assets	110	38
Amortisation of capitalised costs	(130)	(55)
Net research and development cost	(770)	(589)
Entry fees received	126	33
Entry fees deferred in respect of charges in future years	(50)	(5)
Recognition of previously deferred entry fees	11	30
Net cost recognised in the income statement	(683)	(531)
Underlying adjustments relating to effects of acquisition accounting and foreign exchange	59	–
Net underlying cost recognised in the income statement	(624)	(531)

* Restated – see note 1.

4 Net financing

	Note	2013 Per consolidated income statement £m	2013 *Underlying financing*[1] £m	2012 Per consolidated income statement £m	2012 *Underlying financing*[1] £m
Financing income					
Interest receivable		15	*15*	10	*10*
Fair value gains on foreign currency contracts[2]	17	287	–	750	–
Put options on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	17	8	–	11	–
Financing income on post-retirement scheme surpluses	19	17	–	26	–
		327	*15*	797	*10*
Financing costs					
Interest payable		(58)	*(58)*	(51)	*(51)*
Fair value losses on foreign currency contracts[2]	17	(3)	–	–	–
Put options on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	17	(259)	–	–	–
Financial charge relating to financial RRSAs	17	(9)	*(9)*	(10)	*(10)*
Fair value losses on commodity derivatives[2]	17	(34)	–	(3)	–
Financing costs on post-retirement scheme deficits	19	(43)	–	(34)	–
Net foreign exchange losses		(5)	–	–	–
Other financing charges		(27)	*(20)*	(10)	*(10)*
		(438)	*(87)*	(108)	*(71)*
Net financing		(111)	*(72)*	689	*(61)*
Analysed as:					
Net interest payable		(43)	*(43)*	(41)	*(41)*
Net post-retirement scheme financing		(26)	–	(8)	–
Net other financing		(42)	*(29)*	738	*(20)*
Net financing		(111)	*(72)*	689	*(61)*
[1] See note 2					
[2] Net gain on fair value items through profit or loss		250	–	747	–

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 Taxation

	UK		Overseas		Total	
	2013 £m	2012* £m	2013 £m	2012* £m	2013 £m	2012* £m
Current tax						
Current tax charge/(credit) for the year	**7**	(3)	**290**	218	**297**	215
Less double tax relief	**(1)**	(1)	**–**	–	**(1)**	(1)
	6	(4)	**290**	218	**296**	214
Adjustments in respect of prior years	**2**	(7)	**29**	(18)	**31**	(25)
	8	(11)	**319**	200	**327**	189
Deferred tax						
Charge/(credit) for the year	**224**	216	**(66)**	38	**158**	254
Adjustments in respect of prior years	**(8)**	1	**(37)**	6	**(45)**	7
Credit resulting from reduction in tax rates	**(59)**	(19)	**(1)**	–	**(60)**	(19)
	157	198	**(104)**	44	**53**	242
Recognised in the income statement	**165**	187	**215**	244	**380**	431

Other tax (charges)/credits

	OCI				Equity	
	Items that will not be reclassified		Items that may be reclassified			
	2013 £m	2012* £m	2013 £m	2012 £m	2013 £m	2012 £m
Current tax:						
Share-based payments – direct to equity					**5**	3
Deferred tax:						
Net investment hedge			**1**	(1)		
Movement in post-retirement schemes	**10**	105				
Share-based payments – direct to equity					**8**	6
	10	105	**1**	(1)	**13**	9

Tax reconciliation

	2013 £m	2012* £m
Profit before taxation	**1,759**	2,766
Less share of results of joint ventures and associates (note 11)	**(160)**	(173)
Profit before taxation excluding joint ventures and associates	**1,599**	2,593
Nominal tax charge at UK corporation tax rate 23.25% (2012 24.5%)	**372**	635
UK R&D credit	**(13)**	(26)
Rate differences	**51**	59
Profit on reclassification of joint ventures to subsidiaries	**(27)**	–
Changes in value of put option on NCI	**60**	–
Restructuring of IAE [1]	**–**	(209)
Other permanent differences	**12**	9
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	**(7)**	–
Tax losses in year not recognised in deferred tax	**6**	–
Adjustments in respect of prior years	**(14)**	(18)
Reduction in closing deferred taxes resulting from decrease in tax rates	**(60)**	(19)
	380	431
Underlying items (note 2)	**434**	317
Non-underlying items	**(54)**	114
	380	431

* Restated – see note 1.
[1] Pursuant to the Substantial Shareholdings Exemption, the majority of the upfront proceeds received on the IAE restructuring were not subject to tax.

5 Taxation (continued)

Deferred taxation assets and liabilities

	2013 £m	2012 £m
At 1 January, as previously reported		(77)
Effect of amendments to IAS 19 – see note 19		(43)
Effect of amendment to RRSAs – see note 1		62
At 1 January as restated	**(242)**	(58)
Amount charged to income statement	**(53)**	(242)
Amount credited to other comprehensive income	**11**	104
Amount credited to equity	**8**	6
Acquisition of businesses	**(282)**	(1)
Transferred to assets held for sale	**–**	(46)
Exchange differences	**(8)**	(5)
At 31 December	**(566)**	(242)
Deferred tax assets	**316**	342
Deferred tax liabilities	**(882)**	(584)
	(566)	(242)

The analysis of the deferred tax position is as follows:

	At 1 January 2013 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Transferred from assets held for sale £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)**

	Restated*							
	At 1 January 2012 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Transferred to assets held for sale £m	Exchange movements £m	At 31 December 2012 £m
Intangible assets	(243)	58	–	–	–	(46)	(1)	(232)
Property, plant and equipment	(135)	(25)	–	–	1	–	1	(158)
Other temporary differences	1	10	(1)	–	–	–	2	12
Amounts recoverable on contracts	(250)	(101)	–	–	–	–	–	(351)
Pensions and other post-retirement scheme benefits	56	(41)	105	–	(2)	–	(8)	110
Foreign exchange and commodity financial assets and liabilities	121	(177)	–	–	–	–	–	(56)
Losses	328	34	–	6	–	–	1	369
Advance corporation tax	64	–	–	–	–	–	–	64
	(58)	(242)	104	6	(1)	(46)	(5)	(242)

* Restated – see note 1.

	2013 £m	2012 £m
Advance corporation tax	**118**	118
Losses and other unrecognised deferred tax assets	**39**	39
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	**157**	157

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 Taxation (continued)

Deferred taxation assets and liabilities

The 2013 Budget announced that the UK corporation tax rate will reduce to 21 per cent from 1 April 2014 and to 20 per cent from 1 April 2015. These reductions were substantively enacted on 2 July 2013. As the reduction to 20 per cent was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been calculated at this rate. The resulting charges or credits have been recognised in the income statement except to the extent that they relate to items previously charged or credited to OCI or equity. Accordingly, in 2013, £59 million has been credited to the income statement, £1 million has been charged to the OCI and £9 million has been charged directly to equity.

The temporary differences associated with investments in subsidiaries, joint ventures and associates, for which a deferred tax liability has not been recognised, aggregate to **£573 million** (2012 £144 million). No deferred tax liability has been recognised on the potential withholding tax due on the remittance of undistributed profits as the Group is able to control the timing of such remittances and it is probable that consent will not be given in the foreseeable future.

6 Earnings per ordinary share

Basic earnings per ordinary share (EPS) are calculated by dividing the profit attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares held under trust, which have been treated as if they had been cancelled.

Diluted EPS are calculated by adjusting the weighted average number of ordinary shares in issue during the year for the bonus element of share options.

2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 19, and the change in the accounting policy for RRSAs – see note 1. The impact of the restatement on the previously reported EPS of 123.23p was an increase of 1.40p relating to the IAS 19 amendments and an increase of 0.75p relating to the change in the accounting policy for RRSAs.

	2013			2012		
	Basic	**Potentially dilutive share options**	**Diluted**	Basic	Potentially dilutive share options	Diluted
Profit attributable to ordinary shareholders (£m)	**1,367**		**1,367**	2,321		2,321
Weighted average number of ordinary shares (millions)	**1,866**	**21**	**1,887**	1,851	25	1,876
EPS (pence)	**73.26**	**(0.82)**	**72.44**	125.38	(1.65)	123.73

The reconciliation between underlying EPS and basic EPS is as follows:

	2013		2012*	
	Pence	**£m**	Pence	£m
Underlying EPS/Underlying profit attributable to ordinary shareholders	**65.59**	**1,224**	59.59	1,103
Total underlying adjustments to profit before tax (note 2)	**–**	**–**	71.96	1,332
Related tax effects	**2.89**	**54**	(6.17)	(114)
Related NCI effects	**4.78**	**89**	–	–
EPS/Profit attributable to ordinary shareholders	**73.26**	**1,367**	125.38	2,321
Excluding IAE restructuring	**73.26**	**1,367**	85.62	1,585
IAE restructuring	**–**	**–**	39.76	736
Diluted underlying EPS	**64.86**		58.80	

* The impact of the restatement on the previously reported underlying EPS of 59.27p was a decrease of 0.71p relating to the IAS 19 amendments and an increase of 1.03p relating to the change in the accounting policy for RRSAs.

7 Employee information

	2013 Number	2012 Number
Average number of employees		
United Kingdom	24,800	22,800
United States	8,500	7,200
Canada	1,600	1,700
Germany	10,500	2,800
Rest of world	9,800	8,300
	55,200	42,800
Civil aerospace	23,400	21,500
Defence aerospace	7,900	7,800
Marine	9,200	8,800
Energy	4,000	3,700
Power Systems	10,700	1,000
	55,200	42,800

	£m	£m
Group employment costs[1]		
Wages and salaries	2,843	2,163
Social security costs	374	265
Share-based payments (note 21)	79	55
Pensions and other post-retirement scheme benefits (note 19)	379	245
	3,675	2,728

[1] Remuneration of key management personnel is shown in note 24.

8 Auditors' remuneration

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

	2013 £m	2012 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements[1]	0.2	0.2
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	5.6	4.5
Total fees payable for audit services	5.8	4.7
Fees payable to the Company's auditors and its associates for other services[2]:		
Audit related assurance services[3]	0.8	0.6
Taxation compliance services	0.8	0.3
Taxation advisory services	0.1	0.2
Internal audit services[4]	0.2	0.6
Information technology services[4]	–	0.4
All other services	1.0	0.1
	8.7	6.9
Fees payable in respect of the Group's pension schemes:		
Audit	0.2	0.2
Taxation compliance services	0.1	0.1

[1] The level of fees payable to the Company's auditors for the audit of the Company's annual financial statements reflects the fact that limited incremental work is required in respect of the audit of these financial statements. Rolls-Royce plc, a subsidiary of the Company, is also required to prepare consolidated financial statements and the fees payable to the Company's auditors for the audit of those financial statements, including the audit of the sub-consolidation, is included in the audit of the Company's subsidiaries pursuant to legislation.
[2] As described on page 46, in 2013, fees for other services to KPMG in respect of Rolls-Royce Power Systems AG (RRPS) were £2.1m. Following the consolidation of RRPS on 1 January 2013, the audit committee approved the continuation of engagements already in progress at that date.
[3] This includes **£0.3m** (2012 £0.3m) for the review of the half-year report.
[4] In 2012, as part of the Group's IT modernisation programme, KPMG provided specialist internal audit support while the Group recruited its own personnel. In addition, consulting services were provided by a firm which was acquired by KPMG after being engaged by the Group.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

9 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure[1] £m	Recoverable engine costs £m	Customer relationships[1] £m	Software[1] £m	Other[1] £m	Total £m
Cost:								
At 1 January 2012	1,106	720	998	464	45	267	134	3,734
Exchange differences	(4)	(2)	(1)	–	–	(1)	(3)	(11)
Additions	–	28	38	35	–	119	5	225
Acquisitions of businesses	10	–	–	–	–	2	7	19
Transferred from subsidiary to associate	–	–	(1)	–	–	–	–	(1)
Disposals	(1)	(6)	(6)	–	–	(2)	(1)	(16)
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 of businesses	(5)	–	(5)	–	–	–	–	(10)
At 31 December 2013	**1,861**	**928**	**1,646**	**551**	**475**	**453**	**532**	**6,446**
Accumulated amortisation:								
At 1 January 2012	7	197	274	231	7	104	32	852
Charge for the year[2]	–	34	55	64	5	41	10	209
Impairment	3	–	–	–	–	–	–	3
Disposals	(1)	(6)	(6)	–	–	(1)	(1)	(15)
At 1 January 2013	**9**	**225**	**323**	**295**	**12**	**144**	**41**	**1,049**
Exchange differences	(1)	–	(7)	–	(8)	–	5	(11)
Charge for the year[2]	–	40	130	28	61	54	91	404
Impairment	17	–	3	–	4	–	–	24
Disposal of businesses	(2)	–	(5)	–	–	–	–	(7)
At 31 December 2013	**23**	**265**	**444**	**323**	**69**	**198**	**137**	**1,459**
Net book value:								
At 31 December 2013	**1,838**	**663**	**1,202**	**228**	**406**	**255**	**395**	**4,987**
At 31 December 2012	1,102	515	705	204	33	241	101	2,901
At 1 January 2012	1,099	523	724	233	38	163	102	2,882

[1] Following the acquisition of RRPS on 1 January 2013, intangible assets relating to R&D, customers relationships and software have been reclassified from 'other' into their respective categories from 1 January 2012 onwards.
[2] 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	2013 £m	2012 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**230**	223
Commercial marine – arising from the acquisitions of Vinters Limited and Scandinavian Electric Holding AS	Marine	**620**	649
Commercial marine – arising from the acquisition of ODIM ASA	Marine	**88**	115
Rolls-Royce Power Systems AG	Power Systems	**785**	–
Other	Various	**115**	115
		1,838	1,102

9 Intangible assets (continued)

Goodwill has been tested for impairment during 2013 on the following basis:

- The carrying value of goodwill has 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 forecast 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 per cent) 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 per cent** (2012 13 per cent), based on the Group's weighted average cost of capital, adjusted for specific risk where appropriate.

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 beyond the ten-year forecasts are assumed to grow at two per cent. Following the recognition of RRPS at fair value on 1 January 2013, reasonably possible changes in the key assumptions could cause the value of goodwill to fall below its carrying value, such as a reduction in the level of cash generation of nine per cent, a reduction in the assumed long-term growth rate to 0.8 per cent or an increase in the assumed discount rate of 0.7 per cent.
- **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 per cent** (2012 2.5 per cent). 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 85 per cent 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 per cent** (2012 2.5 per cent). 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 per cent to cause an impairment of this balance.

