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Rolls-Royce plc
Directors' report and financial statements 2013

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 focus remains on the 4 Cs: Customer, Cost, Cash and Concentration."

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	2012**	% change
Order book – firm and announced	**£71,612m**	£60,146m	+19%
Underlying revenue*	**£15,505m**	£12,209m	+27%
Underlying profit before tax*	**£1,760m**	£1,434m	+23%
Reported revenue	**£15,513m**	£12,161m	+28%
Reported profit before tax	**£2,019m**	£2,766m	-27%
Net cash	**£1,939m**	£1,316m	

* See explanation in note 2 on page 54
** Restated to reflect the adoption to IAS19 *Employee Benefits* and change in accounting policy on the treatment of Risk and Revenue Sharing Arrangement entry fees – see note 1

Forward looking statements
This 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

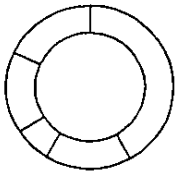
This report is intended to provide information to shareholders is not designed to be relied upon by any other party or for any other purpose and the Company and its directors accept no liability to any other person other than that required under English law

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

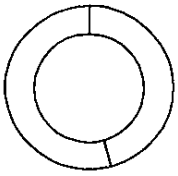


- **42%** Civil aerospace
- **17%** Defence aerospace
- **7%** Energy
- **16%** Marine
- **18%** Power Systems

- 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

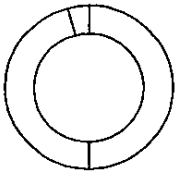
£844m
Underlying profit 2013

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

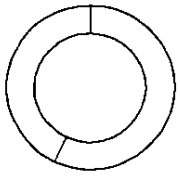
1 500th AE 2100 engine delivered
Upgraded AE 1107 engines for V-22 Osprey
- T56 engine enhancement kits gained first sales

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

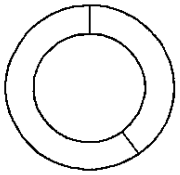
£281m
Underlying profit 2013

- 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

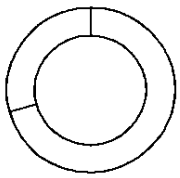
33 RB211s ordered for oil and gas applications
Major service contract secured with Petrobras
New Santa Cruz, Brazil assembly plant operational
Signed tripartite agreement with Rosatom and Fortum to assess nuclear reactor design for UK new build

- 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

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 6 and 7

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 12 to 21

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

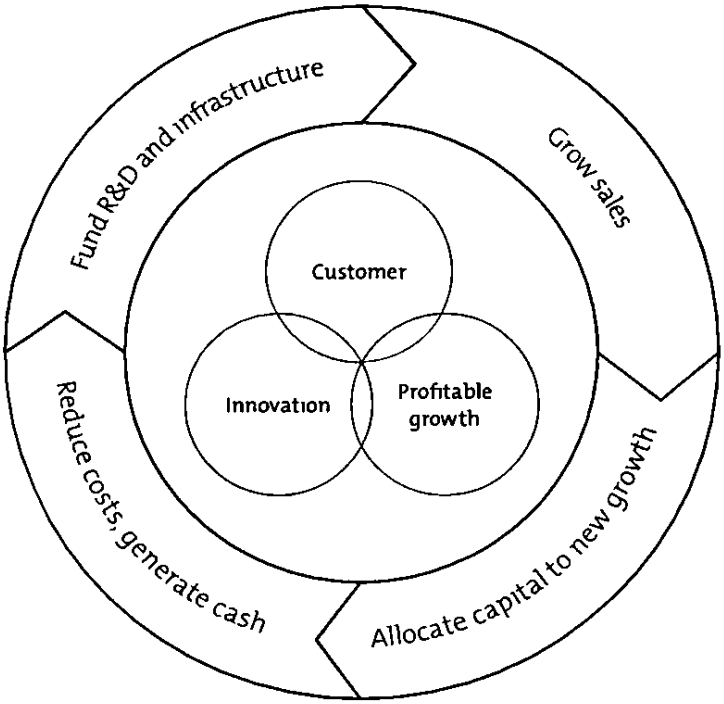
OUR STRATEGY

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 £bn	**71 6**	60 1	+19%
Underlying revenue £m	**15,505**	12,209	+27%
Underlying profit before tax £m	**1,760**	1,434	+23%
Reported revenue £m	**15,513**	12,161	+28%
Reported profit before tax £m	**2,019**	2,766	-27%
Net cash £m	**1,939**	1 316	
Average net cash	**350**	(144)	

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, 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 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 of 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

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 predetermined share of any sales receipts during the production phase On this basis the entry fees received would be deferred in their entirety and recognised over the period of production

The 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	**2,058**	**1,799**	**8,342**	2,741	1 409	6,886
Difference	**(39)**	**(39)**	**(208)**	25	25	(170)
Adopted policy	**2,019**	**1,760**	**8,134**	2,766	1,434	6 716
Difference	**(37)**	**(37)**	**(365)**	(10)	(10)	(323)
Alternative policy[1]	**1,982**	**1,723**	**7,769**	2,756	1,424	6 393

[1] Consistent with FRC Conduct Committee s view

CHIEF FINANCIAL OFFICER'S REVIEW

Underlying income statement

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 12 to 21

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 111

Net 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 more 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 £2,019 million In addition to the changes in underlying profit before tax described above, reported profit before tax has been affected by the impact of mark-to-market adjustments on derivative contracts (£497 million reduction), (ii) the impact of consolidating RRPS (£65 million reduction, comprising the unrealised profit on reclassification to a subsidiary and the additional amortisation on recognised intangible assets), (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

Balance sheet

The balances recognised on 1 January 2013 as a result of the consolidation of Rolls-Royce Power Systems AG are set out in note 24

Intangible assets (note 8) 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 (note 9) 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 18) 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 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

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%
RRPS	**2,831**	287	+886%
Intra segment	**(147)**	(143)	
Profit before financing costs and taxation	**1,832**	1,495	+23%
Civil aerospace	**844**	743	+14%
Defence aerospace	**438**	395	+11%
Marine	**281**	294	4%
Energy	**26**	19	+37%
Power Systems	**294**	109	+170%
Inter-segment	**2**	(11)	
Central costs	**(53)**	(54)	
Net financing costs	**(72)**	(61)	-18%
Profit before taxation	**1,760**	1,434	+23%
Taxation	**(434)**	(317)	-37%
Profit for the year	**1,326**	1,117	+19%
Other items			
Gross R&D investment	**1,118**	919	+22%
Net R&D charged to the income statement	**624**	589	+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

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

Investment 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 and financial RRSAs, set out in detail in note 16 The change largely relates to movements in the GBP/USD exchange rate on the valuation of foreign exchange contracts

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 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

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 17 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

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	**(1,013)**	(275)	(777)
Net funds	**1,939**	1 353	1 316
Provisions	**(733)**	(741)	(461)
Net financial assets and liabilities	**287**	23	50
Joint ventures and associates	**601**	522	1,800
Assets held for sale	**6**	4	4
Other net assets and liabilities	**(539)**	(519)	(236)
Net assets	**8,134**	7,500	6 716
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 12)
[2] Included in accruals and deferred income (note 15)

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 (MIPS) – comprising Marine, Power Systems, Energy and Nuclear

The 2013 figures on the revised basis are included in note 25 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

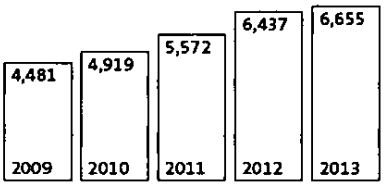
We expect profitability to be much stronger in the second half of 2014, reflecting the timing and mix of trading and cost reduction To be more consistent with market practice, our cash guidance in the future will be based on free cash flow We expect our 2014 free cash flow to be similar to 2013 (£781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

Additional financial information can be found on pages 111 and 112

CIVIL AEROSPACE

OVERVIEW

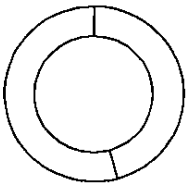
Underlying revenue (£m)



£6,655m

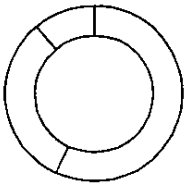
Underlying revenue 2013

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*	47102	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

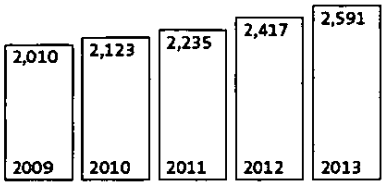
Developing new technology for future engine programmes and enhancing existing products remains a major priority

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

OVERVIEW

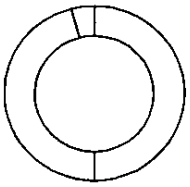
Underlying revenue (£m)