Other intangible assets

Certification costs and participation fees, customer relationships, technology, patents and licences, order backlog, trademark, development costs and recoverable engine costs 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 per cent** (2012 11 per cent), 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

10 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At 1 January 2012	981	2,646	216	454	4,297
Exchange differences	(14)	(25)	(1)	(9)	(49)
Additions	50	124	18	299	491
Acquisitions of businesses	–	45	–	–	45
Disposals of businesses	–	(4)	–	–	(4)
Reclassifications	60	168	4	(232)	–
Disposals/write-offs	(5)	(65)	(14)	(1)	(85)
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 31 December 2013	**1,297**	**3,490**	**324**	**700**	**5,811**
Accumulated depreciation:					
At 1 January 2012	315	1,598	44	2	1,959
Exchange differences	(3)	(13)	–	–	(16)
Charge for the year [1]	39	196	20	–	255
Reclassifications	7	(7)	–	–	–
Disposals of businesses	–	(2)	–	–	(2)
Disposals/write-offs	(3)	(58)	(2)	(2)	(65)
At 1 January 2013	**355**	**1,714**	**62**	**–**	**2,131**
Exchange differences	(9)	(22)	(1)	–	(32)
Charge for the year [1]	48	301	23	–	372
Reclassifications	(8)	8			–
Disposals of businesses	–	(1)	–	–	(1)
Disposals/write-offs	–	(51)	–	–	(51)
At 31 December 2013	**386**	**1,949**	**84**	**–**	**2,419**
Net book value:					
At 31 December 2013	**911**	**1,541**	**240**	**700**	**3,392**
At 31 December 2012	717	1,175	161	511	2,564
At 1 January 2012	666	1,048	172	452	2,338

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

Property, plant and equipment includes:

	2013 £m	2012 £m
Net book value of finance leased assets:		
Land and buildings	**7**	7
Plant and equipment	**4**	4
Assets held for use in operating leases:		
Cost	**320**	242
Depreciation	**(79)**	(65)
Net book value	**241**	177
Capital expenditure commitments	**317**	258
Cost of fully depreciated assets	**899**	721

The Group's share of equity accounted entities' capital commitments is **£150 million** (2012 £31 million).

11 Investments

	Equity accounted			Other
	Joint ventures £m	Associates £m	Total £m	Unlisted £m
At 1 January 2012	1,680	–	1,680	10
Exchange differences	(58)	–	(58)	–
Additions	191	–	191	–
Taxation paid by the Group	6	–	6	–
Transfer to subsidiary	(5)	–	(5)	–
Impairment	(2)	–	(2)	–
Share of retained profit	44	–	44	–
Transferred from subsidiary to associate	–	2	2	–
Disposals	–	–	–	(4)
Share of OCI – will not be reclassified to profit and loss	(46)	–	(46)	–
Share of OCI – may be reclassified to profit or loss	(12)	–	(12)	–
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	–
Transfers to subsidiaries[1]	(1,327)	–	(1,327)	–
Acquisition of businesses	30	–	30	20
Share of retained profit	61	–	61	–
Disposals	(2)	–	(2)	(1)
Share of OCI – will not be reclassified to profit and loss	–	–	–	–
Share of OCI – may be reclassified to profit or loss	(6)	–	(6)	–
At 31 December 2013	**599**	**2**	**601**	**27**

[1] At 31 December 2012, Rolls-Royce Power Systems GmbH (a 50:50 joint holding company with Daimler AG) held 99 per cent of the RRPS AG shares. As part of the shareholders' agreement, certain conditions allowed the Group to classify RRPS AG as a subsidiary and consolidate it. These conditions were fulfilled and the rights exercised on 1 January 2013, resulting in £1,328m being transferred to subsidiaries.

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

	Joint ventures				Associates		Total	
	2013 Other £m	2012 Power Systems £m	2012 Other £m	2012 £m	**2013 £m**	2012 £m	**2013 £m**	2012 £m
Assets:								
Non-current assets	**1,839**	1,590	1,717	3,307	**1**	1	**1,840**	3,308
Current assets	**852**	718	818	1,536	**2**	2	**854**	1,538
Liabilities:								
Current liabilities	**(623)**	(421)	(655)	(1,076)	**(1)**	(1)	**(624)**	(1,077)
Non-current liabilities	**(1,469)**	(559)	(1,410)	(1,969)	**–**	–	**(1,469)**	(1,969)
	599	1,328	470	1,798	**2**	2	**601**	1,800
Liabilities include borrowings of:	**(1,291)**	(103)	(1,271)	(1,374)	**–**	–	**(1,291)**	(1,374)
Revenue	**2,343**	1,223	2,827	4,050	**1**	3	**2,344**	4,053
Profit before financing and taxation	**188**	33	189	222	**–**	–	**188**	222
Net financing	**(16)**	(10)	(22)	(32)	**–**	–	**(16)**	(32)
Taxation	**(12)**	(1)	(16)	(17)	**–**	–	**(12)**	(17)
Results recognised in the consolidated income statement	**160**	22	151	173	**–**	–	**160**	173
Dividends received	**(99)**	(28)	(101)	(129)	**–**	–	**(99)**	(129)
Retained profit	**61**	(6)	50	44	**–**	–	**61**	44

The principal joint ventures at 31 December 2013 are listed on pages 128 and 129.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12 Inventories

	2013 £m	2012 £m
Raw materials	593	336
Work in progress	1,177	1,056
Long-term contracts work in progress	15	10
Finished goods	1,426	1,282
Payments on account	108	42
	3,319	2,726
Inventories stated at net realisable value	447	136
Amount of inventory write-down	89	64
Reversal of inventory write-down	5	1

13 Trade and other receivables

	2013 £m	2012 £m
Trade receivables	1,601	1,182
Amounts recoverable on contracts	2,239	1,902
Amounts owed by joint ventures and associates	380	351
Other receivables	637	479
Prepayments and accrued income	235	205
	5,092	4,119
Analysed as:		
Financial instruments (note 17):		
Trade receivables and similar items	2,118	1,662
Other non-derivative financial assets	527	364
Non-financial instruments	2,447	2,093
	5,092	4,119
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	51	40
Amounts recoverable on contracts	1,751	1,473
Amounts owed by joint ventures and associates	–	3
Other receivables	41	63
Prepayments and accrued income	84	32
	1,927	1,611

14 Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	982	674
Money-market funds	1,157	408
Short-term deposits	1,851	1,503
	3,990	2,585
Overdrafts (note 15)	(3)	–
Cash and cash equivalents per cash flow statement (page 77)	3,987	2,585
Cash held as collateral against third-party obligations (note 18)	50	64

Cash and cash equivalents at 31 December 2013 includes **£286 million** (2012 £78 million) that is not available for general use by the Group. This balance relates to cash held in non-wholly owned subsidiaries and the Group's captive insurance company.

15 Borrowings

	Current		Non-current		Total	
	2013 £m	2012 £m	**2013 £m**	2012 £m	**2013 £m**	2012 £m
Unsecured						
Overdrafts	**3**	–	**–**	–	**3**	–
Bank loans	**204**	2	**412**	404	**616**	406
7 3/8% Notes 2016 £200m	**–**	–	**200**	200	**200**	200
6.38% Notes 2013 US$230m [1]	**–**	147	**–**	–	**–**	147
6.55% Notes 2015 US$83m [1]	**–**	–	**55**	58	**55**	58
6.75% Notes 2019 £500m [2]	**–**	–	**535**	571	**535**	571
2.125% Notes 2021 €750m [1]	**–**	–	**611**	–	**611**	–
3.375% Notes 2026 £375m [2]	**–**	–	**350**	–	**350**	–
Secured						
Obligations under finance leases [3]	**–**	–	**1**	1	**1**	1
	207	149	**2,164**	1,234	**2,371**	1,383

[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.

16 Trade and other payables

	Current		Non-current		Total	
	2013 £m	2012* £m	**2013 £m**	2012* £m	**2013 £m**	2012* £m
Payments received on account [1]	**1,594**	1,361	**750**	609	**2,344**	1,970
Trade payables	**1,370**	1,109	**16**	–	**1,386**	1,109
Amounts owed to joint ventures and associates	**191**	202	**–**	1	**191**	203
Other taxation and social security	**101**	107	**–**	–	**101**	107
Other payables	**1,820**	1,574	**143**	95	**1,963**	1,669
Accruals and deferred income	**1,969**	2,048	**1,229**	967	**3,198**	3,015
	7,045	6,401	**2,138**	1,672	**9,183**	8,073
[1] Includes payments received on account from joint ventures and associates	**180**	262	**151**	162	**331**	424

Included within trade and other payables are government grants of **£100 million** (2012 £89 million). During the year, **£26 million** (2012 £16 million) of government grants were released to the income statement.

Included in accruals and deferred income are deferred receipts from RRSA workshare partners of **£260 million** (2012 £221 million).

Trade and other payables are analysed as follows:

	2013 £m	2012* £m
Financial instruments (note 17):		
Trade payables and similar items	**2,989**	2,571
Other non-derivative financial liabilities	**806**	704
Non-financial instruments	**5,388**	4,798
	9,183	8,073

* Restated – see note 1.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 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 2013									
Unlisted non-current asset investments	11	A	**–**	**27**	**–**	**–**	**–**	**–**	**27**
Trade receivables and similar items	13	B	**–**	**2,118**	**–**	**–**	**–**	**–**	**2,118**
Other non-derivative financial assets	13	B	**–**	**527**	**–**	**–**	**–**	**–**	**527**
Derivative financial assets		C	**748**	**–**	**–**	**–**	**–**	**–**	**748**
Short-term investments		B	**–**	**321**	**–**	**–**	**–**	**–**	**321**
Cash and cash equivalents	14	B	**–**	**1,851**	**1,157**	**982**	**–**	**–**	**3,990**
Borrowings	15	D	**–**	**–**	**–**	**–**	**–**	**(2,371)**	**(2,371)**
Derivative financial liabilities		C	**–**	**–**	**–**	**–**	**(295)**	**–**	**(295)**
Exercise prices of put options on NCI		E	**–**	**–**	**–**	**–**	**–**	**(1,858)**	**(1,858)**
Financial RRSAs		F	**–**	**–**	**–**	**–**	**–**	**(167)**	**(167)**
C Shares		B	**–**	**–**	**–**	**–**	**–**	**(16)**	**(16)**
Trade payables and similar items	16	B	**–**	**–**	**–**	**–**	**–**	**(2,989)**	**(2,989)**
Other non-derivative financial liabilities	16	B	**–**	**–**	**–**	**–**	**–**	**(806)**	**(806)**
			748	**4,844**	**1,157**	**982**	**(295)**	**(8,207)**	**(771)**
At 31 December 2012									
Unlisted non-current asset investments	11	A	–	6	–	–	–	–	6
Trade receivables and similar items	13	B	–	1,662	–	–	–	–	1,662
Other non-derivative financial assets	13	B	–	364	–	–	–	–	364
Derivative financial assets		C	707	–	–	–	–	–	707
Short-term investments		B	–	11	–	–	–	–	11
Cash and cash equivalents	14	B	–	1,503	408	674	–	–	2,585
Borrowings	15	D	–	–	–	–	–	(1,383)	(1,383)
Derivative financial liabilities		C	–	–	–	–	(360)	–	(360)
Exercise price of put option on NCI		E	–	–	–	–	–	(167)	(167)
Financial RRSAs		F	–	–	–	–	–	(193)	(193)
C Shares		B	–	–	–	–	–	(10)	(10)
Trade payables and similar items	16	B	–	–	–	–	–	(2,571)	(2,571)
Other non-derivative financial liabilities	16	B	–	–	–	–	–	(704)	(704)
			707	3,546	408	674	(360)	(5,028)	(53)

Fair values equate to book values for both 2013 and 2012, with the following exceptions:

	2013		2012	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	**(2,371)**	**(2,495)**	(1,383)	(1,542)
Financial RRSAs	**(167)**	**(184)**	(193)	(215)

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

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

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

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

D Borrowings are carried at amortised cost. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date (Level 2 as defined by IFRS 13).

E The value of the put option on NCI is determined in accordance with the contractual terms, which requires averaging three valuations, covering forecasts of the business performance and external metrics of comparable business and transactions.

F 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.

17 Financial instruments (continued)

Carrying values of other financial assets and liabilities

	Derivatives							
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Exercise price of put options on NCI £m	Financial RRSAs £m	C Shares £m	Total £m
At 31 December 2013								
Non-current assets	**631**	**–**	**43**	**674**	**–**	**–**	**–**	**674**
Current assets	**72**	**2**	**–**	**74**	**–**	**–**	**–**	**74**
	703	**2**	**43**	**748**	**–**	**–**	**–**	**748**
Current liabilities	**(63)**	**(16)**	**(1)**	**(80)**	**(1,858)**	**(22)**	**(16)**	**(1,976)**
Non-current liabilities	**(142)**	**(25)**	**(48)**	**(215)**	**–**	**(145)**	**–**	**(360)**
	(205)	**(41)**	**(49)**	**(295)**	**(1,858)**	**(167)**	**(16)**	**(2,336)**
	498	**(39)**	**(6)**	**453**	**(1,858)**	**(167)**	**(16)**	**(1,588)**
At 31 December 2012								
Non-current assets	498	4	90	592	–	–	–	592
Current assets	104	6	5	115	–	–	–	115
	602	10	95	707	–	–	–	707
Current liabilities	(97)	(8)	–	(105)	(167)	(30)	(10)	(312)
Non-current liabilities	(233)	(15)	(7)	(255)	–	(163)	–	(418)
	(330)	(23)	(7)	(360)	(167)	(193)	(10)	(730)
	272	(13)	88	347	(167)	(193)	(10)	(23)

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 £m	Commodity instruments £m	Interest rate instruments £m	Total £m
At 1 January 2012	(447)	(12)	81	(378)
Movements in fair value hedges [1]	(8)	–	6	(2)
Movements in cash flow hedges	(4)	–	–	(4)
Movements in other derivative contracts [2]	750	(3)	1	748
Contracts settled [3]	(19)	2	–	(17)
At 1 January 2013	**272**	**(13)**	**88**	**347**
Business acquisitions	4	(1)	–	3
Movements in fair value hedges [1]	3	–	(91)	(88)
Movements in other derivative contracts [2]	284	(34)	–	250
Contracts settled [3]	(65)	9	(3)	(59)
At 31 December 2013	**498**	**(39)**	**(6)**	**453**

[1] Gain on related hedged items **£88m** (2012 £2m net gain).
[2] Included in financing.
[3] Includes contracts settled in fair value hedges **£17m** (2012 nil) and cash flow hedges **£nil** (2012: £4m loss).

Exercise price of put option on non-controlling interests and financial RRSAs

The Group has agreed a put option with Daimler AG, such that Daimler can sell its interest in Rolls-Royce Power Systems Holding GmbH (RRPSH) to the Group. The exercise price of this option is included as a financial liability.

The Group has financial liabilities arising from financial RRSAs. These financial liabilities are valued at each reporting date using the amortised cost method. This involves calculating the present value of the forecast cash flows of the arrangements using the internal rate of return at the inception of the arrangements as the discount rate.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 Financial instruments (continued)

Movements in the carrying values were as follows:

	Put options on NCI		Financial RRSAs	
	2013 £m	2012 £m	2013 £m	2012 £m
At 1 January	**(167)**	–	**(193)**	(230)
Cash paid to partners	**–**	–	**33**	35
Business acquisitions	**(2)**	–	**–**	–
Additions	**(1,432)**	(167)	**–**	–
Exchange adjustments included in OCI	**–**	–	**(4)**	1
Financing charge [1]	**–**	–	**(9)**	(10)
Excluded from underlying profit:				
Changes in put options exercise prices [1]	**(212)**	(5)		
Exchange adjustments [1]	**(45)**	5	**4**	9
Changes in forecast payments [1]			**2**	2
At 31 December	**(1,858)**	(167)	**(167)**	(193)

[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.

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.

17 Financial instruments (continued)

Derivative financial instruments

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

	Nominal amount £m	Expected maturity: Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Fair value: Assets £m	Liabilities £m
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)**
At 31 December 2012							
Foreign exchange contracts:							
Fair value hedges	175	129	–	46	–	15	–
Non-hedge accounted	17,701	4,585	3,542	9,029	545	587	(330)
Interest rate contracts:							
Fair value hedges	692	141	51	–	500	89	–
Non-hedge accounted	7	–	–	7	–	6	(7)
Commodity contracts:							
Non-hedge accounted	286	76	68	99	43	10	(23)
	18,861	4,931	3,661	9,181	1,088	707	(360)

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 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**
At 31 December 2012					
Currencies sold forward:					
Sterling	–	495	–	23	518
US dollar	14,407	–	1,817	840	17,064
Euro	–	–	–	177	177
Other	21	11	70	15	117

Other derivative financial instruments are denominated in the following currencies:

	2013 £m	2012 £m
Sterling	**880**	506
US dollar	**300**	479
Euro	**637**	–
Other	**–**	–

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17 Financial instruments (continued)

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

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2013					
Assets					
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**
	2,389	**2,123**	**1,928**	**543**	**6,983**
Liabilities					
Borrowings	**(1,490)**	**(55)**	**(826)**	**–**	**(2,371)**
Exercise prices of put options on NCI	**–**	**–**	**(1,858)**	**–**	**(1,858)**
Financial RRSAs	**–**	**(114)**	**(53)**	**–**	**(167)**
C Shares	**(16)**	**–**	**–**	**–**	**(16)**
Trade payables and similar items	**(1,501)**	**(641)**	**(653)**	**(194)**	**(2,989)**
Other non-derivative financial liabilities	**(208)**	**(328)**	**(158)**	**(112)**	**(806)**
	(3,215)	**(1,138)**	**(3,548)**	**(306)**	**(8,207)**
	(826)	**985**	**(1,620)**	**237**	**(1,224)**
At 31 December 2012					
Assets					
Unlisted non-current investments	1	–	4	1	6
Trade receivables and similar items	234	1,176	169	83	1,662
Other non-derivative financial assets	121	75	40	128	364
Short-term investments	5	–	–	6	11
Cash and cash equivalents	495	1,038	606	446	2,585
	856	2,289	819	664	4,628
Liabilities					
Borrowings	(1,173)	(205)	(5)	–	(1,383)
Exercise price of put option on NCI	–	–	(167)	–	(167)
Financial RRSAs	–	(139)	(54)	–	(193)
C Shares	(10)	–	–	–	(10)
Trade payables and similar items	(1,254)	(825)	(289)	(203)	(2,571)
Other non-derivative financial liabilities	(250)	(320)	(17)	(117)	(704)
	(2,687)	(1,489)	(532)	(320)	(5,028)
	(1,831)	800	287	344	(400)

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 operation	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2013					
Sterling [1]	**–**	**13**	**(1,855)**	**12**	**(1,830)**
US dollar	**8**	**–**	**–**	**7**	**15**
Euro	**(1)**	**(2)**	**–**	**–**	**(3)**
Other	**(5)**	**41**	**(11)**	**(4)**	**21**
At 31 December 2012					
Sterling [1]	–	22	(166)	4	(140)
US dollar	4	–	(6)	5	3
Euro	(1)	(2)	–	–	(3)
Other	6	1	(5)	1	3

[1] Included in the **£1,855m** liability (2012 £166m liability) euro currency exposure is a **£1,858m** liability (2012 £167m liability) relating to the put option on Daimler's interest in RRPSH – see page 105.

17 Financial instruments (continued)

Ageing beyond contractual due date of financial assets

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
At 31 December 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**
At 31 December 2012					
Unlisted non-current asset investments	6	–	–	–	6
Trade receivables and similar items	1,470	132	43	17	1,662
Other non-derivative financial assets	343	18	1	2	364
Derivative financial assets	707	–	–	–	707
Short-term investments	11	–	–	–	11
Cash and cash equivalents	2,585	–	–	–	2,585
	5,122	150	44	19	5,335

Contractual maturity analysis of financial liabilities

	Gross values					
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
At 31 December 2013						
Borrowings	**(290)**	**(140)**	**(609)**	**(1,894)**	**562**	**(2,371)**
Derivative financial liabilities	**(87)**	**(76)**	**(146)**	**(90)**	**104**	**(295)**
Exercise prices of put options on NCI	**(1,858)**	**–**	**–**	**–**	**–**	**(1,858)**
Financial RRSAs	**(33)**	**(34)**	**(65)**	**(75)**	**40**	**(167)**
C Shares	**(16)**	**–**	**–**	**–**	**–**	**(16)**
Trade payables and similar items	**(2,972)**	**(17)**	**–**	**–**	**–**	**(2,989)**
Other non-derivative financial liabilities	**(751)**	**(28)**	**(16)**	**(11)**	**–**	**(806)**
	(6,007)	**(295)**	**(836)**	**(2,070)**	**706**	**(8,502)**
At 31 December 2012						
Borrowings	(210)	(257)	(403)	(778)	265	(1,383)
Derivative financial liabilities	(108)	(103)	(138)	(14)	3	(360)
Exercise price of put option on NCI	(167)	–	–	–	–	(167)
Financial RRSAs	(35)	(32)	(75)	(100)	49	(193)
C Shares	(10)	–	–	–	–	(10)
Trade payables and similar items	(2,568)	(1)	(1)	(1)	–	(2,571)
Other non-derivative financial liabilities	(694)	(10)	–	–	–	(704)
	(3,792)	(403)	(617)	(893)	317	(5,388)

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17 Financial instruments (continued)

Interest rate risk

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

2013	Effective interest rate %	Total £m	Period in which interest rate reprices: 6 months or less £m	6–12 months £m
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				
7 3/8% 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 + 0.8330	–	(350)	–
Other secured				
Obligations under finance leases	5.0000%	(1)	(1)	–
		1,940		

2012	Effective interest rate %	Total £m	Period in which interest rate reprices: 6 months or less £m	6–12 months £m
Short-term investments[1]		11	9	2
Cash and cash equivalents[2]		2,585	2,585	–
Unsecured bank loans				
Other borrowings		(6)	(4)	
Interest rate swaps	5.3225%	–	7	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–
Unsecured bond issues				
7 3/8% Notes 2016 £200m	7.3750%	(200)	–	–
6.38% Notes 2013 US$230m	6.3800%	(147)	–	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(147)	–
6.55% Notes 2015 US$83m	6.5500%	(58)	–	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(58)	–
6.75% Notes 2019 £500m	6.7500%	(571)	–	–
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(571)	–
Other secured				
Obligations under finance leases	5.0000%	(1)	–	–
		1,213		

[1] Interest on the short-term investments are at fixed rates.
[2] Cash and cash equivalents comprise bank balances and demand deposits and earn interest at rates based on daily deposit rates.

17 Financial instruments (continued)

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 undrawn committed borrowing facilities available as follows:

	2013 £m	2012 £m
Expiring in one to two years	–	–
Expiring after two years	1,250	1,000
	1,250	1,000

Sensitivity analysis

Sensitivities at 31 December (all other variables held constant) – impact on profit after tax and equity	2013 £m	2012 £m
Sterling 10% weaker against the US dollar	(1,177)	(1,073)
Sterling 10% stronger against the US dollar	963	878
Euro 10% weaker against the US dollar	(128)	(146)
Euro 10% stronger against the US dollar	100	118
Sterling 10% weaker against the Euro	(95)	–
Sterling 10% stronger against the Euro	78	–
Commodity prices 10% lower	(16)	(20)
Commodity prices 10% higher	16	20

At 31 December 2013 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 106.

C Shares and payments to shareholders

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. C Shares in respect of a year are issued in the following year. Shareholders are able to redeem any number of their C Shares for cash. Any C Shares retained attract a dividend of 75 per cent of LIBOR on the 0.1 pence nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. The Company has the option to compulsorily redeem the C Shares, at any time, if the aggregate number of C Shares in issue is less than ten per cent of the aggregate number of C Shares issued, or on the acquisition or capital restructuring of the Company.

Movements in the C Shares during the year were as follows:

	2013		2012	
	Millions	Nominal value £m	Millions	Nominal value £m
Issued and fully paid				
At 1 January	10,418	10	6,371	6
Issued	366,041	366	327,643	328
Redeemed	(360,173)	(360)	(323,596)	(324)
At 31 December	16,286	16	10,418	10

Payments to shareholders in respect of the year represent the value of C Shares to be issued in respect of the results for the year. Issues of C Shares were declared as follows:

	2013		2012	
	Pence per share	£m	Pence per share	£m
Interim	8.6	162	7.6	142
Final	13.4	252	11.9	223
	22.0	414	19.5	365

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 Provisions for liabilities and charges

	At 1 January 2013 £m	Exchange differences £m	Acquisitions of businesses £m	Disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At 31 December 2013 £m
Warranty and guarantees	**247**	1	201	(2)	(39)	150[1]	(139)[1]	**419**
Contract loss	**54**	–	27	–	(13)	24	(25)	**67**
Restructuring	**4**	–	4	9	(6)	17	(3)	**25**
Customer financing	**82**	–	–	–	(11)	23	(21)	**73**
Insurance	**47**	–	–	–	(7)	31	(9)	**62**
Other	**27**	1	48	–	(11)	48	(26)	**87**
	461	2	280	7	(87)	293	(223)	**733**
Current liabilities	**220**							**348**
Non-current liabilities	**241**							**385**

[1] The amount of warranty and guarantee provision charged to the income statement and utilised by RRPS was £86m and £78m respectively.

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. 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 Chief Financial Officer's review on page 13. It is estimated that the provision will be utilised as follows:

	2013 £m	2012 £m
Potential claims with specific claim dates:		
In one year or less	**29**	30
In more than one year but less than five years	**38**	43
In more than five years	**5**	8
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	**1**	–
Up to five years	**–**	1
	73	82

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 estimated values of aircraft providing security are based on advice from a specialist aircraft appraiser.

	2013 £m	2013 $m	2012 £m	2012 $m
Gross commitments	**356**	***589***	569	*925*
Value of security[1]	**(217)**	***(360)***	(381)	*(620)*
Indemnities	**(80)**	***(132)***	(118)	*(191)*
Net commitments	**59**	***97***	70	*114*
Net commitments with security reduced by 20%[2]	**78**	***129***	133	*216*
[1] Security includes unrestricted cash collateral of:	**50**	***83***	64	*104*

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

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

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

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

19 Post-retirement benefits

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

- UK defined benefit schemes are funded, with the assets held in separate trustee administered funds. Employees are entitled to retirement benefits based on either their final or career average salaries and length of service; and
- 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 2013.

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 an investment policy to mitigate some of these risks. This involves investing a significant proportion of the scheme 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.

The Group has adopted amendments to IAS 19 *Employee Benefits* with effect from 1 January 2013. The impact is described further below. 2012 figures have been restated to put them on a comparable basis.

Amounts recognised in the income statement

	2013			2012		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost and administrative expenses	**153**	**55**	**208**	129	42	171
Past-service cost	**66**	**5**	**71**	2	–	2
	219	**60**	**279**	131	42	173
Defined contribution schemes	**30**	**44**	**74**	23	41	64
Operating cost	**249**	**104**	**353**	154	83	237
Net financing (income)/charge in respect of defined benefit schemes	**(12)**	**38**	**26**	(17)	25	8
Total income statement charge	**237**	**142**	**379**	137	108	245

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2013 £m	2012 £m	**2013 £m**	2012 £m	**2013 £m**	2012 £m
Cost of sales – included in underlying profit	**144**	124	**49**	46	**193**	170
Commercial and administrative costs	**106**	38	**15**	14	**121**	52
Research and development	**29**	11	**10**	4	**39**	15
	279	173	**74**	64	**353**	237

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 **£37 million** (2012 £36 million) in the year.

Net financing comprises:

	2013			2012		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Financing on scheme obligations	**371**	**59**	**430**	354	47	401
Financing on scheme assets	**(431)**	**(21)**	**(452)**	(444)	(22)	(466)
Financing on unrecognised surpluses and minimum funding liability	**48**	**–**	**48**	73	–	73
Net financing (income)/charge in respect of defined benefit schemes	**(12)**	**38**	**26**	(17)	25	8
Financing income on scheme surpluses	**(16)**	**(1)**	**(17)**	(26)	–	(26)
Financing costs on scheme deficits	**4**	**39**	**43**	9	25	34

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

19 Post-retirement benefits (continued)

Amounts recognised in OCI in respect of defined benefit schemes

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Actuarial gains and losses arising from demographic assumptions	(87)	(12)	(99)	(27)	(1)	(28)
Actuarial gains and losses arising from financial assumptions	(200)	116	(84)	(639)	(104)	(743)
Actuarial gains and losses arising from experience adjustments	65	31	96	7	(13)	(6)
Return on scheme assets excluding financing income	(363)	(42)	(405)	(155)	26	(129)
Movement in unrecognised surplus and related finance cost	407	–	407	529	–	529
Movement in minimum funding liability and related finance cost	133	–	133	72	–	72
	(45)	93	48	(213)	(92)	(305)

Amounts recognised in the balance sheet in respect of defined benefit schemes

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(9,046)	(558)	(9,604)	(8,569)	(609)	(9,178)
Fair value of scheme assets	9,776	504	10,280	9,794	534	10,328
Net asset/(liability) on funded schemes	730	(54)	676	1,225	(75)	1,150
Present value of unfunded obligations	–	(935)	(935)	–	(569)	(569)
Unrecognised surplus[1]	(488)	–	(488)	(853)	–	(853)
Minimum funding liability[2]	(46)	–	(46)	(173)	–	(173)
Net asset/(liability) recognised in the balance sheet	196	(989)	(793)	199	(644)	(445)
Post-retirement scheme surpluses	242	6	248	336	12	348
Post-retirement scheme deficits	(46)	(995)	(1,041)	(137)	(656)	(793)

[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.
[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:

	2013			2012		
	Assets £m	Obligations £m	Net £m	Assets £m	Obligations £m	Net £m
Canada	135	(181)	(46)	139	(200)	(61)
Germany	–	(500)	(500)	–	(86)	(86)
US pension schemes	347	(420)	(73)	369	(449)	(80)
US healthcare schemes	–	(352)	(352)	–	(399)	(399)
Other	22	(40)	(18)	26	(44)	(18)
Net asset/(liability) recognised in the balance sheet	504	(1,493)	(989)	534	(1,178)	(644)

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:

		2013	2012
Discount rate		4.4%	4.4%
Inflation assumption[1]		3.5%	3.0%
Rate of increase in salaries		4.5%	4.1%
Male life expectancy	– current pensioner	22.5	22.6
	– future pensioner currently aged 45	24.2	24.4

[1] For the UK schemes, this is the assumption for the Retail Price Index. The Consumer Price Index is assumed to be one per cent 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.