£2,591m

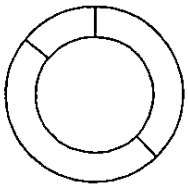
Underlying revenue 2013

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

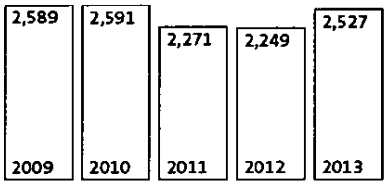
Our inclusion in the Hawk Advanced Jet Training System team to pursue the US Air Force T-X training contract provides just one of several paths to growth Customers also continue to invest in their transport aircraft fleets, where we have a strong position Defence applications for the Trent 700 should 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

OVERVIEW

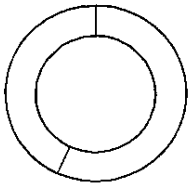
Underlying revenue (£m)



£2,527m

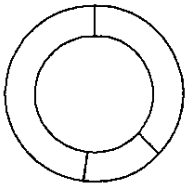
Underlying revenue 2013

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

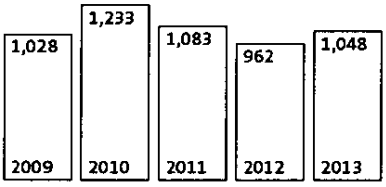
We will continue to develop the synergies between the Marine and Power Systems segments We are working with a number of oil majors, in developing the availability of LNG The aftermarket offers growth opportunities as we continue to utilise our growing global network of service engineers and workshops 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

OVERVIEW

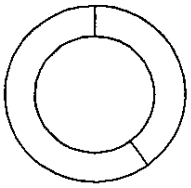
Underlying revenue (£m)



£1,048m

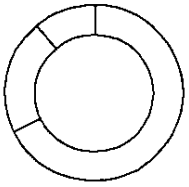
Underlying revenue 2013

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

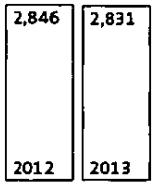
In international markets, we will extend the suite of products and services that we offer to nuclear utilities to enable them to achieve safe, efficient and reliable lifetime nuclear reactor operations

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

OVERVIEW

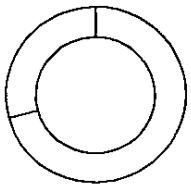
Underlying revenue (£m)



£2,831m

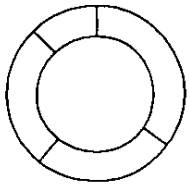
Underlying revenue 2013

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 Zachod 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

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

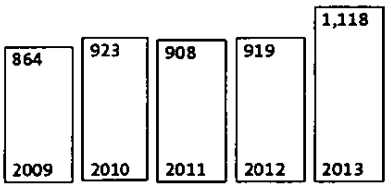
Research and development
Flight test results have shown the Trent XWB to be the world's most efficient large, civil, aero engine

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

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

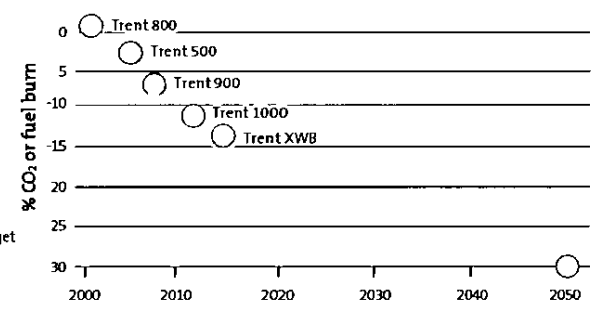
In Marine, our Environship design together with our advanced propulsion systems can reduce CO_2 emissions by up to 40 per cent compared to conventional diesel-powered vessels The Environship concept was awarded the Green Ship Technology Award this year

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



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 4 and 5, 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 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

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 ($ktCO_2e$) This represents a reduction of nine per cent compared with 572 $ktCO_2e$ 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 Non-financial key performance indicators are shown in the sustainability section on pages 24 to 27

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

Rolls Royce RRPS

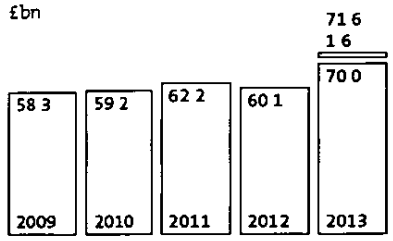
CUSTOMER

ORDER BOOK

+19%

+16% before RRPS

The order book provides an indicator of future business It is measured at constant exchange rates and list prices and includes both firm and announced orders In Civil aerospace it is common for a customer to take options for future orders in addition to firm orders placed Such options are excluded from the order book In Defence aerospace long-term programmes are often ordered for only one year at a time In such circumstances, even though there may be no alternative engine choice available to the customer, only the contracted business is included in the order book Only the first seven years' revenue of long-term aftermarket contracts is included

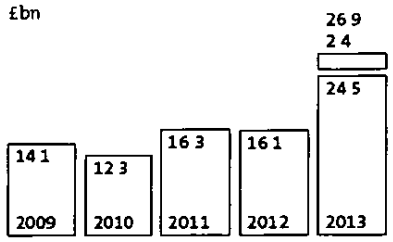


ORDER INTAKE

+67%

+52% before RRPS

Order intake is a measure of new business secured during the year and represents new firm orders, net of the movement in the announced order book between the start and end of the period Any orders which were recorded in previous periods and which are subsequently cancelled reducing the order book, are included as a reduction to intake Order intake is measured at constant exchange rates and list prices and consistent with the order book policy of recording the first seven years' revenue of long-term aftermarket contracts Order intake for any given year includes the seventh year of revenue.



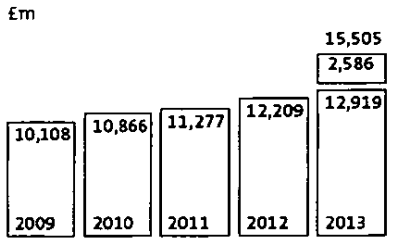
UNDERLYING REVENUE

+27%

+6% before RRPS

Monitoring of revenues provides a measure of business growth Underlying revenue is used in order to eliminate the effect of the decision not to adopt hedge accounting and to provide a clearer year-on-year measure

The Group measures foreign currency revenue at the actual exchange rate achieved as a result of settling foreign exchange contracts from forward cover

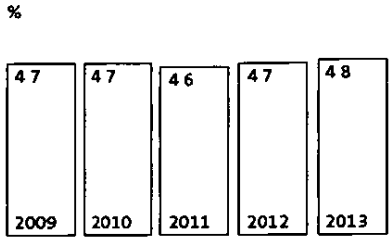


INNOVATION

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

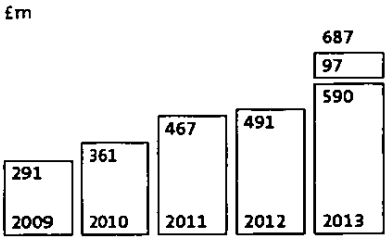


CAPITAL EXPENDITURE

+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



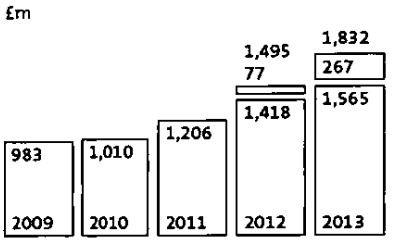
PROFITABLE GROWTH

UNDERLYING PROFIT BEFORE FINANCING

+22%

+10% before RRPS

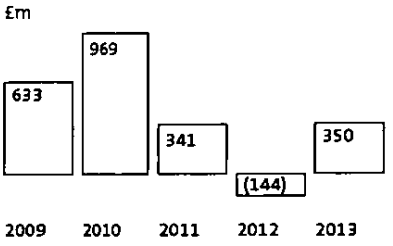
Underlying profit before financing is presented on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements In particular (a) revenues and costs denominated in US dollars and euros are presented on the basis 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

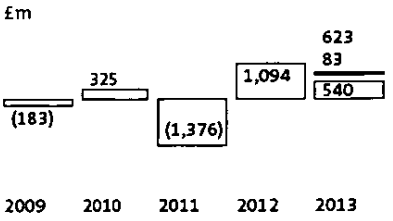


CASH FLOW

+£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 • 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 23) • 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 23) • 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 22) • 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 4 and 5 and Chief Financial Officer's review on page 8) • Protecting credit lines (see additional financial information on pages 111 and 112) • Investing in innovation, manufacturing and production (see operations section on page 23) • 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 Groups 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 26)
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 Groups intangible assets and the impact of potential litigation	• Major programmes are subject to Board approval (see additional financial information on page 111) • 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 111) • 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 • A legal and compliance team has been put in place to manage the current specific issue 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 Groups 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 112) • 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 111)
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

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

By order of the Board
Nigel T Goldsworthy
Company Secretary

BOARD OF DIRECTORS

Ian Davis
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

John Rishton
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

Iain Conn
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

Dame Helen Alexander
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

Lewis Booth CBE
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

Sir Frank Chapman
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

Warren East CBE
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 a non-executive director of Dyson Ltd BT Group plc and Micron Technology Inc

BOARD OF DIRECTORS

Lee Hsien Yang
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

John McAdam
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 Unicherna 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

John Neill CBE
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

Jasmin Staiblin
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

James Guyette
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

Mark Morris
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

Colin Smith CBE
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

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)

At 31 December 2013, all the directors were also directors of Rolls-Royce Holdings plc the ultimate parent company As directors of the ultimate parent company, there is no requirement to disclose their remuneration or their interests in the shares of Rolls-Royce group companies in this Directors' report as they are included in the annual report of Rolls Royce Holdings plc.

INTERNAL CONTROL AND RISK MANAGEMENT

The Board's responsibility for internal control and risk management
The directors are responsible for the Group's system of internal control and for maintaining and reviewing its effectiveness from both a financial and an operational perspective The Group's risk management process is a key element of the internal control system This system of internal control is designed to identify and manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss The Board's report on the Group's principal risks and actions taken to mitigate them is on pages 30 to 32

The Group's approach to internal control is based on the underlying principle of line management's accountability for control and risk management In reviewing the effectiveness of the system of internal control, the Board has taken account of the results of the work carried out to audit and review the activities of the Group

Each of the Company's principal risks are owned by specific members of the executive team, which continually reviews and challenges as to whether these continue to be the principal risks and whether the management of those risks remains effective

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

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 reviewed

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 acknowledge that their business has complied with the Group's Finance Manual

The audit committee
Rolls-Royce Holdings plc has an audit committee, whose key objective is assist the Board in ensuring the integrity of its financial statements In addressing the key objective, the committee reviewed financial statements with both management and the external auditor, concentrating on

- 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, and
- any relevant correspondence from regulators

The 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, it 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 The committee receive reports on the results of these reviews

The 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 profits and cash flows are generated 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 the primary responsibilities of the committee is to ensure that the bases for these judgements and estimates are robust

A resolution to reappoint the external auditor, KPMG Audit Plc, and to authorise the directors to determine the auditor's remuneration, will be proposed at the AGM

The risk committee
Rolls-Royce Holdings plc has established a risk committee 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 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 The discussion on IT vulnerability led us to have an in-depth review of the IT Operations Centre and give detailed consideration to how IT security risks, including the growing global threat of cyber attack, are managed

INTERNAL CONTROL AND RISK MANAGEMENT

The Director of Risk leads the 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

Ethics committee and the referral to the Serious Fraud Office
Rolls-Royce Holdings plc has established an ethics committee On 6 December 2012, the Group announced that we had passed information to the SFO relating to concerns in overseas markets Since that date the committee has continued its investigations and is engaging with the SFO and other authorities in the UK, USA and elsewhere In December 2013, the Group 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 Company 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 The Group continues to demand the highest standards of behaviour from its people John Rishton has stated unequivocally that neither he nor the Board will tolerate improper conduct of any sort and all necessary action will be taken to ensure compliance

Lord Gold's review
The Company has taken significant further action to strengthen and enhance its ethics and compliance programme In January 2013, the Company appointed Lord Gold to review its ethical and compliance procedures and make recommendations in respect of the same 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 The report made various detailed recommendations The ethics committee, the Board and the Executive Leadership Team have all reviewed and accepted Lord Gold's interim report and the recommendations made in it and the Company has started to implement those recommendations

SHAREHOLDERS AND SHARE CAPITAL

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

The ordinary shares are not listed

Dividends
A dividend of £900 million was paid during the year The directors do not propose the payment of a final dividend

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
Rolls-Royce Holdings plc 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

DIRECTORS' REPORT AND FINANCIAL STATEMENTS

Statement of directors' responsibilities in respect of the directors' report and the financial statements
The directors as listed on pages 33 and 34 are responsible for preparing the directors' 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 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 inother jurisdictions

Going concern
As described on page 111, 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 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 preparing the consolidated financial statements

Disclosure of information to auditors
Each of the persons who is a director at the date of approval of this report confirms that

i) so far as the director is aware, there is no relevant 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
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, and

ii) the strategic report on pages 1 to 32 and pages 111 to 112 of the directors' report includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face

By order of the Board

Nigel T Goldsworthy
Company Secretary
12 February 2014

CONSOLIDATED FINANCIAL STATEMENTS

COMPANY FINANCIAL STATEMENTS

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		**(1,322)**	(993)
Research and development costs	3	**(683)**	(531)
Share of results of joint ventures and associates	10	**160**	173
Operating profit		**1,536**	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)	24	**216**	699
Profit before financing and taxation	2	**1,871**	2 077
Financing income	4	**327**	797
Financing costs	4	**(179)**	(108)
Net financing		**148**	689
Profit before taxation [1]		**2,019**	2,766
Taxation	5	**(380)**	(431)
Profit for the year		**1,639**	2 335
Attributable to			
Ordinary shareholders		**1,627**	2,321
Non-controlling interests (NCI)		**12**	14
Profit for the year		**1,639**	2,335

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2013

	Notes	2013 £m	Restated 2012 £m
Profit for the year		**1,639**	2,335
Other comprehensive income (OCI)			
Items that will not be reclassified to profit or loss			
Movements in post-retirement schemes	18	**48**	(305)
Share of OCI of joint ventures and associates	10	**–**	(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	10	**(6)**	(12)
Related tax movements	5	**1**	(1)
		(69)	(131)
Total comprehensive income for the year		**1,628**	1 958
Attributable to			
Ordinary shareholders		**1,617**	1,944
Non controlling interests		**11**	14
Total comprehensive income for the year		**1,628**	1,958

* 2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 18 and the change in the accounting policy for RRSAs – see note 1

CONSOLIDATED BALANCE SHEET

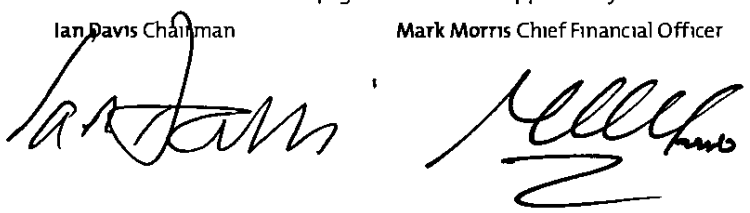
At 31 December 2013

	Notes	2013 £m	Restated* 31 December 2012 £m	1 January 2012 £m
ASSETS				
Non-current assets				
Intangible assets	8	**4,987**	2,901	2 882
Property, plant and equipment	9	**3,392**	2 564	2,338
Investments – joint ventures and associates	10	**601**	1,800	1,680
Investments – other	10	**27**	6	10
Other financial assets	16	**674**	592	327
Deferred tax assets	5	**316**	342	387
Post retirement scheme surpluses	18	**248**	348	520
		10,245	8 553	8 144
Current assets				
Inventories	11	**3,319**	2,726	2 561
Trade and other receivables	12	**5,940**	4 665	4,205
Taxation recoverable		**16**	33	20
Other financial assets	16	**74**	115	91
Short-term investments		**321**	11	11
Cash and cash equivalents	13	**3,990**	2,584	1 309
Assets held for sale		**6**	4	313
		13,666	10,138	8 510
Total assets		**23,911**	18,691	16 654
LIABILITIES				
Current liabilities				
Borrowings	14	**(207)**	(149)	(20)
Other financial liabilities	16	**(102)**	(135)	(107)
Trade and other payables	15	**(7,936)**	(6,403)	(6,303)
Tax liabilities		**(204)**	(126)	(138)
Provisions for liabilities and charges	17	**(348)**	(220)	(276)
Liabilities associated with assets held for sale		**–**	–	(135)
		(8,797)	(7033)	(6 979)
Non-current liabilities				
Borrowings	14	**(2,164)**	(1,234)	(1,184)
Other financial liabilities	16	**(360)**	(418)	(919)
Trade and other payables	15	**(2,138)**	(1,672)	(1 533)
Tax liabilities		**(10)**	–	–
Deferred tax liabilities	5	**(882)**	(584)	(445)
Provisions for liabilities and charges	17	**(385)**	(241)	(226)
Post-retirement scheme deficits	18	**(1,041)**	(793)	(807)
		(6,980)	(4 942)	(5,114)
Total liabilities		**(15,777)**	(11,975)	(12,093)
Net assets		**8,134**	6 716	4 561
EQUITY				
Equity attributable to ordinary shareholders				
Called-up share capital	19	**326**	326	326
Share premium account		**631**	631	631
Cash flow hedging reserve		**(68)**	(63)	(52)
Other reserves		**247**	310	430
Retained earnings		**6,300**	5 449	3 225
		7,436	6 653	4,560
Non controlling interests		**698**	63	1
Total equity		**8,134**	6,716	4,561

2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 18 and the change in the accounting policy for RRSAs – see note 1