19 Post-retirement benefits (continued)

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 2013 core projections and long-term improvements of 1.25 per cent. 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 the discount rate, **4.5 per cent** (2012 3.9 per cent) and inflation, **2.3 per cent** (2012 2.4 per cent).

Changes in present value of defined benefit obligations

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January, as previously reported				(7,713)	(1,052)	(8,765)
Effect of amendments to IAS 19				17	(1)	16
At 1 January, as restated	(8,569)	(1,178)	(9,747)	(7,696)	(1,053)	(8,749)
Exchange differences	–	16	16	–	42	42
Current service cost	(147)	(53)	(200)	(122)	(40)	(162)
Past-service cost	(66)	(4)	(70)	(2)	–	(2)
Finance cost	(371)	(59)	(430)	(354)	(47)	(401)
Contributions by employees	(4)	(4)	(8)	(4)	(2)	(6)
Benefits paid out	334	63	397	322	38	360
Acquisition of businesses	(1)	(402)	(403)	(54)	–	(54)
Actuarial (losses)/gains	(222)	134	(88)	(659)	(118)	(777)
Settlement/curtailment	–	–	–	–	2	2
Other movements	–	(6)	(6)			
At 31 December	(9,046)	(1,493)	(10,539)	(8,569)	(1,178)	(9,747)
Funded schemes	(9,046)	(558)	(9,604)	(8,569)	(609)	(9,178)
Unfunded schemes	–	(935)	(935)	–	(569)	(569)
The defined benefit obligations are in respect of:						
Active plan participants	(3,492)	(849)	(4,341)	(3,129)	(915)	(4,044)
Deferred plan participants	(1,647)	(74)	(1,721)	(1,583)	(15)	(1,598)
Pensioners	(3,907)	(570)	(4,477)	(3,857)	(248)	(4,105)
Weighted average duration of obligations	16	13	16			

Changes in fair value of scheme assets

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	9,794	534	10,328	9,519	497	10,016
Exchange differences	–	(19)	(19)	–	(18)	(18)
Administrative expenses	(6)	(2)	(8)	(7)	(2)	(9)
Financing	431	21	452	444	22	466
Return on plan assets excluding financing	(363)	(42)	(405)	(155)	26	(129)
Contributions by employer	249	66	315	252	47	299
Contributions by employees	4	4	8	4	2	6
Benefits paid out	(334)	(63)	(397)	(322)	(38)	(360)
Acquisition of businesses	1	5	6	59	–	59
Settlements/curtailment	–	–	–	–	(2)	(2)
At 31 December	9,776	504	10,280	9,794	534	10,328
Total return on scheme assets	68	(21)	47	289	48	337

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

19 Post-retirement benefits (continued)

Fair value of scheme assets at 31 December

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Sovereign debt	5,929	231	6,160	6,088	–	6,088
Derivatives on sovereign debt	(987)	2	(985)	(1,225)	–	(1,225)
Corporate debt instruments	1,045	190	1,235	969	–	969
Interest rate swaps	1,361	–	1,361	1,922	–	1,922
Inflation swaps	(13)	–	(13)	(289)	–	(289)
Cash and similar instruments	257	44	301	429	–	429
Liability driven investment (LDI) portfolios [1]	7,592	467	8,059	7,894	–	7,894
Longevity swap [2]	3	–	3	(126)	–	(126)
Listed equities	994	3	997	1,126	119	1,245
Unlisted equities	172	–	172	–	–	–
Sovereign debt	215	4	219	245	313	558
Corporate debt instruments	540	4	544	334	74	408
Cash	253	4	257	–	–	–
Other	7	22	29	321	28	349
	9,776	504	10,280	9,794	534	10,328

[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. Following the adoption of the amendments to IAS 19 and the interaction with IFRS 13 from 2013 the longevity swap has been valued on an external fair market basis, rather than using the same assumptions as used for the valuation of the scheme's liabilities. As the surplus on the RRPF is restricted, this has had no impact on the net surplus/deficit recognised in the balance sheet. Had the longevity swap been valued on the same basis as 2012, its value would have been a liability of £156m, the movement since 2012 largely reflecting the changes in mortality and discount rate assumptions. The valuation is based on an estimate of the assumptions that a hypothetical third party would use for the future mortality and premium.

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 liability

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January, as previously reported				(1,554)	(94)	(1,648)
Effect of amendments to IAS 19				–	94	94
At 1 January, as restated	(1,026)	–	(1,026)	(1,554)	–	(1,554)
Movements in unrecognised surplus through OCI	407	–	407	529	–	529
Movements in minimum funding liability through OCI	133	–	133	72	–	72
Related finance costs	(48)	–	(48)	(73)	–	(73)
At 31 December	(534)	–	(534)	(1,026)	–	(1,026)

Future contributions

The Group expects to contribute approximately £325 million to its defined benefit schemes in 2014.

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 2013 £m	Valuation date
Rolls-Royce Pension Fund	6,543	31 March 2012
Rolls-Royce Group Pension Scheme	1,540	5 April 2013
Vickers Group Pension Scheme	637	31 March 2013

19 Post-retirement benefits (continued)

Sensitivities

The calculations of the defined benefit obligations are sensitive to the assumptions set out on page 114. The following table summarises the estimated impact of a change in the assumption on the UK defined benefit obligation at 31 December 2013, 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]	Obligations	**(412)**
	Plan assets (LDI portfolio)	**465**
Increase in inflation of 0.25%	Obligations	**(201)**
	Plan assets (LDI portfolio)	**185**
Increase in real increase in salaries of 0.25%	Obligations	**(88)**
One year increase in life expectancy	Obligations	**(212)**
	Plan assets (longevity swap)	**86**

[1] The difference 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 97 per cent.

Amendments to IAS 19

Prior period figures have been restated to reflect the adoption of the amendments to IAS 19. Consequential tax effects have been reflected in deferred tax.

		As previously reported			Amendments			As restated		
	Notes	UK £m	Overseas £m	Total £m	UK £m	Overseas £m	Total £m	UK £m	Overseas £m	Total £m
At 1 January 2012	A	252	(649)	(397)	17	93	110	269	(556)	(287)
Exchange adjustments		–	24	24	–	–	–	–	24	24
Current service cost and administrative expenses	B	(123)	(38)	(161)	(6)	(4)	(10)	(129)	(42)	(171)
Past-service cost	A	(2)	12	10	–	(12)	(12)	(2)	–	(2)
Net financing	C	(41)	(23)	(64)	58	(2)	56	17	(25)	(8)
Contributions by employer		250	47	297	2	–	2	252	47	299
Acquisition of business		5	–	5	–	–	–	5	–	5
Actuarial losses	C	(659)	(118)	(777)	–	–	–	(659)	(118)	(777)
Return on plan assets excluding financing	C	(30)	20	(10)	(125)	6	(119)	(155)	26	(129)
Movement in unrecognised surplus	C	465	–	465	64	–	64	529	–	529
Movement on minimum funding liability	C	63	–	63	9	–	9	72	–	72
At 31 December 2012		180	(725)	(545)	19	81	100	199	(644)	(445)
Post-retirement scheme surpluses		317	12	329				336	12	348
Post-retirement scheme deficits		(137)	(737)	(874)				(137)	(656)	(793)

A An unrecognised past-service credit related to the restructuring of certain overseas healthcare schemes in 2011. This has now been recognised in full at 1 January 2012. As a consequence, the amortisation of this past-service credit in 2012 is eliminated. In addition, an adjustment has been made in the calculation of the defined benefit obligation on one of the UK schemes to put it on a consistent basis with the other schemes.

B Previously all administrative costs were offset against the expected return on scheme assets. The amendments only allow this in respect of the costs of managing scheme assets; other administrative expenses are now included in the current service cost.

C Previously net financing comprised the actual expected return on scheme assets based on the underlying assets and a financing charge on scheme liabilities calculated using a 'AA' corporate bond rate. The amendments require net financing to be calculated on the net asset or liability recognised on the balance sheet using an AA corporate bond rate. This has a consequential impact on amounts recognised in OCI: (i) the change in assumed return on scheme assets affects the related actuarial gains or losses; and (ii) implicit financing on movements in the unrecognised surplus and the minimum funding liability is not included in the income statement.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

20 Share capital

	Non-equity		Equity	
	Special Share of £1	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid				
At 1 January 2012	**1**	**–**	**1,872**	**374**
Proceeds from shares issued for share option schemes			–	–
At 31 December 2012	**1**	**–**	**1,872**	**374**
Proceeds from shares issued for share option schemes			8	2
At 31 December 2013	**1**	**–**	**1,880**	**376**

The rights attaching to each class of share are set out on page 70.

During 2013, the Group also received £30 million from participants in ShareSave schemes. Shares to satisfy these options were issued from those already held by the Group for this purpose, as described on page 79.

In accordance with IAS 32 *Financial Instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 17.

21 Share-based payments

Effect of share-based payment transactions on the Group's results and financial position

	2013 £m	2012 £m
Total expense recognised for equity-settled share-based payments transactions	**61**	49
Total expense recognised for cash-settled share-based payments transactions	**18**	6
Share-based payments recognised in the consolidated income statement	**79**	55
Liability for cash-settled share-based payment transactions	**19**	18

A description of the share-based payment plans is included in the remuneration report on pages 57 to 58.

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 2012	27.5	447	0.5	100	19.5	3.3
Granted	–	–	–	–	4.3	2.0
Additional entitlements arising from TSR performance	–	–	–	–	2.8	–
Forfeited	(0.6)	446	–	–	(0.8)	(0.1)
Exercised	(0.1)	409	(0.4)	103	(11.8)	(1.2)
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 31 December 2013	**16.0**	**660**	**–**	**–**	**12.0**	**3.1**
Exercisable at 31 December 2013	**–**	**–**	**–**	**–**	**–**	**–**
Exercisable at 31 December 2012	–	–	0.1	77	–	–

As share options are exercised throughout the year, the weighted average share price during the year of **1123 pence** (2012 836 pence) is representative of the weighted average share price at the date of exercise. The closing price at 31 December 2013 was **1275 pence** (2012 873.5 pence).

There were no exercisable options as at 31 December 2013. The average remaining contractual life of the exercisable options as at 31 December 2012 was 0.2 years.

21 Share-based payments (continued)

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:

	2013	2012
PSP – 25% TSR uplift	**1128p**	885p
PSP – 50% TSR uplift	**1254p**	985p
ShareSave – three year grant	**287p**	n/a
ShareSave – five year grant	**349p**	n/a
APRA	**1027p**	809p

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.

22 Operating leases

Leases as lessee

	2013 £m	2012 £m
Rentals paid – hire of plant and machinery	**134**	94
– hire of other assets	**55**	34
Non-cancellable operating lease rentals are payable as follows:		
Within one year	**179**	147
Between one and five years	**545**	490
After five years	**507**	526
	1,231	1,163

Leases as lessor

	2013 £m	2012 £m
Rentals received – credited within revenue from aftermarket services	**56**	30
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	**19**	2
Between one and five years	**48**	7
After five years	**23**	1
	90	10

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** (2012 £4 million) and sublease receipts of **£27 million** (2012 £17 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 from 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 28 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 **£8 million** (2012 £10 million) and sublease receipts expected to be received is **£42 million** (2012 £9 million).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

23 Contingent liabilities

On 6 December 2012, the Company announced that it had passed information to the SFO relating to concerns in overseas markets. Since that date the Company has continued its investigations and is engaging with the SFO and other authorities in the UK, the USA and elsewhere.

In December 2013, the Company announced that it had been informed by the SFO that it had commenced a formal investigation. The consequence of these disclosures will be decided by the regulatory authorities. It remains 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 (including debarment from government contracts, suspension of export privileges and reputational damage) 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 **£13 million** (2012 £48 million).

Contingent liabilities in respect of customer financing commitments are described in note 18.

24 Related party transactions

	2013 £m	2012 £m
Sales of goods and services to joint ventures and associates	3,149	2,937
Purchases of goods and services from joint ventures and associates	(3,269)	(3,082)
Operating lease payments to joint ventures and associates	(69)	(57)
Guarantees of joint ventures' and associates' borrowings	7	12
Dividends received from joint ventures and associates	99	129
RRSA receipts from joint ventures and associates	4	13
Other income received from joint ventures and associates	1	2

The aggregated balances with joint ventures are shown in notes 13 and 16. Transactions with Group pension schemes are shown in note 19.

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.

Key management personnel are deemed to be the directors and the members of the ELT as set out on page 38. Remuneration for key management personnel is shown below:

	2013 £m	2012 £m
Salaries and short-term benefits	11	15
Post-retirement schemes	1	1
Share-based payments	7	8
	19	24

More detailed information regarding the directors' remuneration, shareholdings, pension entitlements, share options and other long-term incentive plans is shown in the remuneration report on pages 53 to 69.

25 Acquisitions and disposals

Acquisitions

Rolls-Royce Power Systems AG (RRPS – formerly Tognum AG)

From 25 August 2011 to 31 December 2012 the Group's interest in RRPS was classified as a joint venture and equity accounted. On 1 January 2013, conditions were fulfilled which gave the Group certain rights that result in RRPS being classified as a subsidiary and consolidated. Accordingly, the Group's joint venture interest in Rolls-Royce Power Systems Holding GmbH (RRPSH) has been reclassified as a subsidiary. The fair values of the identifiable assets and liabilities assumed are £1,339 million, giving rise to goodwill of £773 million, as set out in the table below. Rolls-Royce and Daimler AG (Daimler) each hold 50 per cent of the shares of RRPSH, which itself held over 99 per cent of the shares of RRPS. During 2013, RRPSH acquired the remaining 1 per cent of shares of RRPS. RRPS is a premium supplier of engines, propulsion systems and components for marine, energy, defence, and other industrial applications (often described as 'off-highway' applications).

Other

On 30 April 2013, the Group acquired 100 per cent of the issued share capital of Hyper-Therm High-Temperature Composites, Inc., a producer of state-of-the-art composite materials, including ceramic matrix composites, engineered coatings and thermal-structural components.

On 15 August 2013, the Group acquired 100 per cent of SmartMotor AS, a leading specialist in the development of permanent magnet technology.

On 24 December 2013, the Group acquired the remaining 49 per cent of shares not held in Composite Technology and Applications Limited, a business engaged in the development of composite fan blades and containment cases for the next generation of advanced turbofan engines.