The financial statements on pages 40 to 87 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		**1,536**	1,378
Loss/(profit) on disposal of property, plant and equipment		**7**	(9)
Share of results of joint ventures and associates	10	**(160)**	(173)
Dividends received from joint ventures and associates	10	**99**	129
Amortisation and impairment of intangible assets	8	**428**	231
Depreciation and impairment of property, plant and equipment	9	**372**	256
Impairment of investments	10	**–**	2
Decrease in provisions		**(17)**	(40)
Decrease/(increase) in inventories		**119**	(158)
Increase in trade and other receivables		**(834)**	(634)
Increase in trade and other payables		**349**	180
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	20	**79**	55
Net cash inflow from operating activities before taxation		**1,951**	1 062
Taxation paid		**(238)**	(219)
Net cash inflow from operating activities		**1,713**	843
Cash flows from investing activities			
Additions of unlisted investments	10	**(1)**	–
Disposals of unlisted investments	10	**1**	4
Additions of intangible assets	8	**(503)**	(250)
Disposals of intangible assets	8	**–**	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	24	**(37)**	(20)
Reclassifications of joint ventures to subsidiaries	24	**245**	–
Acquisitions of preference shares in subsidiary	24	**(34)**	–
Restructuring of IAE International Aero Engines AG		**–**	942
Disposals of businesses	24	**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)**	–
Dividend to NCI		**(60)**	–
Net cash inflow/(outflow) from financing activities		**464**	81
Net increase in cash and cash equivalents		**1,437**	1 348
Cash and cash equivalents at 1 January		**2,584**	1,290
Exchange losses on cash and cash equivalents		**(34)**	(54)
Cash and cash equivalents at 31 December		**3,987**	2 584

2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 18 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	**1,437**	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	**870**	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	**728**	1,096
Net funds at 1 January excluding the fair value of swaps	**1,212**	116
Net funds at 31 December excluding the fair value of swaps	**1,940**	1,212
Fair value of swaps hedging fixed rate borrowings	**(1)**	104
Net funds at 31 December	**1,939**	1 316

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	**673**	334		(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	**2,584**	1 437		(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	**1,212**	870	(204)	(43)	105	–	**1,940**
Fair value of swaps hedging fixed rate borrowings	**104**				(105)		**(1)**
Net funds	**1,316**	870	(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	Cash flow hedging reserve[1] £m	Translation reserve £m	Retained earnings £m	Total £m	Non controlling interests £m	Total equity £m
At 1 January 2012, as previously reported		326	631	(52)	430	3 342	4 677	1	4 678
Effect of amendments to IAS 19	18	–	–	–	–	67	67	–	67
Effect of amendment to RRSA accounting policy	1	–	–	–	–	(184)	(184)	–	(184)
At 1 January 2012, as restated		326	631	(52)	430	3 225	4 560	1	4,561
Profit for the year		–	–	–	–	2 321	2,321	14	2,335
Foreign exchange translation differences on foreign operations		–	–	–	(118)	–	(118)	–	(118)
Movement on post retirement schemes	18	–	–	–	–	(305)	(305)	–	(305)
Share of other comprehensive income of joint ventures and associates	10	–	–	(11)	(1)	(46)	(58)	–	(58)
Related tax movements	5	–	–	–	(1)	105	104	–	104
Total comprehensive income for the year		–	–	(11)	(120)	2 075	1 944	14	1 958
Share-based payments – direct to equity[2]		–	–	–	–	24	24	–	24
Transactions with NCI[3]		–	–	–	–	116	116	48	164
Related tax movements	5	–	–	–	–	9	9	–	9
Other changes in equity in the year		–	–	–	–	149	149	48	197
At 1 January 2013		**326**	**631**	**(63)**	**310**	**5,449**	**6,653**	**63**	**6,716**
Profit for the year		–	–	–	–	1,627	1 627	12	1,639
Foreign exchange translation differences on foreign operations		–	–	–	(63)	–	(63)	(1)	(64)
Movement on post retirement schemes	18	–	–	–	–	48	48	–	48
Share of other comprehensive income of joint ventures and associates	10	–	–	(5)	(1)	–	(6)	–	(6)
Related tax movements	5	–	–	–	1	10	11	–	11
Total comprehensive income for the year		–	–	(5)	(63)	1,685	1,617	11	1,628
Dividend paid		–	–	–	–	(900)	(900)	–	(900)
Share based payments – direct to equity[2]		–	–	–	–	53	53	–	53
Reclassification of Rolls Royce Power Systems AG[4]	24	–	–	–	–	–	–	669	669
Transactions with NCI		–	–	–	–	–	–	(45)	(45)
Related tax movements	5	–	–	–	–	13	13	–	13
Other changes in equity in the year		–	–	–	–	(834)	(834)	624	(210)
At 31 December 2013		**326**	**631**	**(68)**	**247**	**6,300**	**7,436**	**698**	**8,134**

[1] See accounting policies note 1

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

[3] On 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

[4] 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 24

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies

The Company
The consolidated financial statements of Rolls-Royce plc (the 'Company') for the year ended 31 December 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 88 to 106 and the accounting policies in respect of Company financial statements are set out on page 90

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 38 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 9, 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 9, 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

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 the directors believe do not conflict with IFRS in this regard) The resulting accounting policy (described below) represents of the commercial effect 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 partners), 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 Rolls-Royce Power Systems Holding GmbH
The fair value of intangible assets of RRPS AG 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

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 **£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 revenue and costs are inherently imprecise and significant estimates are required to assess engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred, and life cycle cost improvements over the term of the contracts The estimates take account of the inherent uncertainties and the risk of non-recovery of any resulting contract balances

Post-retirement benefits
The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19 The accounting valuation, which 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 18

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

Provisions
As described in the accounting policy on page 52, 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

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 (OE) and spare parts) are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured – this is generally on delivery On occasion, the Group may participate in the financing of OE, most commonly by the provision of guarantees as described in note 17 In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing when the significant risks and rewards of ownership have been transferred to the customer As described on page 46, 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 46, the assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on flying hours or equivalent for long-term aftermarket arrangements where the service is provided on a continuous basis, costs incurred to the extent these relate to services performed up to the reporting date, or achievement of contractual milestones where relevant

As described on page 46, **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

1 Accounting policies (continued)

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

Risk and revenue sharing arrangements (RRSAs)
As described on page 46, 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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

Foreign currency translation

Transactions denominated in currencies other than the functional currency of the transacting Group undertaking (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 payable and financial RRSAs are classified as other liabilities, and
- derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as fair value through profit or loss

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

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

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

Hedge accounting

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

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

Changes in the fair values of derivatives designated as fair value hedges and changes in 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

1 Accounting policies (continued)

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in 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 46, 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 relates 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 46, 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 relates to the acquired company's established relationships with its existing customers that result in repeat purchases and customer loyalty Amortisation occurs on a straight-line basis over its useful economic life, up to a maximum of 15 years

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

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

i) land and buildings, as advised by the Group's professional advisers
   a) freehold buildings – five to 45 years (average 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

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

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

1 Accounting policies (continued)

Share-based payments
The Group provides share-based payment arrangements to certain employees These are principally equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant The fair value is expensed on a straight-line basis over the vesting period The amount recognised as an expense is adjusted to reflect the actual number of shares or options that will vest, except where additional shares vest as a result of the Total Shareholder Return (TSR) performance condition in the Performance Share Plan (PSP)

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

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 47, 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 18 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 cost **£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*, IFSR 12 *Disclosure of Interests in Other Entities* and amendments to IAS 27 *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 method accounting previously applied The Group has reviewed its material joint ventures and has concluded that none fall 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

NOTES TO THE CONSOLIDATED 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	10,011	1,606	2,080	1,484	3,935	(744)	18,372
Investments in joint ventures and associates	495	17	6	54	29	–	601
Segment liabilities	(4,822)	(1,092)	(743)	(434)	(4,864)	734	(11,221)
Net assets/(liabilities)	5,684	531	1,343	1,104	(900)	(10)	7,752
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

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	8 963	1 543	2,163	1 328	155	(683)	13,469
Investments in joint ventures and associates	440	(22)	4	50	1 328	–	1 800
Segment liabilities	(5 729)	(1,762)	(1 434)	(554)	(282)	672	(9 089)
Net assets/(liabilities)	3 674	(241)	733	824	1 201	(11)	6 180
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	(53) [1]	1,673	(297)	1,376
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	(53)	1,832	39	1,871
Net financing		(72)	(72)	220	148
Profit before taxation		(125)	1,760	259	2,019
Taxation		(434)	(434)	54	(380)
Profit for the year		(559)	1,326	313	1,639
Ordinary shareholders			1,225	402	1,627
Non controlling interets			101	(89)	12
Profit for the year			1,326	54	1,639

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 interets			14	–	14
Profit for the year			1 117	1,218	2 335