For each of the other acquisitions noted, the acquisition cost (net of cash and borrowings acquired) has been allocated to identifiable assets and liabilities – principally technology, patents and licences, customer relationships, trademark, order backlog and other intangible assets.

Recognised amounts of identifiable assets acquired and liabilities assumed

	RRPS £m	Other £m	Total £m
Intangible assets	1,192	35	**1,227**
Property, plant and equipment	545	1	**546**
Investments in joint ventures, associates and other unlisted investments	50	–	**50**
Inventory	737	–	**737**
Trade and other receivables	487	2	**489**
Taxation recoverable	48	–	**48**
Cash and cash equivalents	240	5	**245**
Trade and other payables	(693)	(3)	**(696)**
Current tax payables	(77)	–	**(77)**
Borrowings	(203)	(1)	**(204)**
Other financial assets and liabilities	(27)	–	**(27)**
Deferred tax	(283)	1	**(282)**
Provisions	(280)	–	**(280)**
Post-retirement schemes	(397)	–	**(397)**
Total identifiable assets and liabilities	**1,339**	**40**	**1,379**
Goodwill arising	773	–	**773**
Total consideration	**2,112**	**40**	**2,152**
Exercise price of put option on NCI	(1,432)	–	**(1,432)**
	680	**40**	**720**
Consideration satisfied by:			
Cash consideration	–	37	**37**
Existing shareholding	1,443	3	**1,446**
NCI	669	–	**669**
	2,112	**40**	**2,152**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

25 Acquisitions and disposals (continued)

	RRPS £m	Other £m	Total £m
Net cash outflow arising on acquisition:			
Cash consideration	–	37	**37**
Less: cash and cash equivalents acquired	(240)	(5)	**(245)**
Cash (inflow)/outflow per cash flow statement	**(240)**	**32**	**(208)**
Identifiable intangible assets comprise:			
Technology, patents and licences	420	35	**455**
Customer relationships	433	–	**433**
Trademark	105	–	**105**
Order backlog	94	–	**94**
In-process development	53	–	**53**
Other	87	–	**87**
	1,192	**35**	**1,227**

In accordance with the provisions of IFRS 3 *Business Combinations*, the Group has opted not to recognise goodwill in respect of the non-controlling interest in RRPS. The previous joint venture investment holding in RRPSH of £1,328 million was revalued, giving rise to a gain of £115 million.

As part of the RRPSH shareholders' agreement, Daimler AG has the option to sell its shares in RRPSH to Rolls-Royce for a period of six years from 1 January 2013. The initial fair value of the exercise price of this option in respect of RRPS has been recognised as a liability (£1,432 million), which has been charged to NCI and retained earnings.

The goodwill arising on the acquisition of RRPS amounting to £773 million (which is not tax deductible) consists of anticipated synergies and the assembled workforce. The anticipated synergies principally arise from:

- increases in revenue from the combination of the routes to market; and
- cost savings from the combination of the supply chain and central functions.

The gross contractual value of trade receivables acquired is £446 million. At the acquisition date, it was estimated that contractual cash flows of £24 million would not be collected.

The acquisition of the controlling interest in RRPS contributed £2,593 million of revenue and profit before tax of £10 million (including amortisation of intangible assets arising on acquisition) to the Group's results for the year.

Disposals

On 29 January 2013, Alstom acquired Tidal Generation Limited.

On 2 September 2013, Turbomeca (a Safran company) acquired the Group's 50 per cent shareholding and interest in the RTM322 helicopter engine programme for which it has received a cash consideration of €293 million. Rolls-Royce will progressively transfer its operational responsibilities in the engine programme to Turbomeca over a multi-year period.

Assets and liabilities disposed

	RTM322 £m	Tidal Generation £m	Total £m
Intangible assets – goodwill	–	3	**3**
Investment in joint venture	2	–	**2**
Cash and cash equivalents	–	2	**2**
Trade and other payables	–	(2)	**(2)**
Provisions for liabilities and charges	(2)	–	**(2)**
Net assets	**–**	**3**	**3**
Profit on disposal of businesses	194	22	**216**
Disposal costs	3	–	**3**
Proceeds deferred in respect of transitional services and retained obligations	53	–	**53**
Disposal proceeds	**250**	**25**	**275**
Cash and cash equivalents disposed	–	(2)	**(2)**
Cash inflow per cash flow statement	**250**	**23**	**273**

25 Acquisitions and disposals (continued)

During 2012, the Group acquired:

- on 19 June 2012, Superstructure Capital Limited, a business engaged in marketing and sale of safety and risk management software to the aerospace industry;
- on 13 July 2012, PFW Aerospace UK, a business engaged in the manufacture of precision components for the aerospace industry;
- on 13 December 2012, Rolls-Royce Goodrich Engine Control Systems Limited (acquisition of 50 per cent not already held), a business engaged in the development and manufacture of aero-engine controls; and
- 27 December 2012, PKMJ Technical Services, Inc., a nuclear engineering services business in the US.

and disposed of:

- on 27 June 2012, Rolls-Royce Fuel Cell Systems Inc. (dilution of existing shareholding to 49 per cent); and
- on 29 June 2012, for US$1.5 billion, the equity, programme share and related goodwill of IAE International Aero Engines AG, which gave rise to a profit before tax of £699 million.

26 Segmental analysis from 1 January 2014

As described in the Chief Financial Officer's review on page 13, the management structure of the business has been revised and the internal reporting structure has been developed to reflect this. These changes will be reflected in the segmental analysis with effect from 1 January 2014. Had they been in place during 2013, the segmental analysis shown in note 2 would be as follows:

	Aerospace			MIPS						
	Civil £m	Defence £m	Total £m	Marine £m	Power Systems £m	Nuclear & Energy £m	Intra-segment £m	Total £m	Inter-segment £m	Total reportable segments £m
Year ended 31 December 2013										
Underlying revenue from sale of original equipment	3,035	1,385	4,420	1,236	2,004	617	(72)	3,785	–	8,205
Underlying revenue from aftermarket services	3,620	1,206	4,826	801	827	921	(75)	2,474	–	7,300
Total underlying revenue	6,655	2,591	9,246	2,037	2,831	1,538	(147)	6,259	–	15,505
Underlying operating profit excluding share of results of joint ventures and associates	708	424	1,132	233	296	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	233	294	74	2	603	–	1,885
Segment assets	9,587	1,437	11,024	1,701	3,927	1,616	(10)	7,234	(734)	17,524
Investments in joint ventures and associates	495	17	512	5	29	55	–	89	–	601
Segment liabilities	(6,243)	(1,660)	(7,903)	(985)	(3,034)	(1,015)	–	(5,034)	733	(12,204)
Net assets	3,839	(206)	3,633	721	922	656	(10)	2,289	(1)	5,921
Investment in intangible assets, property, plant and equipment and joint ventures and associates	891	103	994	23	142	80	–	245		1,239
Depreciation, amortisation and impairment	349	53	402	63	272	63	–	398		800

COMPANY BALANCE SHEET

At 31 December 2013

	Notes	2013 £m	2012 £m
Fixed assets			
Investments – subsidiary undertakings	2	**12,000**	11,954
Creditors – amounts falling due within one year			
Financial liabilities	3	**(16)**	(10)
Amounts owed to subsidiary undertakings due within one year		**(995)**	(595)
Net current liabilities		**(1,011)**	(605)
Total assets less current liabilities		**10,989**	11,349
Capital and reserves			
Called-up share capital	4	**376**	374
Share premium account	5	**80**	–
Merger reserve	5	**8,203**	8,569
Capital redemption reserve	5	**857**	497
Other reserve	5	**109**	63
Profit and loss account	5	**1,364**	1,846
Equity shareholders' funds		**10,989**	11,349

The financial statements on pages 124 to 126 were approved by the Board on 12 February 2014 and signed on its behalf by:

Ian Davis Chairman **Mark Morris** Chief Financial Officer

Company's registered number: 7524813

RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

For the year ended 31 December 2013

	£m
At 1 January 2013	**11,349**
Profit for the year	(1)
Arising on issue of ordinary shares	82
Issue of C Shares	(366)
Share-based payments – direct to equity	(75)
At 31 December 2013	**10,989**

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 Accounting policies

Basis of accounting

The financial statements have been prepared in accordance with applicable UK Accounting Standards on the historical cost basis.

As permitted by section 408 of the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements. As permitted by the audit fee disclosure regulations, disclosure of non-audit fees information is not included in respect of the Company. As permitted by FRS 1 *Cash flow statements*, no cash flow statement for the Company has been included. As permitted by FRS 8 *Related party disclosures*, no related party disclosures in respect of transactions between the Company and its wholly owned subsidiaries have been included.

Investments in subsidiary undertakings

Investments in subsidiary undertakings are reported at cost less any amounts written off.

Share-based payments

As described in the remuneration report on pages 53 to 69, the Company grants awards of its own shares to employees of its subsidiary undertakings, (see note 21 of the consolidated financial statements). The costs of share-based payments in respect of these awards are accounted for, by the Company, as an additional investment in its subsidiary undertakings. The costs are determined in accordance with FRS 20 *Share-based payment*. Any payments made by the subsidiary undertakings in respect of these arrangements are treated as a return of this investment.

Financial instruments

In accordance with FRS 25 *Financial instruments*: *Presentation*, the Company's C Shares are classified as financial liabilities and held at amortised cost from the date of issue until redeemed.

2 Investments – subsidiary undertakings

	£m
Cost:	
At 1 January 2013	**11,954**
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	46
At 31 December 2013	**12,000**

3 Financial liabilities

C Shares

Movements in C Shares during the year were as follows:

	C Shares of 0.1p Millions	Nominal value £m
Issued and fully paid		
At 1 January 2013	**10,418**	**10**
Shares issued	366,041	366
Shares redeemed	(360,173)	(360)
At 31 December 2013	**16,286**	**16**

The rights attaching to C Shares are set out on page 70.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

4 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid					
At 1 January 2013	**1**	**–**	**–**	**1,872**	**374**
Proceeds from shares issued for share options schemes	–	–	–	8	2
At 31 December 2013	**1**	**–**	**–**	**1,880**	**376**

The rights attaching to each class of share are set out on page 70.

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 3.

5 Movements in capital and reserves

	Non-distributable reserves						
	Share capital £m	Share premium	Merger reserve £m	Capital redemption reserve £m	Other reserve[1] £m	Profit and loss account £m	Total £m
At 1 January 2013	**374**	**–**	**8,569**	**497**	**63**	**1,846**	**11,349**
Profit for the year	–	–	–	–	–	(1)	(1)
Proceeds from shares issued for share option schemes	–	–	–	–	–	–	–
Shares issued to share trust	2	80	–	–	–	–	82
Issue of C Shares	–	–	(366)	–	–	–	(366)
Redemption of C Shares	–	–	–	360	–	(360)	–
Share-based payments – direct to equity	–	–	–	–	46	(121)	(75)
At 31 December 2013	**376**	**80**	**8,203**	**857**	**109**	**1,364**	**10,989**

[1] The 'Other reserve' represents the value of share-based payments in respect of employees of subsidiary undertakings for which payment has not been received.

6 Contingent liabilities

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee.

At 31 December 2013, these guarantees amounted to **£1 billion** (2012 £nil).

7 Other information

Emoluments of directors
The remuneration of the directors of the Company is shown in the directors' remuneration report on pages 62 to 69.

Employees
The Company had no employees in 2013.

Share-based payments
Shares in the Company have been granted to employees of the Group as part of share-based payment plans, and are charged in the employing company.

SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

At 31 December 2013

Subsidiaries incorporated within the UK – directly held

Rolls-Royce Group plc	Holding company

Subsidiaries incorporated within the UK – indirectly held

Composite Technology and Applications Limited	Development of aero engine fan blades and fan cases
MTU UK Limited	Sales and service of off-highway diesel engines (50%)
Optimized Systems and Solutions Limited	Equipment health management and advanced data management services
Rolls-Royce Controls and Data Services Limited	Development and manufacture of aero engine controls
Rolls-Royce International Limited	International support and commercial information services
Rolls-Royce Leasing Limited	Engine leasing
Rolls-Royce Marine Electrical Systems Limited	Marine electrical systems
Rolls-Royce Marine Power Operations Limited	Nuclear submarine propulsion systems
Rolls-Royce plc	Principal trading company
Rolls-Royce Power Development Limited	Generation of electricity from independent power projects
Rolls-Royce Power Engineering plc	Energy and marine systems
Rolls-Royce Total Care Services Limited	Aero engine aftermarket support services
Vinters Engineering Limited	Production, repair and overhaul of power generation, transmission and conversion equipment for military and commercial activities

The above companies operate principally in the UK and the effective Group interest is 100 per cent unless otherwise stated.

Subsidiaries incorporated overseas – indirectly held

Brazil	Rolls-Royce Brasil Limitada	Industrial gas turbines and aero engine repair and overhaul, energy and marine aftermarket support services
Canada	Rolls-Royce Canada Limited	Industrial gas turbines and aero engine sales, service and overhaul
China	MTU Engineering (Suzhou) Company Limited	Service centre and spare parts (50%)
China	Rolls-Royce Marine Manufacturing (Shanghai) Limited	Manufacture and supply of marine equipment and marine aftermarket support services
Finland	Rolls-Royce OY AB	Manufacture of marine winches and propeller systems
France	Rolls-Royce Civil Nuclear SAS	Instrumentation and control systems and life-cycle management for nuclear power plants
France	Rolls-Royce Technical Support SARL	Aero engine project support
Germany	L'Orange GmbH	Development and production of high-pressure injection systems for diesel engines (50%)
Germany	MTU Friedrichshafen GmbH	Development, production and distribution of gas turbines and engines (50%)
Germany	MTU Onsite Energy GmbH	Sales and service of gas engines (50%)
Germany	Rolls-Royce Deutschland Ltd & Co KG	Aero engine design, development and manufacture
Germany	Rolls-Royce Power Systems AG	Supplier of engines and power trains for marine propulsion, distributed power generation and industrial off-highway sectors (50%)
Guernsey	Nightingale Insurance Limited	Insurance services
Hong Kong	MTU Hong Kong Limited	Distributor for off-highway products and after-sales service (50%)
India	Rolls-Royce India Private Limited	Diesel engine project management and customer support
India	Rolls-Royce Marine India Private Limited	Provision of marine support services
India	Rolls-Royce Operations (India) Private Limited	Engineering support services
Italy	Europea Microfusioni Aerospaziali S.p.A.	Manufacture of gas turbine engine castings
Italy	MTU Italia S.r.l	Distributor for all off-highway applications and after-sales service (50%)
Netherlands	MTU Benelux B.V.	Sales and after-sales support for diesel engines (50%)
Norway	Rolls-Royce Marine AS	Design and manufacture of ship equipment
Norway	Bergen Engines AS	Design and manufacture of medium-speed diesel engines (50%)
Singapore	Rolls-Royce Singapore Pte. Limited	Aero engine parts manufacturing and engine assembly, energy and marine aftermarket support services
Singapore	Tognum Asia Pte. Limited	Distributor of diesel engines and spare parts (50%)
Spain	MTU Ibérica Propulsión y Energía S.L.	Sales and service of transmission equipment with diesel and gas engines (50%)
Sweden	Rolls-Royce AB	Manufacture of marine propeller systems
Turkey	MTU Motor Türbin Sanayi ve Tic. A.S.	Production of diesel engines and manufacturer of control systems (50%)

SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

Subsidiaries incorporated overseas – indirectly held (continued)

US	Data Systems & Solutions LLC	Instrumentation and control systems and life-cycle management for nuclear power plants
US	Optimized Systems and Solutions Inc.	Equipment health management and advanced data management services
US	PKMJ Technical Services, Inc.	Nuclear engineering services and software solutions
US	R. Brooks Associates Inc.	Specialist civil nuclear reactor services
US	Rolls-Royce Corporation	Design, development and manufacture of gas turbine engines
US	Rolls-Royce Crosspointe LLC	Manufacturing facility for aero engine parts
US	Rolls-Royce Energy Systems Inc.	Energy turbine generator packages
US	Rolls-Royce Engine Services – Oakland Inc.	Aero engine repair and overhaul
US	Rolls-Royce Defense Services Inc.	Aero engine repair and overhaul
US	Rolls-Royce High Temperature Composites Inc.	Production of state-of-the-art composite materials
US	Rolls-Royce Marine North America Inc.	Design and manufacture of marine equipment and marine aftermarket support services
US	MTU America Inc.	Sales and service of engines and systems (50%)

The companies above and on page 127 operate principally in the country of their incorporation and the effective Group interest is 100 per cent unless otherwise stated.

Jointly controlled entities and associates incorporated within the UK – indirectly held

	Class	% of class held	% of equity held
Airtanker Holdings Limited Strategic tanker aircraft PFI project	Ordinary	20	20
Airtanker Services Limited Provision of aftermarket services for strategic tanker aircraft	Ordinary	22	22
Alpha Partners Leasing Limited Aero engine leasing	A Ordinary B Ordinary	100 –	50
Genistics Holdings Limited Trailer-mounted field mobile generator sets	A Ordinary B Ordinary	100 –	50
Rolls-Royce Snecma Limited (UK & France) Aero engine collaboration	A Shares B Shares	– 100	50
Rolls Wood Group (Repair and Overhauls) Limited Industrial gas turbine repair and overhaul	A Ordinary B Ordinary	100 –	50
TRT Limited Aero engine turbine blade repair services	A Ordinary B Ordinary	– 100	49.5
Turbine Surface Technologies Limited Aero engine turbine surface coatings	A Ordinary B Ordinary	– 100	50
Turbo-Union Limited (UK, Germany and Italy) RB199 engine collaboration	Ordinary A Shares	40 37.5	40

The above companies are incorporated and operate in the UK unless otherwise stated.

Jointly controlled entities and associates incorporated overseas – indirectly held

		Class	% of class held	% of equity held
Australia	MTU Detroit Diesel Australia Pty. Limited (effective interest 25%) Sales and servicing of diesel engines	Ordinary	50	50
China	Xian XR Aero Components Co Limited Manufacturing facility for aero engine parts	Ordinary	49	49
China	Shanxi North MTU Diesel Co. Ltd (effective interest 24.5%) Manufacture and sale of MTU engines	Ordinary	49	49
Germany	EPI Europrop International GmbH (effective interest 35.5%) A400M engine collaboration	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) EJ200 engine collaboration	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) MTR390 engine collaboration	Ordinary	33.3	33.3
Germany	MTU Onsite Energy Systems GmbH (effective interest 37.5%) Manufacturing and distribution of diesel-powered generating sets	Ordinary	75.1	75.1
Germany	N3 Engine Overhaul Services GmbH & Co KG Aero engine repair and overhaul	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited Aero engine repair and overhaul	Ordinary	45	45
India	International Aerospace Manufacturing Private Limited Manufacture of compressor shrouds, compressor rings, turbine blades and nozzle guide vanes	Ordinary	50	50
Israel	Techjet Aerofoils Limited Manufacture of compressor aerofoils for gas turbines	A Ordinary B Ordinary	50 50	50
Malaysia	Advanced Gas Turbine Solutions Sdn Bhd Industrial gas turbine aftermarket services	Ordinary	49	49
Singapore	International Engine Component Overhaul Pte Limited Aero engine repair and overhaul	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%) Aero engine repair and overhaul	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA Aero engine component manufacture and maintenance	Ordinary	46.9	46.9
US	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 Aero engine leasing	Partnerships	50	–
US	Exostar LLC Business to business internet exchange	Partnership	18.5	–
US	LG Fuel Cell Systems Inc. Development of fuel cells	Common Stock	39.9	39.9
US	Texas Aero Engine Services, LLC Aero engine repair and overhaul	Partnership	50	–

Unincorporated overseas – indirectly held

US	Light Helicopter Turbine Engine Company (LHTEC) Rolls-Royce Corporation has a 50% interest in this unincorporated partnership which was formed to develop and market jointly the T800 engine

The above companies operate principally in the country of their incorporation. The countries of principal operations are stated in brackets after the name of the company, if not the country of their incorporation.

In accordance with section 410 of the Companies Act 2006, the subsidiaries, jointly controlled entities and associates listed on pages 127 to 129 is of those whose 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.

INDEPENDENT AUDITOR'S REPORT

to the members of Rolls-Royce Holdings plc only

Opinions and conclusions arising from our audit

1 Our opinion on the financial statements is unmodified

We have audited the financial statements of Rolls-Royce Holdings plc for the year ended 31 December 2013 set out on pages 75 to 129. 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 2013 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (Adopted IFRS);
- the parent company financial statements have been properly prepared in accordance with UK Accounting Standards; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

2 Our assessment of risks

In arriving at our opinions set out in this report, the risks that had the greatest effect on our audit and the key procedures we applied to address them are set out below. Those procedures were designed in the context of the financial statements as a whole and, consequently, where we set out findings we do not express any opinion on these individual risks.

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

Refer to page 81 (Key areas of judgement – Long-term aftermarket contracts), page 83 (Significant accounting policies – Revenue recognition) and page 44 (Audit committee report – Financial reporting)

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

- Our response We made our own independent assessment, with reference to the relevant accounting standards, of the accounting basis that should be applied to each long-term aftermarket contract entered into during the year and compared this to the accounting basis applied by the Group.

- Our findings We found that the Group has developed a framework for selecting the accounting basis to be used which is consistent with accounting standards and has applied this consistently. For almost all the agreements entered into during this year, it was clear which accounting basis should apply. Where there was room for interpretation, we found the Group's judgement to have been balanced.

The measurement of revenue and profit in the Civil aerospace business

Refer to page 81 (Key areas of judgement – Long-term aftermarket contracts), page 83 (Significant accounting policies – Revenue recognition) and page 44 (Audit committee report – Financial reporting)

- The risk The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the assessment of the percentage of completion of long-term aftermarket contracts and the forecast cost profile of each arrangement. As long-term aftermarket contracts can extend over significant periods and the profitability of these arrangements typically assumes significant life-cycle cost improvement over the term of the contracts, the estimated outturn requires significant judgement to be applied in assessing engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred. The inherent nature of these estimates means that their continual refinement can have an impact on the profits of the Civil aerospace business that can be significant in an individual financial year. The assessment of the estimated outturn for each arrangement involves detailed calculations using large and complex databases with a significant level of manual intervention.

- Our response We tested the controls designed and applied by the Group to provide assurance that the estimates used in assessing revenue and cost profiles are appropriate and that the resulting estimated cumulative profit on such contracts is accurately reflected in the financial statements; these controls operated over both the inputs and the outputs of the calculations. We challenged the appropriateness of these estimates for each programme and assessed whether or not the estimates showed any evidence of management bias. Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes, detailed discussions and assessments of the achievability of the Group's plans to reduce life-cycle costs and an analysis of the impact of these plans on forecast cost profiles taking account of contingencies and analysis of the impact of known technical issues on cost forecasts. Our analysis considered each significant airframe that is powered by the Group's engines and was based on our own experience supplemented by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuer was objective and suitably qualified. We also checked the mathematical accuracy of the revenue and profit for each arrangement and considered the implications of identified errors and changes in estimates.

- Our findings Our testing identified weaknesses in the design and operation of controls. In response to this we assessed the effectiveness of the Group's plans for addressing these weaknesses and we increased the scope and depth of our detailed testing and analysis from that originally planned. We found no significant errors in calculation. Overall, our assessment is that the assumptions and resulting estimates (including appropriate contingencies) resulted in mildly cautious profit recognition.

Recoverability of intangible assets (certification costs and participation fees, development expenditure and recoverable engine costs) and amounts recoverable on contracts primarily in the Civil aerospace business

Refer to page 82 (Key sources of estimation uncertainty – Forecasts and discount rates), pages 86 and 87 (Significant accounting policies – Certification costs and participation fees, Research and development, Recoverable engine costs and Impairment of non-current assets), page 99 (Note 9 to the financial statements – Intangible assets) and page 44 (Audit committee report – Financial reporting)

- The risk The recovery of these assets depends on a combination of achieving sufficiently profitable business in the future as well as the ability of customers to pay amounts due under contracts often over a long period of time. Assets relating to a particular engine programme are more prone to the risk of impairment in the early years of a programme as the engine's market position is established. In addition, the pricing of business with launch customers makes assets relating to these engines more prone to the risk of impairment.
- Our response We tested the controls designed and applied by the Group to provide assurance that the assumptions are regularly updated, that changes are monitored, scrutinised and approved by appropriate personnel and that the final assumptions used in impairment testing have been appropriately approved. We challenged the appropriateness of the key assumptions in the impairment test (including market size, market share, pricing, engine and aftermarket unit costs, individual programme assumptions, price and cost escalation, discount rate and exchange rates) focusing particularly on those assets with a higher risk of impairment (those relating to the Trent 900 programme and launch customers on the Trent 900 and 1000 programmes). Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, our understanding of the commercial prospects of key engine programmes, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes and customers and comparison of assumptions with publicly available data where this was available. We considered the appropriateness of the related disclosures in note 9 to the financial statements.
- Our findings Our testing did not identify any deviation in the operation of controls which would have required us to amend the nature or scope of our planned detailed test work. We found that the assumptions and resulting estimates were balanced and that the disclosures in note 9 appropriately describe the inherent degree of subjectivity in the estimates and the potential impact on future periods of revisions to these estimates. We found no errors in calculations.

Accounting for the consolidation of Rolls-Royce Power Systems Holding GmbH and valuation of Daimler AG's put option

Refer to page 81 (Key areas of judgement – Rolls-Royce Power Systems Holding GmbH), page 82 (Key sources of estimation uncertainty – Intangible assets arising on consolidation of Rolls-Royce Power Systems AG and put option on Rolls-Royce Power Systems Holding GmbH), page 83 (Accounting policies – Basis of consolidation) and page 44 (Audit committee report – Financial reporting)

Control of Rolls-Royce Power Systems Holding GmbH

- The risk Rolls-Royce Power Systems Holding GmbH (a special purpose vehicle owned equally by the Group and Daimler AG (RRPSH)) acquired a controlling interest in Rolls-Royce Power Systems AG (RRPS) on 25 August 2011. From that date, the Group equity accounted for its joint venture interest in RRPSH as control was shared with Daimler AG. On 1 January 2013, conditions were fulfilled which the Group considered gave it control over RRPSH and from that date the Group's 50 per cent interest has been classified as a subsidiary and RRPSH has been consolidated in the Group financial statements. Assessing whether or not the Group controls RRPSH is a critical accounting judgement. The rights of the Group and Daimler AG are encapsulated in shareholder agreements and assessing whether the Group's rights are sufficient to give it control over RRPSH requires detailed consideration of the relevant provisions and a commercial assessment as to which rights are most important.
- Our response We analysed the shareholder agreements with particular reference to rights relating to key matters including the existence of a casting vote in respect of key matters described on page 81 at the shareholders meeting and Shareholders' Committee of RRPSH.
- Our findings We found that the terms of the agreements provide the Group with the power to establish key operating and capital decisions of RRPSH and to appoint, remove and set the remuneration of key management personnel. The agreements also provide Daimler AG with rights (in particular over matters that would significantly change the scale, scope and financing of RRPSH's business, certain significant supplier relationships and changes to contractual arrangements between RRPSH with Rolls-Royce) which we have determined provide protection to Daimler AG over its interest in RRPSH but are not sufficient to prevent the Group from controlling RRPSH. On that basis, we consider that it is appropriate that RRPSH (and hence RRPS) has been consolidated from 1 January 2013.

INDEPENDENT AUDITOR'S REPORT

Consolidation of Rolls-Royce Power Systems Holding GmbH

- The risk Estimating the fair value of intangible assets of RRPS at the date of consolidation involved the use of complex valuation techniques and the estimation of future cash flows over a considerable period of time. To the extent that greater or lesser value is attributed to intangibles (which are subject to amortisation), lesser or greater value is attributed to goodwill (which is not).
- Our response We evaluated the basis upon which the Directors identified and assessed the fair value of each significant asset, liability and contingent liability of RRPS and its subsidiaries having regard to the relevant accounting standards. For the intangible assets, we assessed whether the measurement basis and assumptions underlying the estimate of the fair values were reasonable, taking account of our experience of similar assets in other comparable situations and of the work performed by a valuer engaged by the Group. We assessed whether the valuer was objective and suitably qualified, had been appropriately instructed and had been provided with complete, accurate data on which to base its evaluation. We also assessed whether or not the estimates showed any evidence of management bias with a focus on whether there was any indication of value being inappropriately attributed to goodwill rather than depreciable assets.
- Our findings We found that the intangible assets identified were typical for acquisitions of similar businesses and that the valuation bases used were in accordance with accounting standards. We have no concerns with the basis on which the valuer had been instructed by the Group and found that (i) the valuer was objective and competent, (ii) the estimates used in the valuations were balanced and did not result in either too much or too little goodwill being recognised and (iii) the valuations arrived at by the valuer had been adopted by the Group without adjustment.

Valuation of Daimler AG's put option

- The risk As part of the shareholder agreements, for a period of six years from 1 January 2013 Daimler AG has the option to require the Group to purchase its 50 per cent interest in RRPSH. The estimated amount of the purchase price of this option has been recognised as a financial liability on the Group balance sheet. The purchase price is based on averaging three valuations, which are based on both internal and external metrics, at the date the option is exercised. The external metrics include price/earnings ratios for comparable companies and those implicit in comparable transactions. There is judgement involved in choosing appropriate comparable companies and transactions and in predicting what these might be at a future date.
- Our response We analysed the shareholder agreements and tested the reasonableness of the estimate of the purchase price of the option, including assessing whether the Group's judgement as to which external metrics should be used was appropriate, and the accuracy of its calculation. We also assessed whether or not the estimates showed any evidence of management bias with a particular focus on the risk that the liability might be understated given its visibility.
- Our findings We found that the resulting estimate was acceptable but mildly optimistic resulting in a somewhat lower liability being recorded than might otherwise have been the case.