[1] Central corporate costs

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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**	**1,832**	**(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	**–**	**–**	**8**	**–**	–	–	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**	**220**	**54**	(48)	582	750	(114)
Reported per consolidated income statement	**15,513**	**1,871**	**148**	**(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 10
[5] Other includes the exclusion of other operating income of £63m and the revaluation of preference shares in RRPS which have now been acquired

		Restated*	
	2013 £m	31 December 2012 £m	1 January 2012 £m
Reportable segment assets	**18,372**	13 469	12,621
Investments in joint ventures and associates	**601**	1,800	1 680
Cash and cash equivalents and short term investments	**4,311**	2 595	1,320
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	**23,911**	18,691	16 654
Reportable segment liabilities	**(11,221)**	(9,089)	(9 499)
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	**(15,777)**	(11,975)	(12 093)
Net assets	**8,134**	6,716	4,561

* Restated – see note 1

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 10 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

	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)
Effect of acquisition accounting and foreign exchange movements	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]	16	287	–	750	–
Put option on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	16	8	–	11	–
Financing on post-retirement scheme surpluses	18	17	–	26	–
		327	*15*	797	*10*
Financing costs					
Interest payable		(58)	*(58)*	(51)	*(51)*
Fair value losses on foreign currency contracts[2]	16	(3)	–	–	–
Financial charge relating to financial RRSAs	16	(9)	*(9)*	(10)	*(10)*
Fair value losses on commodity derivatives[2]	16	(34)	–	(3)	–
Financing on post retirement scheme deficits	18	(43)	–	(34)	–
Net foreign exchange losses		(5)	–	–	–
Other financing charges		(27)	*(20)*	(10)	*(10)*
		(179)	*(87)*	(108)	*(71)*
Net financing		148	*(72)*	689	*(61)*
Analysed as					
Net interest payable		(43)	*(43)*	(41)	*(41)*
Net post retirement scheme financing		(26)	–	(8)	–
Net other financing		217	*(29)*	738	*(20)*
Net financing		148	*(72)*	689	*(61)*

[1] See note 2

[2] Net gain on fair value items through profit or loss 250 – 747 –

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	**2,019**	2 766
Less share of results of joint ventures and associates (note 10)	**(160)**	(173)
Profit before taxation excluding joint ventures and associates	**1,859**	2,593
Nominal tax charge at UK corporation tax rate 23 25% (2012 24 5%)	**432**	635
UK R&D credit	**(13)**	(26)
Rate differences	**51**	59
Profit on reclassification of joint ventures to subsidiaries	**(27)**	–
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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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 18		(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	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)**

	At 1 January 2012 £m	Restated 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 for the effect of the amendments to IAS 19 and amendment to accounting policy for RRSAs – 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

5 Taxation (continued)

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 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 20)	**79**	55
Pensions and other post-retirement scheme benefits (note 18)	**379**	245
	3,675	2 728

[1] Remuneration of key management personnel is shown in note 23

7 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 5**	0 2
Fees payable to the Company s auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**4 1**	4 5
Total fees payable for audit services	**5 6**	4 7
Fees payable to the Company s auditors and its associates for other services		
Audit related assurance services	**0 5**	0 6
Taxation compliance services	**0 8**	0 3
Taxation advisory services	**0 1**	0 2
Internal audit services	**0 2**	0 6
Information technology services	**–**	0 4
All other services	**1 0**	0 1
	8 2	6 9
Fees payable in respect of the Group's pension schemes		
Audit	**0 2**	0 2
Taxation compliance services	**0 1**	0 1

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

8 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure[1] £m	Recoverable engine costs £m	Customer relationships[1] £m	Software[2] £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 Ltd 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

8 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** – volumes 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

9 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost					
At 1 January 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)

10 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 Holding 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 [1] £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)	(1 043)	**–**	–	**(1,291)**	(1,043)
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 108 and 109

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

11 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

12 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
Amounts owed by parent undertaking	848	546
Other receivables	637	479
Prepayments and accrued income	235	205
	5,940	4,665
Analysed as		
Financial instruments (note 16)		
Trade receivables and similar items	2,118	1,662
Other non-derivative financial assets	527	364
Non-financial instruments	3,295	2,639
	5,940	4,665
Trade and other receivables expected to be recovered in more than one year		
Trade receivables	51	40
Amounts recoverable on contracts	1,902	1 473
Amounts owed by joint ventures and associates	–	3
Other receivables	41	63
Prepayments and accrued income	84	32
	2,078	1,611

13 Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	982	673
Money market funds	1,157	408
Short-term deposits	1,851	1,503
	3,990	2,584
Overdrafts (note 14)	(3)	–
Cash and cash equivalents per cash flow statement (page 42)	3,987	2 584
Cash held as collateral against third-party obligations (note 17)	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

14 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
7⅜% 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

15 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 parent undertaking	**891**	2	**–**	–	**891**	2
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
	7,936	6 403	**2,138**	1,672	**10,074**	8,075
[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 16)		
Trade payables and similar items	**2,989**	2,571
Other non derivative financial liabilities	**806**	704
Non financial instruments	**6,279**	4,800
	10,074	8 075

* Restated – see note 1

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 Financial instruments

Carrying values and fair values of financial instruments

	Notes	Basis for determining fair value	Assets: Fair value through profit or loss £m	Assets: Loans and receivables £m	Assets: Available for sale £m	Assets: Cash £m	Liabilities: Fair value through profit or loss £m	Liabilities: Other £m	Total £m
Year ended 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)
Financial RRSAs		E	–	–	–	–	–	(167)	(167)
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)	(6,333)	1,103
Year ended 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	673	–	–	2 584
Borrowings	15	D	–	–	–	–	–	(1,383)	(1,383)
Derivative financial liabilities		C	–	–	–	–	(360)	–	(360)
Financial RRSAs		E	–	–	–	–	–	(193)	(193)
Trade payables and similar items	16	B	–	–	–	–	–	(2 571)	(2 571)
Other non derivative financial liabilities	16	B	–	–	–	–	–	(704)	(704)
			707	3 546	408	673	(360)	(4 851)	123

Fair values equate to book values for both 2013 and 2012, with the following exceptions

	2013 Book value £m	2013 Fair value £m	2012 Book value £m	2012 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 (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 fair value of RRSAs is estimated by discounting expected future cashflows The contractual cash flows are based on future trading activity which is estimated based on latest forecasts (Level 3 as defined by IFRS 13)

IFRS 13 defines a three level valuation hierarchy
Level 1 – quoted prices for similar instruments
Level 2 – directly observable market inputs other than Level 1 inputs and
Level 3 – inputs not based on observable market data

16 Financial instruments (continued)

Carrying values of other financial assets and liabilities

	Derivatives					
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Financial RRSAs £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)**	**(22)**	**(102)**
Non-current liabilities	**(142)**	**(25)**	**(48)**	**(215)**	**(145)**	**(360)**
	(205)	**(41)**	**(49)**	**(295)**	**(167)**	**(462)**
	498	**(39)**	**(6)**	**453**	**(167)**	**286**
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)	(30)	(135)
Non-current liabilities	(233)	(15)	(7)	(255)	(163)	(418)
	(330)	(23)	(7)	(360)	(193)	(553)
	272	(13)	88	347	(193)	154

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)

Financial RRSAs

The Group has financial liabilities arising from financial RRSAs These financial liabilities are valued at each reporting date using the amortised cost method This involves calculating the present value of the forecast cash flows of the arrangements using the internal rate of return at the inception of the arrangements as the discount rate

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 Financial instruments (continued)

Movements in the carrying values were as follows

	Put options on NCI	Financial RRSAs	
	2013 £m	2013 £m	2012 £m
At 1 January	–	(193)	(230)
Cash paid to partners		33	35
Business acquisitions	(2)	–	–
Additions	–	–	–
Exchange adjustments included in OCI		(4)	1
Financing charge [1]		(9)	(10)
Excluded from underlying profit			
Change in put option exercise price [1]	2		
Exchange adjustments [1]	–	4	9
Changes in forecast payments [1]		2	2
At 31 December	–	(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.