Liabilities arising from sales financing arrangements

Refer to page 82 (Key areas of judgement – financing support), page 88 (Significant accounting policies – Sales financing support, page 112 (Note 18 to the financial statements – Provisions for liabilities and charges) and page 44 (Audit committee report – Financial reporting)

- The risk The Group has contingent liabilities in respect of financing and asset value support provided to customers. This support typically takes the form of either a guarantee with respect to the value of an aircraft at a future date or a guarantee of a customer's future payments under an aircraft financing arrangement. Judgement is required to assess the likelihood of these liabilities crystallising, in order to assess whether a provision should be recognised and if so the amount of that provision. The total potential liability is significant and can be affected by the assessment of the residual value of the aircraft and the creditworthiness of the customers.
- Our response We analysed the terms of guarantees on aircraft delivered during the year in detail and obtained aircraft values from and held discussions with aircraft valuation specialists engaged by the Group. We assessed whether the valuer was objective and suitably qualified, had been appropriately instructed and had been provided with complete, accurate data on which to base its evaluation. For all contracts on delivered aircraft, we assessed the commercial factors relevant to the likelihood of the guarantees being called, including the credit ratings and recent financial performance of the relevant customers and their fleet plans, and critically assessed the Group's estimate of the required provisions for those liabilities. We considered movements in aircraft values and potential changes in the assessed probability of a liability crystallising since the previous year end and considered whether the evidence supported the Group's assessment as to whether or not a liability needs to be recognised and the amount of the liability recognised or contingent liability disclosed. We considered the appropriateness of the related disclosure in note 18 to the financial statements.
- Our findings We found that the assumptions and estimates were balanced and that note 18 appropriately discloses the potential liability in excess of the amount provided for in the financial statements for delivered aircraft and highlights the significant but unquantifiable contingent liability in respect of aircraft which will be delivered in the future.

Accounting for risk and revenue sharing arrangements

Refer to page 81 (Key areas of judgement – Risk and revenue sharing arrangements), page 84 (Significant accounting policies – Risk and revenue sharing arrangements), page 11 (Chief Financial Officer's review) and page 44 (Audit committee report – Financial reporting)

- The risk The Group receives non-refundable cash payments under risk and revenue sharing arrangements (which are referred to as entry fees). The assessment of when these entry fees should be recognised in the income statement involves analysis of their commercial substance in the context of the agreement as a whole. As there is no single accounting standard that directly addresses these types of agreements, management has to apply very significant judgement in deciding how to apply the various provisions of accounting standards that are relevant to different aspects of the agreements. 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.
- Our response We independently analysed the agreements under which significant entry fees have been received to establish the range of possible accounting treatments that could be adopted and to assess which of these would in our view most appropriately reflect the requirements of accounting standards. The most significant accounting standards considered were IAS 8 *Accounting policies, changes in accounting estimates and errors*, IAS 18 *Revenue*, IFRS 11 *Joint arrangements* in terms of the timing of recognition of the entry fees and IAS 1 *Presentation of financial statements* in respect of their presentation as an offset against the expenditure to which they relate. We also had regard to the definitions of assets, liabilities, income and expenses in the IFRS *Framework* and, to the extent they did not conflict with Adopted IFRS, to pronouncements of other standard-setting bodies that more explicitly address accounting for payments from suppliers and collaborative arrangements. We examined correspondence between the Group and the Financial Reporting Council and attended meetings between them. We sought to identify the accounting applied in similar circumstances by other companies including the Group's direct competitors and compare these to the approach adopted by the Group and the requirements of Adopted IFRS. We assessed whether the change to the accounting policy made in the year was appropriate and recalculated the resulting amounts in the financial statements. We considered the appropriateness of the related disclosures.
- Our findings Our analysis indicated that in substance, from the point of view of both the Group and the risk and revenue sharing workshare partners, the entry fees represent the reimbursement of expenditure incurred by the Group as part of an engine development programme and that this represented a significant transfer of development risk from the Group to the partners that should be reflected in the income statement at the time the reimbursed expenditure is recognised. On that basis, we found that the revised accounting policy most appropriately reflects the commercial substance of the entry fees. So far as it was possible to tell, we found that the accounting applied by the Group was similar to the approach taken by others. We found that the change to the accounting policy made by the Group was appropriate given the incidence of entry fees in the year and the costs capitalised on the programmes to which these entry fees relate. We found that the disclosures in the financial statements properly describe the accounting treatment adopted by the Group and the directors' basis for applying that treatment.

Bribery and corruption

Refer to page 120 (Note 23 to the financial statements – Contingent liabilities) and page 44 (Audit committee report – Financial reporting)

- The risk A large part of the Group's business is characterised by competition for individually significant contracts with customers which are often directly or indirectly associated with governments and the award of individually significant contracts to suppliers. The procurement processes associated with these activities are highly susceptible to the risk of corruption. In addition the Group operates in a number of territories where the use of commercial intermediaries is either required by the government or is normal practice. The Group is currently under investigation by law enforcement agencies, primarily the Serious Fraud Office in the UK and the US Department of Justice. Breaches of laws and regulations in this area can lead to fines, penalties, criminal prosecution, commercial litigation and restrictions on future business.
- Our response We evaluated and tested the Group's policies, procedures and controls over the selection and renewal of intermediaries, contracting arrangements, ongoing management, payments and responses to suspected breaches of policy. We sought to identify and tested payments made to intermediaries during the year, made enquiries of appropriate personnel and evaluated the tone set by the Board and the Executive Leadership Team and the Group's approach to managing this risk. Having enquired of management, the audit committee and the Board as to whether the Group is in compliance with laws and regulations relating to bribery and corruption, we made written enquiries of the Group's legal advisers to corroborate the results of those enquiries and maintained a high level of vigilance to possible indications of significant non-compliance with laws and regulations relating to bribery and corruption whilst carrying out our other audit procedures. We discussed the areas of potential or suspected breaches of law, including the ongoing investigation, with the audit committee and the Board of directors as well as the Group's legal advisers and assessed related documentation. We assessed whether the financial effects of potential or suspected breaches of law or regulation have been properly disclosed in note 23 to the financial statements.
- Our findings We found that the disclosures in note 23 to the financial statements reflect appropriately the matters required to be disclosed by accounting standards and highlighted that, as the investigation is at too early a stage to assess the consequences (if any), including in particular the size of any possible fines, no provision can be made at year end.

INDEPENDENT AUDITOR'S REPORT

The presentation of 'underlying' profit

Refer to page 10 (Chief Financial Officer's review), page 89 (Note 2 to the financial statements – Segmental analysis) and page 44 (Audit committee report – Financial reporting)

- The risk In addition to its Adopted IFRS financial statements, the Group presents an alternative income statement on an 'underlying' basis. The directors believe the 'underlying' income statement reflects better the Group's trading performance during the year. The basis of adjusting between the Adopted IFRS and 'underlying' income statements and a full reconciliation between them is set out in note 2 to the financial statements on pages 89 and 91. A significant recurring adjustment between the Adopted IFRS income statement and the 'underlying' income statement relates to the foreign exchange rate used to translate foreign currency transactions. The Group uses forward foreign exchange contracts to manage the cash flow exposures of forecast transactions denominated in foreign currencies but does not generally apply hedge accounting in its Adopted IFRS income statement. The 'underlying' income statement translates these amounts at the achieved foreign exchange rate on forward foreign exchange contracts settled in the period, retranslates assets and liabilities at exchange rates forecast to be achieved from future settlement of such contracts and excludes unrealised gains and losses on such contracts which are included in the Adopted IFRS income statement. In addition, adjustments are made to exclude one-off past-service credits on post-retirement schemes and the effect of acquisition accounting and a number of other items.

  Alternative performance measures can provide investors with appropriate additional information if properly used and presented. In such cases, measures such as these can assist investors in gaining a better understanding of a company's financial performance and strategy. However, when improperly used and presented, these kinds of measures might mislead investors by hiding the real financial position and results or by making the profitability of the reporting entity seem more attractive.

- Our response We assessed the appropriateness of the basis for the adjustments between the Adopted IFRS income statement and the 'underlying' income statement and recalculated the adjustments with a particular focus on the impact of the foreign exchange rate used to translate foreign currency amounts in the 'underlying' income statement. As the Group has discretion over which forward foreign exchange contracts are settled in each financial year, which could impact the achieved rate both for the period and in the future, we assessed whether or not this showed any evidence of management bias. We also assessed: (i) the extent to which the prominence given to the 'underlying' financial information and related commentary in the annual report compared to the Adopted IFRS financial information and related commentary could be misleading; (ii) whether the Adopted IFRS and 'underlying' financial information are reconciled with sufficient prominence given to that reconciliation; (iii) whether the basis of the 'underlying' financial information is clearly and accurately described and consistently applied; and (iv) whether the 'underlying' financial information is not otherwise misleading in the form and context in which it appears in the annual report.

- Our findings We have no concerns regarding the basis of the 'underlying' financial information or its calculation and found no indication of management bias in the way the Group managed forward foreign exchange contracts during the year. We consider that there is sufficient appropriate disclosure of the nature and amounts of the adjustments to allow shareholders to understand the implications of the two bases on the financial measures being presented. We consider that the 'underlying' financial information is useful to shareholders as an adjunct to the Adopted IFRS financial information particularly in the context of isolating trends resulting from trading performance from trends that result from other factors. We found the presentation of the 'underlying' financial information to be balanced.

In addition to these key audit risks, we also focused on the recognition of revenue and profit on other long-term contracts; the implementation of a new consolidation system; warranties and guarantees; valuation of derivative contracts; valuation of post-retirement scheme liabilities; and the recoverability of tax assets and the adequacy of provisions for tax contingencies.

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

The materiality for the Group financial statements as a whole was set at £86 million. This has been calculated with reference to a benchmark of profit before taxation (representing 4.9% of reported and 'underlying' profit before taxation) which we consider to be one of the principal considerations for members of the company in assessing the financial performance of the Group.

We agreed with the audit committee to report to it the following misstatements that we identified through our audit: (i) all material corrected misstatements; (ii) uncorrected misstatements with a value in excess of £4 million for income statement items (or £8 million for balance sheet reclassifications); and (iii) other misstatements below that threshold that we believe warranted reporting on qualitative grounds.

In order to gain appropriate audit coverage of the risks described above and of each individually significant reporting component:

(a) audits for Group reporting purposes were carried out at 13 key reporting components located in the following countries: United Kingdom (9 key reporting components), USA (1), Germany (2) and Norway (1). In addition, audits for Group reporting purposes were performed at a further 20 reporting components. Together these covered 90 per cent of revenue, 87 per cent of underlying profit before taxation and 85 per cent of total assets; and

(b) specified reporting procedures were carried out over key risk areas at a further 12 reporting components, none of which are considered to be key.

In total our procedures covered 98 per cent of revenue, 99 per cent of underlying profit before taxation and 94 per cent of total assets.

Detailed audit instructions were sent to the auditors of all these reporting components. These instructions covered the significant audit areas that should be covered by these audits (which included the relevant risks of material misstatement detailed above) and set out the information required to be reported back to the group audit team. The group audit team visited the following locations: United Kingdom, USA, Germany, Norway and Singapore. Telephone meetings were also held with the auditors at these locations and the majority of the other locations that were not physically visited.

The audits undertaken for Group reporting purposes at the reporting components were all performed to materiality levels set by, or agreed with, the group audit team. These materiality levels were set individually for each such component and ranged from £0.5 million to £50 million.

4 Our opinion on other matters prescribed by the Companies Act 2006 is unmodified

In our opinion:
- the part of the directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Strategic report and Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

5 We have nothing to report in respect of the matters on which we are required to report by exception

Under ISA (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the annual report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading. In particular, we are required to report to you if:
- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy; or
- the audit committee report does not appropriately address matters communicated by us to the audit committee.

Under the Companies Act 2006 we are required to report to you if, in our opinion:
- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the directors' remuneration report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:
- the directors' statement, set out on page 72, in relation to going concern; and
- the part of the corporate governance report on page 39 relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code (2010) specified for our review.

We have nothing to report in respect of the above responsibilities.

Scope of report and responsibilities

As explained more fully in the Directors' responsibilities statement set out on pages 72 and 73, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of accounts is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2013a, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

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

Chartered Accountants
15 Canada Square
London
E14 5GL
12 February 2014

GROUP FIVE-YEAR REVIEW

For the years ended 31 December

Income statement	2013 £m	Restated* 2012 £m	2011 £m	2010 £m	2009 £m
Revenue	**15,513**	12,161	11,124	11,085	10,414
Profit before net research and development and share of results of joint ventures and associates	**2,393**	2,435	1,536	1,463	1,458
Research and development (net) [1]	**(683)**	(531)	(463)	(422)	(379)
Share of results of joint ventures and associates	**160**	173	116	93	93
Profit before financing	**1,870**	2,077	1,189	1,134	1,172
Net financing	**(111)**	689	(84)	(432)	1,785
Profit before taxation [2]	**1,759**	2,766	1,105	702	2,957
Taxation	**(380)**	(431)	(257)	(159)	(740)
Profit for the year	**1,379**	2,335	848	543	2,217
Attributable to:					
Equity shareholders of the parent	**1,367**	2,321	850	539	2,221
Non-controlling interests	**12**	14	(2)	4	(4)
Profit for the year	**1,379**	2,335	848	543	2,217
[1] Research and development (gross)	**(1,118)**	(919)	(908)	(923)	(864)
[2] Underlying profit before taxation	**1,759**	1,434	1,157	955	915
Earnings per ordinary share:					
Underlying	**65.59p**	59.59p	48.54p	38.73p	39.67p
Basic	**73.26p**	125.38p	45.95p	29.20p	120.38p
Payments to shareholders per ordinary share	**22.00p**	19.50p	17.50p	16.00p	15.00p

Balance sheet	2013 £m	Restated* 2012 £m	2011 £m	2010 £m	2009 £m
Assets	**23,063**	18,146	16,423	16,234	15,422
Liabilities	**(16,760)**	(12,150)	(11,904)	(12,255)	(11,640)
	6,303	5,996	4,519	3,979	3,782
Called-up share capital	**376**	374	374	374	371
Reserves	**5,229**	5,605	4,144	3,601	3,411
Equity attributable to equity holders of the parent	**5,605**	5,979	4,518	3,975	3,782
Non-controlling interests	**698**	17	1	4	–
	6,303	5,996	4,519	3,979	3,782

Cash flow	2013 £m	2012 £m	2011 £m	2010 £m	2009 £m
Cash inflow from operating activities	**2,040**	1,255	1,306	1,378	859
Cash (outflow)/inflow from investing activities	**(740)**	424	(2,207)	(759)	(606)
Cash inflow/(outflow) from financing activities	**136**	(331)	(655)	(743)	384
Increase/(decrease) in cash and cash equivalents	**1,436**	1,348	(1,556)	(124)	637
Net funds	**1,939**	1,317	223	1,533	1,275

* Restated for the adoption of the amendments to IAS 19 *Employee Benefits* on 1 January 2013 and the change to the accounting policy for RRSAs – see note 1. It is not practicable to restate prior years on a comparable basis.