16 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

	Expected maturity					Fair value	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
At 31 December 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**	–

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 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)
Financial RRSAs	–	(114)	(53)	–	(167)
Trade payables and similar items	(1,501)	(641)	(653)	(194)	(2,989)
Other non derivative financial liabilities	(208)	(328)	(158)	(112)	(806)
	(3,199)	(1,138)	(1,690)	(306)	(6,333)
	(810)	985	238	237	650
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	1,037	606	446	2,584
	856	2,288	819	664	4,627
Liabilities					
Borrowings	(1 173)	(205)	(5)	–	(1,383)
Financial RRSAs	–	(139)	(54)	–	(193)
Trade payables and similar items	(1 254)	(825)	(289)	(203)	(2,571)
Other non-derivative financial liabilities	(250)	(320)	(17)	(117)	(704)
	(2 677)	(1,489)	(365)	(320)	(4,851)
	(1,821)	799	454	344	(224)

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	–	13	3	12	28
US dollar	8	–	–	7	15
Euro	(1)	(2)	–	–	(3)
Other	(5)	41	(11)	(4)	21
At 31 December 2012					
Sterling	–	22	1	4	27
US dollar	4	–	(6)	5	3
Euro	(1)	(2)	–	–	(3)
Other	6	1	(5)	1	3

16 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	2 584	–	–	–	2,584
	5,121	150	44	19	5 334

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)**
Financial RRSAs	**(33)**	**(34)**	**(65)**	**(75)**	**40**	**(167)**
Trade payables and similar items	**(2,972)**	**(17)**	**–**	**–**	**–**	**(2,989)**
Other non-derivative financial liabilities	**(751)**	**(28)**	**(16)**	**(11)**	**–**	**(806)**
	(4,133)	**(295)**	**(836)**	**(2,070)**	**706**	**(6,628)**
At 31 December 2012						
Borrowings	(210)	(257)	(403)	(778)	265	(1,383)
Derivative financial liabilities	(108)	(103)	(138)	(14)	3	(360)
Financial RRSAs	(35)	(32)	(75)	(100)	49	(193)
Trade payables and similar items	(2 568)	(1)	(1)	(1)	–	(2,571)
Other non derivative financial liabilities	(694)	(10)	–	–	–	(704)
	(3 615)	(403)	(617)	(893)	317	(5,211)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16 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]		2 584	2,584	–
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)	–	–
		1,212		

[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

16 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 70

17 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 provisions charged to 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 Provisions for liabilities and charges (continued)

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 11. 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		2012	
	£m	$m	£m	$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.

18 Post-retirement benefits

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

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

18 Post-retirement benefits (continued)

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	**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 £37million (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

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)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 Post-retirement benefits (continued)

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

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)

18 Post-retirement benefits (continued)

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

18 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
At 31 December	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 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

18 Post-retirement benefits (continued)

Sensitivities

The calculations of the defined benefit obligations are sensitive to the assumptions set out on page 78 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

19 Share capital

	Ordinary shares of 20p each[1] Millions	Nominal value £m
Issued and fully paid		
At 1 January 2012 and 31 December 2013	1,631	326

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

20 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

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	**26 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

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

21 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)

22 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 17

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

23 Related party transactions

	2013 £m	2012 £m
Sales of goods and services to joint ventures and associates	3,149	2937
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
RRSP 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 11 and 14 Transactions with Group pension schemes are shown in note 18

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis

Key management personnel are deemed to be the directors and the members of the ELT as set out in the annual report of Rolls-Royce Holdings plc Remuneration for key management personnel is shown below

	2013 £m	2012 £m
Salaries and short-term benefits	11	15
Post retirement schemes	1	1
Share based payments	7	8
	19	24

24 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

24 Acquisitions and disposals (continued)

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**
Consideration satisfied by			
Cash consideration	–	37	**37**
Existing shareholding	1 443	3	**1,446**
NCI	669	–	**669**
	2,112	**40**	**2,152**

	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 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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

24 Acquisitions and disposals (continued)

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 – other	–	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

Acquisitions and disposals in 2012

During 2012, the Group acquired

- on 19 June, Superstructure Capital Limited, a business engaged in marketing and sale of safety and risk management software to the aerospace industry,
- on 13 July, PFW Aerospace UK, a business engaged in the manufacture of precision components for the aerospace industry,
- on 13 December, Rolls-Royce Goodrich Engine Controls Limited (acquisition of 50 per cent not already held), a business engaged in the development and manufacture of aero-engine controls, and
- 27 December, PKMJ Technical Services, Inc , a nuclear engineering services business in the US

and disposed of

- on 27 June, Rolls-Royce Fuel Cell Systems Inc (dilution of existing shareholding to 49 per cent), and
- on 29 June, 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

25 Segmental analysis from 1 January 2014

As described in the Chief Financial Officer's review on page 11, during 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	10,011	1,606	11,617	1,837	3,935	1,727	(10)	7,489	(734)	18,372
Investments in joint ventures and associates	495	17	512	5	29	55	–	89	–	601
Segment liabilities	(4,822)	(1,092)	(5,914)	(530)	(4,864)	(646)	–	(6,040)	733	(11,221)
Net assets	5,684	531	6,215	1,312	(900)	1,136	(10)	1,538	1	7,752
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			
Intangible assets	3	**872**	717
Tangible assets	4	**1,270**	1,152
Investments – subsidiary undertakings	5	**1,749**	1,773
– joint ventures	5	**70**	45
		3,961	3,687
Current assets			
Stocks	6	**1,237**	1 371
Debtors – amounts falling due within one year	7	**3,447**	3,216
– amounts falling due after one year	7	**475**	554
Other financial assets – amounts falling due within one year	8	**83**	124
– amounts falling due after one year	8	**687**	594
Short-term deposits		**1,973**	1 487
Cash at bank and in hand		**1,237**	384
Assets held for resale		**2**	–
		9,141	7,730
Creditors – amounts falling due within one year			
Borrowings	9	**(805)**	(696)
Other financial liabilities	8	**(142)**	(174)
Other creditors	10	**(6,940)**	(5,843)
		(7,887)	(6 713)
Net current assets		**1,254**	1 017
Total assets less current liabilities		**5,215**	4,704
Creditors – amounts falling due after one year			
Borrowings	9	**(1,951)**	(1 229)
Other financial liabilities	8	**(403)**	(447)
Other creditors	10	**(1,130)**	(929)
		(3,484)	(2 605)
Provisions for liabilities and charges	11	**(140)**	(122)
Net assets excluding post-retirement schemes		**1,591**	1 977
Post retirement schemes – surpluses	13	**332**	796
– deficits	13	**–**	(15)
Net assets		**1,923**	2 758
Capital and reserves			
Called up share capital	14	**326**	326
Share premium account	15	**631**	631
Revaluation reserve	15	**26**	29
Other reserves	15	**167**	167
Profit and loss account	15	**773**	1,605
Total shareholders' funds		**1,923**	2 758

Restated – see note 1

The financial statements on pages 88 to 106 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 1003142

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

For the year ended 31 December 2013

	2013 £m	2012 £m
Profit attributable to the shareholders of Rolls-Royce plc	**448**	1 394
Net movement on post-retirement schemes	**(561)**	(182)
Related tax movements	**149**	67
Total recognised gains relating to the year	**36**	1,279

* Restated – see note 1

RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

For the year ended 31 December 2013

	2013 £m	2012 £m
At 1 January as previously reported		1 614
Effect of amendment to accounting policy for Risk and Revenue Sharing Arrangements – see note 1		(152)
At 1 January as restated	**2,758**	1 462
Total recognised gains for the year	**36**	1 279
Dividends paid	**(900)**	–
Share-based payments – direct to equity	**29**	17
At 31 December	**1,923**	2 758

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 Accounting policies

Basis of accounting
The financial statements have been prepared in accordance with applicable accounting standards on the historical cost basis, modified to include the revaluation of land and buildings, and on a going concern basis as described on page 38

As permitted by the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements

As permitted by FRS 1 *Cash flow statements*, no cash flow statement has been prepared, as a consolidated cash flow statement has been prepared by the ultimate parent company

Change to accounting policy
As explained in more detail in the Chief Financial Officer's Review on page 9, following discussions with the Financial Reporting Council, the Group has reassessed its policy for the recognition of entry fees received from Risk and Revenue Sharing Arrangements 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 at the time they become due and payable, on the principle that this matched it to the recognition of costs incurred on behalf of the workshare partner This policy has been refined, to reflect better the fact that some of these costs are capitalised Under the amended policy, where the relevant costs in the development programme are capitalised (ie certification costs and participation fees paid to airframers), an equivalent portion of the entry fee received has been deferred and recognised as the related costs are amortised after entry into service

As required by FRS 18 *Accounting Policies*, this change has been made retrospectively, the impact of the change in policy in 2012 was to increase retained profit by £27 million and to reduce net assets at 31 December 2012 by £125 million Had the policy not been amended, retained profit in 2013 would have been £18 million higher and at 31 December 2013 net assets £86 million higher

Revenue recognition
Revenues comprise sales to external customers after discounts, and excluding value added tax

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured

Sales of services and long-term contracts are recognised when the outcome of the transaction can be reliably estimated Revenue is recognised by reference to the stage of completion based on services performed to date as a percentage of the total contractual obligation The assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on costs incurred to the extent these relate to services performed up to the reporting date, achievement of contractual milestones where appropriate, or flying hours or equivalent for long-term aftermarket arrangements

Linked sales of product and services are treated as a single long-term contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single project with an overall profit margin Revenue is recognised on the same basis as for other sales of products and services as described above

Full provision is made for any estimated losses to completion of contracts having regard to the overall substance of the arrangements

Progress payments received on long-term contracts, when greater than recorded turnover, are deducted from the value of work in progress except to the extent that payments on account exceed the value of work in progress on any contract where the excess is included in creditors The amount by which recorded turnover of long-term contracts is in excess of payments on account is classified as 'amounts recoverable on contracts' and is separately disclosed within debtors

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

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 Accounting policies (continued)

Risk and revenue sharing arrangements (RRSAs)
The Company enters into arrangements with certain workshare partners under which these suppliers (i) contribute to the forecast costs of developing an engine, and (ii) supply components for the production phase for which they receive consideration, which is an agreed proportion of the total programme revenues Both the suppliers' contributions to the forecast costs and their consideration are determined by reference to their proportionate scopes of supply relative to that of the engine overall Once the forecast costs and the scopes of supply have been agreed, each party is then accountable for its own incurred costs The suppliers' contributions to the costs of developing the engine include (i) development work, and/or (ii) development components supplied, and/or (iii) non-refundable cash payments No accounting entries are recorded where the suppliers undertake development work or where development components are supplied Cash sums received are recognised in the profit and loss account to match the expensing of the Group's related costs – where the cash sums are received in advance of the related costs being expensed or where the related costs are capitalised as intangible assets, the recognition of the cash received is deferred to match the recognition of the related expense or the amortisation of the related intangible asset respectively The payments to suppliers of their shares of the programme revenues for their production components are charged to the profit and loss account as programme revenues arise

The Company has arrangements with partners who do not undertake development work or supply parts Such arrangements are considered to be financial instruments as defined by FRS 25 *Financial instruments Presentation* and are accounted for using the amortised cost method

Research and development
The charge to the profit and loss account consists of research and development expenditure incurred in the year, excluding known recoverable costs on contracts, contributions to shared engineering programmes and application engineering Application engineering expenditure, incurred in the adaptation of existing technology to new products, is capitalised and amortised over the programme life, up to a maximum of 15 years, where both the technical and commercial risks are considered to be sufficiently low

Interest
Interest receivable/payable is credited/charged to the profit and loss account using the effective interest method

Taxation
Provision for taxation is made at the current rate and for deferred taxation at the projected rate on all timing differences that have originated, but not reversed at the balance sheet date Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled

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

Foreign currency translation
Transactions in overseas currencies are translated into local currency at the exchange rate ruling on the date of the transaction Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rate ruling at the year-end Exchange differences arising on foreign exchange transactions and the retranslation of assets and liabilities into sterling at the rate ruling at the year-end are taken into account in determining profit on ordinary activities before taxation

Financial instruments
FRS 26 *Financial instruments recognition and measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different Rolls-Royce has classified its financial instruments as follows

- Short-term investments are generally classified as available for sale
- Short-term deposits (principally comprising funds held with banks and other financial institutions), trade receivables and short-term investments not designated as available for sale are classified as loans and receivables
- Borrowings, trade creditors and financial RRSPs are classified as other liabilities
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading

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

- Loans and receivables and other liabilities are held at amortised cost and not revalued (except for changes in exchange rates, which are included in the profit and loss account) unless they are included in a fair value hedge accounting relationship Where such a relationship exists, the instruments are revalued in respect of the risk being hedged If instruments held at amortised cost are hedged, generally by interest rate swaps, and the hedges are effective, the carrying values are adjusted for changes in fair value, which are included in the profit and loss account

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 Accounting policies (continued)

- Available for sale assets are held at fair value Changes in fair value arising from changes in exchange rates are included in the profit and loss account All other changes in fair value are taken to reserves On disposal, the accumulated changes in value recorded in reserves are included in the gain or loss recorded in the profit and loss account
- Held for trading instruments are held at fair value Changes in fair value are included in the profit and loss account unless the instrument is included in a cash flow hedge If the instruments are included in a cash flow hedging relationship, which is effective, changes in value are taken to reserves When the hedged forecast transaction occurs, amounts previously recorded in reserves are recognised in the profit and loss account
- Financial instruments are derecognised on expiry or when all contractual rights and obligations are transferred

Hedge accounting
The Company does not apply hedge accounting in respect of forward foreign exchange contracts held to manage the cash flow exposures of forecast future transactions denominated in foreign currencies

The Company does not apply hedge accounting in respect of commodity swaps held to manage the cash flow exposures of forecast future transactions in those commodities

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

Changes in the fair values of derivatives designated as fair value hedges and changes in fair value of the related hedged item are recognised directly in the profit and loss account

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

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

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in reserves The ineffective portion is recognised immediately in the profit and loss account

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

Software
The cost of acquiring software that is not specific to an item of tangible fixed assets is classified as an intangible asset

Tangible fixed assets and depreciation
Tangible fixed assets are stated at cost or valuation less accumulated depreciation and any provision for impairments in value

Depreciation is provided on a straight-line basis to write-off the cost or valuation, less the estimated residual value, over the estimated useful life Estimated useful lives are as follows

i) Land and buildings, as advised by the Group's professional valuers
   a) Freehold buildings – five to 45 years (average 23 years)
   b) Leasehold land and buildings – lower of valuers' estimates or period of lease
   c) No depreciation is provided in respect of freehold land
ii) Plant and equipment – five to 25 years (average 13 years)
iii) Aircraft and engines – five to 20 years (average 15 years)
iv) No depreciation is provided on assets in the course of construction

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 Accounting policies (continued)

Impairment of fixed assets
Impairment of fixed assets is considered in accordance with FRS 11 *Impairment of fixed assets and goodwill* Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the income-generating unit to which the asset belongs

Intangible assets not yet available for use are tested for impairment annually Other fixed assets are assessed for any indications of impairment annually If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount

Recoverable amount is the higher of value in use or fair value less costs to sell – if this is readily available The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset

If the recoverable amount of an asset (or income-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense

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

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

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

Post-retirement benefits
Pensions and similar benefits are accounted for under FRS 17 *Retirement benefits* For defined benefit plans, obligations are measured at discounted present value whilst plan assets are recorded at fair value The service and financing costs of such plans are recognised separately in the profit and loss account, service costs are spread systematically over the lives of employees and financing costs are recognised in the periods in which they arise Actuarial gains and losses are recognised immediately in the statement of total recognised gains and losses Surplus in schemes are recognised as assets only if they represent economic benefits that are available to the Company in the future

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

Share-based payments
The Company participates in Rolls-Royce Holdings plc employee share-based payment arrangements These are equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of shares or options that will eventually vest The costs of these share-based payments are treated as a capital contribution from the parent company Any payments made by the Company to its parent company, in respect of these arrangements, are treated as a return of this capital contribution

The fair values of the share-based payment arrangements are measured as follows

i) ShareSave – using the binomial pricing method,
ii) Performance Share Plan – using a pricing model adjusted to reflect non-entitlement to dividends (or equivalent) and the Total Shareholder Return market based condition,
iii) Annual Performance Related Award plan and free shares under the Share Incentive plan – share price on the date of the award

See note 17 for further description of the share-based payment plans

NOTES TO THE COMPANY FINANCIAL STATEMENTS

2 Emoluments of directors

	2013		2012	
	Highest paid director £000	Other directors £000	Highest paid director £000	Other directors £000
Aggregate emoluments excluding deferred share plans	1,793	3,959	1 960	4 908
Aggregate amounts relating to deferred share plans	330	3,406	496	7,993
Aggregate value of Company contributions to Company defined contribution pensions schemes	50	395	123	383
Accrued pension of highest paid director	–	n/a	–	n/a
Gains realised on exercise of share options [1]	–	6	–	–

	2013 Number	2012 Number
Number of directors with accruing retirement benefits		
Defined contribution schemes	2	3
Defined benefit schemes [2]	3	2
Number of directors exercising share options	1	–
Number of directors receiving shares as part of long term incentives schemes	4	5

[1] Includes gains under the ShareSave plan
[2] One director was a contributing member of both defined contribution and defined benefit schemes (2012 two directors)

3 Intangible assets

	Certification costs and participation fees £m	Software and other £m	Total £m
Cost			
At 1 January 2013	654	431	1,085
Additions	185	59	244
At 31 December 2013	839	490	1,329
Accumulated amortisation			
At 1 January 2013	224	144	368
Charge for the year	33	56	89
At 31 December 2013	257	200	457
Net book value			
At 31 December 2013	582	290	872
At 1 January 2013	430	287	717

NOTES TO THE COMPANY FINANCIAL STATEMENTS

4 Tangible assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost or valuation					
At 1 January 2013	**466**	**1,559**	**37**	**222**	**2,284**
Additions	**3**	**64**	**19**	**183**	**269**
Reclassifications	**17**	**85**	**1**	**(103)**	**–**
Disposals	**–**	**(40)**	**–**	**–**	**(40)**
At 31 December 2013	**486**	**1,668**	**57**	**302**	**2,513**
Accumulated depreciation					
At 1 January 2013	**164**	**951**	**18**	**(1)**	**1,132**
Impairment	–	–	–	–	–
Charge for the year	15	122	7	–	144
Disposals	–	(34)	–	1	(33)
At 31 December 2013	**179**	**1,039**	**25**	**–**	**1,243**
Net book value					
At 31 December 2013	**307**	**629**	**32**	**302**	**1,270**
At 1 January 2013	302	608	19	223	1,152