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:

		2013	2012	Change
USD per GBP	Year end spot rate	**1.65**	1.63	+1%
	Average spot rate	**1.56**	1.59	-2%
EUR per GBP	Year end spot rate	**1.20**	1.23	-2%
	Average spot rate	**1.18**	1.23	-4%

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

Over 95 per cent of the Group's underlying profit before tax (excluding joint ventures) is generated in the United Kingdom, United States of America, 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 75. The main reasons for this are:

i) the consolidated income statement is prepared under IFRS whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;
ii) accounting rules require certain income and costs relating to our commercial activities to be eliminated from, or added to, the aggregate of all the profits of the Group companies when preparing the consolidated income statement ('consolidation adjustments'); and
iii) specific tax rules including exemptions or incentives as determined by the tax laws in each country.

The Group's total corporation tax payments in 2013 were £238 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 27.1 per cent (the underlying tax rate including joint ventures can be found on page 12). This is due to deferred tax accounting, details of which can be found in note 5 to the financial statements. The impact of (iii) will often be permanent depending on the relevant tax law.

Investments and capital expenditure

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

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

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

Financial risk management

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

ADDITIONAL FINANCIAL INFORMATION

Capital structure

£ million	2013	Restated 2012
Total equity	**6,303**	5996
Cash flow hedges	**68**	63
Group capital	**6,371**	6,059
Net funds	**1,939**	1,317

Operations are funded through various shareholders' funds, bank borrowings, bonds and notes. The capital structure of the Group reflects the judgement of the Board as to the appropriate balance of funding required.

Funding is secured by the Group's continued access to the global debt markets. Borrowings are funded in various currencies using derivatives where appropriate to achieve a required currency and interest rate profile. The Board's objective is to retain sufficient financial investments and undrawn facilities to ensure that the Group can both meet its medium-term operational commitments and cope with unforeseen obligations and opportunities.

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

During the year, the Group issued €750 million 2.125% Notes maturing in 2021 and £375 million 3.375% Notes maturing in 2026.

At year end, the Group retained aggregate liquidity of £5.6 billion. This liquidity comprised net funds of £1.9 billion and aggregate borrowing facilities of £3.6 billion, of which £1.2 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 2014 is a £200 million EIB loan. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating.

The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This debt is further outlined in note 11.

Credit rating

	Rating	Outlook	Grade
Moody's Investors Service	A3	Stable	Investment
Standard & Poor's	A	Stable	Investment

The Group subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings. At 31 December 2013, 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 and regulatory

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

In 2013, the Group has adopted Amendments to IAS 19 *Employee Benefits*. There were no other revisions to IFRS that became applicable in 2013 which had a significant impact on the Group's financial statements.

A summary of changes which have not been adopted in 2013 is included within the accounting policies in note 1.

As explained in the Chief Financial Officer's review on page 11, following discussions with the Conduct Committee of the FRC, the Group has reassessed its policy for the recognition of entry fees received under RRSAs.

Governments and regulators around the world continue to implement reforms to the financial markets with the aim of improving transparency and reducing systemic risk. Although the reforms are predominantly directed at financial institutions, they will also affect non-financial institutions such as the Group.

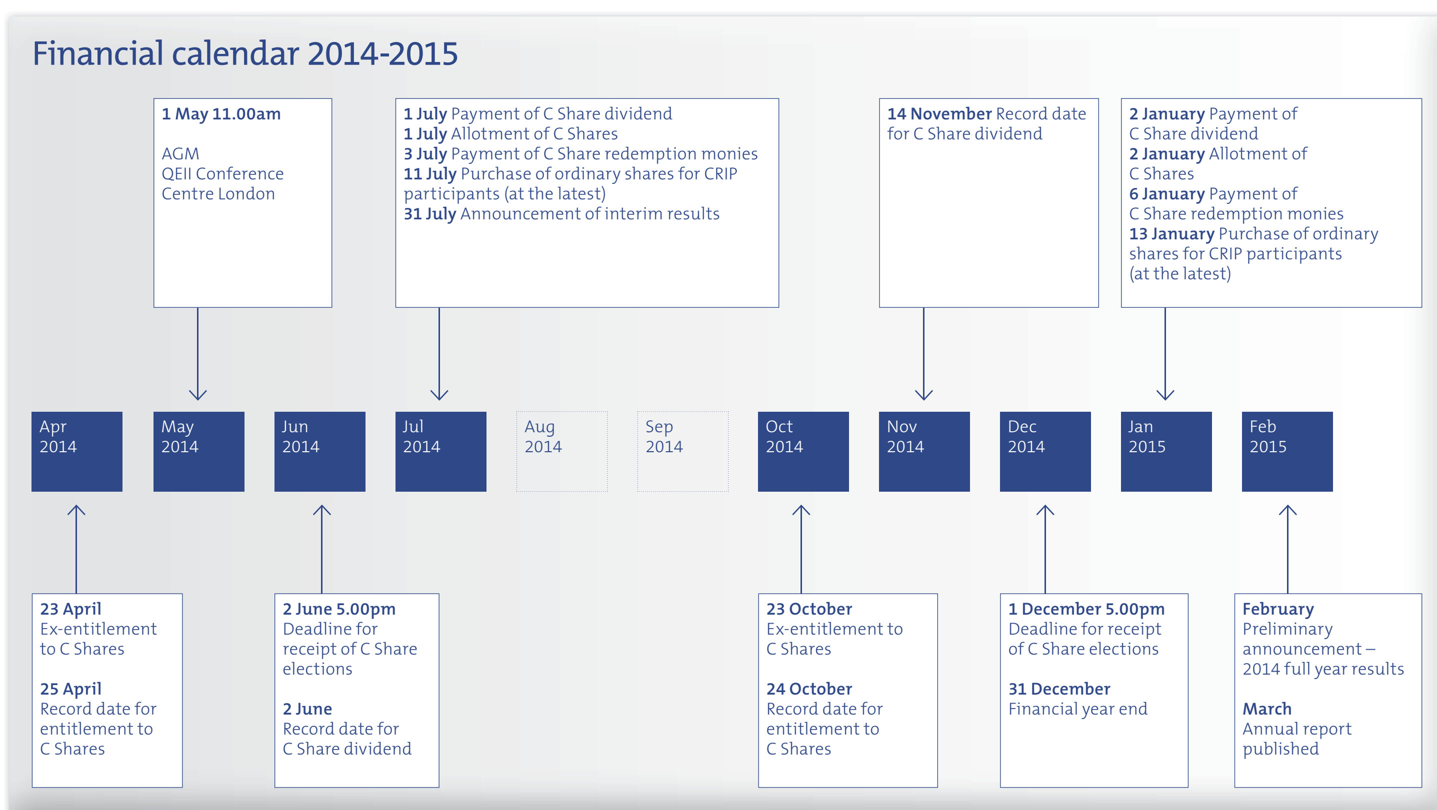
The primary concern was the reform of the over-the-counter (OTC) derivatives market, and in particular a proposal in the EU European Market Infrastructure Regulation (EMIR) that parties to future OTC derivative transactions would be required to use an exchange to clear the transactions and post cash collateral to reduce counterparty risk. The proposal could have adversely affected the Group's future funding requirements and made cash flow more volatile.

The final EMIR rules have now been released, which exempt non-financial institutions engaged in hedging activity from this requirement.

Share price

During the year, the share price increased by 46 per cent from 873.5 pence to 1275 pence, compared to a 38 per cent increase in the FTSE aerospace and defence sector and 14 per cent increase in the FTSE 100. The Company's share price ranged from 873.5 pence in January to 1275 pence in December.

SHAREHOLDER INFORMATION



Managing your shareholding

Your shareholding is managed by Computershare Investor Services PLC (the Registrar). When making contact with the Registrar please quote your Shareholder Reference Number (SRN), an 11-digit number that can be found on the right-hand side of your share certificate or in any other shareholder correspondence. It is very important that you keep your shareholding account details up to date by notifying the Registrar of any changes in your circumstances.

You can manage your shareholding at www.investorcentre.co.uk, speak to the Registrar on +44 (0)870 703 0162 (8.30am to 5.30pm Monday to Friday) or you can write to them at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8AE.

Payments to shareholders

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

Share dealing

The Registrar offers existing shareholders an internet dealing service at www-uk.computershare.com/investor/sharedealing.asp and a telephone dealing service (+44 (0)870 703 0084). The service is available during market hours, 8.00am to 4.30pm, Monday to Friday excluding Bank holidays. The fee for internet dealing is 1 per cent of the transaction value subject to a minimum fee of £30. The fee for telephone dealing is 1 per cent of the transaction plus £35. Please note that, in addition to dealing fees, stamp duty of 0.5 per cent is payable on all purchases. Other share dealing facilities are available but we recommend that you only use a firm regulated by the Financial Conduct Authority (FCA). You can check the FCA register at www.fca.org.uk/register.

Your share certificate

If you sell or transfer your shares you must ensure that you have a valid share certificate in the name of Rolls-Royce Holdings plc. If you place an instruction to sell your shares and cannot provide a valid share certificate the transaction cannot be completed and you will be liable for any costs incurred by the broker. Share certificates previously issued by either Rolls-Royce Group plc or Rolls-Royce plc are invalid and should be destroyed. If you are unable to locate your share certificates please inform the Registrar immediately.

American Depositary Receipts (ADR)

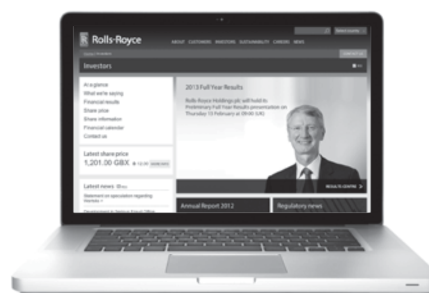
ADR holders should contact the depositary, The Bank of New York Mellon by calling +1 888 269 2377 (toll free within the US) or emailing shrrelations@cpushareownerservices.com.

SHAREHOLDER INFORMATION

Warning to shareholders – boiler room fraud

We are aware that some shareholders might have received unsolicited phone calls or correspondence concerning investment matters. These are typically from overseas based 'brokers' who offer to sell them what often turn out to be worthless or high risk shares in US or UK investments. Such operations are known as 'boiler rooms' and these 'brokers' can be very persistent and extremely persuasive. You should always check that any firm calling you about investment opportunities is properly authorised by the FCA using the following web link www.fca.org.uk/register or by calling their Consumer Helpline on 0800 111 6768 (overseas callers dial +44 20 7066 1000). If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme. You will find lots of useful advice and information about protecting yourself from investment scams on the FCA website www.fca.org.uk/consumers.

Remember the golden rule – IF IT SOUNDS TOO GOOD TO BE TRUE IT PROBABLY IS.



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

Keeping up to date

You can sign up to receive the latest news to your phone or inbox. You can also download the Rolls-Royce Investor Relations iPad app which provides the latest media and financial information.

Dividends paid on C Shares held

C Share calculation period	C Share dividend rate (%)	Record date for C Share dividend	Payment date
1 July 2013 – 31 December 2013	0.225	15 November 2013	2 January 2014
1 January 2013 – 30 June 2013	0.25	3 June 2013	3 July 2013

Previous C Share issues

				Apportionment values		CGT apportionment				
Issue date	No of C Shares issued per ordinary share	Record date for entitlement to C Shares	Latest date for receipt of Payment Instruction Forms by Registrar	Price of ordinary shares on first day of trading (p)	Value of C Share issues per ordinary shares (p)	Ordinary shares (%)	C Shares (%)	Date of redemption of C Shares	CRIP purchase date	CRIP purchase price (p)
2 January 2014	86	25 October 2013	2 December 2013	1265.50	8.6	99.33	0.67	6 January 2014	7 January 2014	1287.3621
2 July 2013	119	24 April 2013	3 June 2013	1151.50	11.9	98.98	1.02	3 July 2013	9 July 2013	1192.7275

For earlier C Share issues, please refer to the Group's website.

Analysis of ordinary shareholders at 31 December 2013

Type of holder:	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	197,937	96.54	101,503,370	5.40
Institutional and other investors	7,101	3.46	1,778,798,284	94.60
Total	205,038	100.00	1,880,301,654	100.00
Size of holding:				
1 – 150	64,735	31.57	6,216,673	0.33
151 – 500	103,476	50.47	27,720,381	1.47
501 – 10,000	34,806	16.98	56,638,725	3.01
10,001 – 100,000	1,344	0.65	36,159,598	1.92
100,001 – 1,000,000	464	0.23	158,602,026	8.44
1,000,001 and over	213	0.10	1,594,964,251	84.83
Total	205,038	100.00	1,880,301,654	100.00

GLOSSARY

ABC	anti-bribery and corruption
ACARE	Advisory Council for Aviation Research and Innovation in Europe
AGM	annual general meeting
APRA	Annual Performance Related Award plan
C Shares	non-cumulative redeemable preference shares
CO_2	carbon dioxide
Company	Rolls-Royce Holdings plc
CPS	cash flow per share
CRIP	C Share Reinvestment Plan
EASA	European Aviation Safety Agency
ELT	Executive Leadership Team
EPS	earnings per ordinary share
EU	European Union
FAA	Federal Aviation Administration
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
GBP	Great British pound or pound sterling
GC 100	Association of general counsel and company secretaries of FTSE 100 companies
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
IAB	International Advisory Board
IAE	IAE International Aero Engines AG
IAG	International Airlines Group (parent company of British Airways)
IAS	International Accounting Standards
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
JAL	Japan Airlines
KPI	key performance indicator
LIBOR	London Inter-Bank Offered Rate
LTSA	Long-Term Service Agreement
LNG	liquefied natural gas
MoD	UK Ministry of Defence
NCI	non-controlling interest
OCI	other comprehensive income
OE	original equipment
OECD	Organisation for Economic Cooperation and Development
PSP	Performance Share Plan
R&D	research and development
REACH	Registration, Evaluation and Authorisation of Chemicals
REC	recoverable engine cost
Registrar	Computershare Investor Services PLC
RRPSH	Rolls-Royce Power Systems Holding GmbH
RRPS	Rolls-Royce Power Systems AG (previously named Tognum AG)
RRSAs	Risk and Revenue Sharing Arrangements
RSUs	restricted stock units
SFO	Serious Fraud Office
SIP	Share Incentive Plan
SRN	Shareholder Reference Number
STEM	Science, Technology, Engineering and Mathematics
STOVL	short take-off and vertical landing
TRI	total reportable injuries
TSR	Total Shareholder Return
UAV	unmanned aerial vehicle
UK GAAP	UK Generally Accepted Accounting Practices
USD	United States dollar

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