	2013 £m	2012 £m
Tangible fixed assets include		
Net book value of finance leased assets	**10**	11
Non depreciable land	**68**	68
Land and buildings at cost or valuation comprise		
Cost	**327**	320
Valuation at 31 December 1996	**159**	146
	486	466
On an historical cost basis the net book value of land and buildings would have been as follows		
Cost	**456**	436
Depreciation	**(175)**	(162)
	281	274
Capital expenditure commitments	**145**	152

NOTES TO THE COMPANY FINANCIAL STATEMENTS

5 Investments

	Subsidiary undertakings[1]	Joint ventures[2]		
	Shares at cost[3] £m	Shares at cost £m	Loans £m	Total £m
At 1 January 2013	**1,773**	**38**	**7**	**45**
Additions	3	12	27	39
Business disposal	(7)	–	–	–
Transfer to subsidiary undertakings'	14	(14)	–	(14)
Impairment	(11)	–	–	–
Disposals/write offs	(23)	–	–	–
At 31 December 2013	**1,749**	**36**	**34**	**70**

[1] The principal subsidiary undertakings are listed on pages 107 and 108
[2] The principal joint ventures are listed on pages 108 and 109
[3] The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited one of its subsidiaries At 31 December 2013 this guarantee was £25m (2012 £25m)

6 Stocks

	2013 £m	2012 £m
Raw materials	**75**	78
Work in progress	**389**	438
Long-term contracts work in progress	**–**	(4)
Finished goods	**764**	837
Payments on account	**9**	22
	1,237	1 371

7 Debtors

	Falling due within one year		Falling due after one year	
	2013 £m	2012 £m	2013 £m	2012 £m
Trade debtors	**300**	361	**–**	39
Amounts recoverable on contracts	**8**	10	**182**	165
Amounts owed by – subsidiary undertakings	**1,565**	1 699	**–**	–
– joint ventures	**335**	319	**–**	3
– parent undertaking	**845**	544	**–**	–
Deferred tax assets (note 12)	**–**	–	**215**	318
Other debtors	**328**	210	**–**	–
Prepayments and accrued income	**66**	73	**78**	29
	3,447	3 216	**475**	554

NOTES TO THE COMPANY FINANCIAL STATEMENTS

8 Other financial assets and liabilities

Details of the Company's policies on the use of financial instruments are given in the accounting policies on pages 91 and 92

The fair values of other financial instruments held by the Company are as follows

		Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Derivative financial instruments £m	Financial RRSPs £m	Total £m
At 31 December 2013							
Assets	– amounts falling due within one year	**81**	**2**	**–**	**83**	**–**	**83**
	– amounts falling due after one year	**644**	**–**	**43**	**687**	**–**	**687**
Liabilities	– amounts falling due within one year	**(85)**	**(16)**	**(1)**	**(102)**	**(40)**	**(142)**
	– amounts falling due after one year	**(143)**	**(25)**	**(48)**	**(216)**	**(187)**	**(403)**
		497	**(39)**	**(6)**	**452**	**(227)**	**225**
At 31 December 2012							
Assets	– amounts falling due within one year	113	6	5	124	–	124
	– amounts falling due after one year	500	4	90	594	–	594
Liabilities	– amounts falling due within one year	(124)	(8)	–	(132)	(42)	(174)
	– amounts falling due after one year	(241)	(15)	(7)	(263)	(184)	(447)
		248	(13)	88	323	(226)	97

Derivative financial instruments

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

Movements in the fair values of derivative financial instruments were as follows

	Foreign exchange instruments £m	Commodity instruments £m	Interest rate instruments £m	Total £m £m
At 1 January 2012	(437)	(12)	81	(368)
Movements in fair value hedges [1]	(8)	–	6	(2)
Movements in cashflow hedges	(4)	–	–	(4)
Movements in other derivative contracts	686	(3)	1	684
Contracts settled	11	2	–	13
At 1 January 2013	**248**	**(13)**	**88**	**323**
Movements in fair value hedges [1]	3	–	(91)	(88)
Movements in cashflow hedges	–	–	–	–
Movements in other derivative contracts	278	(35)	–	243
Contracts settled	(32)	9	(3)	(26)
At 31 December 2013	**497**	**(39)**	**(6)**	**452**

[1] Gain on related hedged items £88m (2012 £2m)

Where applicable, market values have been used to determine fair values Where market values are not available, fair values have been calculated by discounting expected future cash flows at prevailing interest rates and translating at prevailing exchange rates

Financial risk and revenue sharing arrangements (RRSAs)

The Company has financial liabilities arising from financial RRSAs These financial liabilities are valued at each reporting date using the amortised cost method This involves calculating the present value of the forecast cash flows of the arrangements using the internal rate of return at the inception of the arrangements as the discount rate

NOTES TO THE COMPANY FINANCIAL STATEMENTS

8 Other financial assets and liabilities (continued)

The amortised cost values of financial RRSAs were as follows

	2013 £m	2012 £m
At 1 January	(226)	(265)
Cash paid to partners	50	51
Financing charge	(16)	(17)
Exchange adjustments	(35)	12
Changes in forecast payments	–	(7)
At 31 December	(227)	(226)

9 Borrowings

	Falling due within one year		Falling due after one year	
	2013 £m	2012 £m	2013 £m	2012 £m
Unsecured				
Overdrafts	605	549	–	–
Bank loans	200	–	200	400
7 3/4% Notes 2016 £200m	–	–	200	200
6 38% Notes 2013 US$230m [1]	–	147	–	–
6 55% Notes 2015 US$83m [1]	–	–	55	58
6 75% Notes 2019 £500m [2]	–	–	535	571
2 125% Notes 2021 €750m [1]	–	–	611	–
3 375% Notes 2026 £375m [2]	–	–	350	–
	805	696	**1,951**	1 229
Repayable – otherwise than by installments				
Between one and two years			55	–
Between two and five years			200	458
After five years			1,696	771
			1,951	1 229

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

10 Other creditors

	Falling due within one year		Falling due after one year	
	2013 £m	2012 £m	2013 £m	2012 £m
Payments received on account [1]	444	331	651	609
Trade creditors	555	548	14	–
Amounts owed to – subsidiary undertakings	3,458	2,688	–	–
– joint ventures	182	194	1	2
Corporate taxation	84	89	–	–
Other taxation and social security	33	34	–	–
Other creditors	1,181	1,000	84	87
Accruals and deferred income	1 003	959	380	231
	6,940	5 843	**1,130**	929
[1] Includes payments received from joint ventures	65	151	151	162

NOTES TO THE COMPANY FINANCIAL STATEMENTS

11 Provisions for liabilities and charges

	At 31 December 2012 £m	Disposal of business £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At 31 December 2013 £m
Warranties and guarantees	29	(2)	–	3	(2)	28
Contract loss	17	–	–	–	–	17
Customer financing	72	–	(8)	21	(14)	71
Restructuring	4	9	–	14	(3)	24
	122	7	(8)	38	(19)	140

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

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

Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 18 Timing of utilisation is uncertain

12 Deferred taxation

	£m
At 1 January 2013	85
Amount charged to profit and loss account	(102)
Amount charged to statement of total recognised gains and losses	149
At 31 December 2013	132

There are other deferred tax assets totalling £102m (2012 £102m) that have not been recognised on the basis that their future economic benefit is uncertain

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 profit and loss except to the extent that they relate to items previously charged or credited to reserves Accordingly, in 2013, £22m has been credited to the profit and loss account, and £10m has been credited to the statement of total recognised gains and losses

The analysis of the deferred tax position is as follows

	2013 £m	2012 £m
Fixed asset timing differences	(84)	(93)
Other timing differences	17	57
Pensions and other post-retirement scheme benefits	(83)	(233)
Foreign exchange and commodity financial assets and liabilities	(92)	(56)
Losses	307	349
Advance corporation tax	61	61
Research and development expenditure credit	6	–
	132	85
Included within		
Debtors – amounts falling due after one year	215	318
Post-retirement scheme – surpluses	(83)	(238)
– deficits	–	5
	132	85

The above figures exclude taxation payable on capital gains which might arise from the sale of fixed assets at the values at which they are stated in the Company's balance sheet

NOTES TO THE COMPANY FINANCIAL STATEMENTS

13 Post-retirement benefits

Defined benefit schemes

For the defined benefit schemes the assets are held in separate trustee administered funds and employees are entitled to retirement benefits based on either their final or career average salaries and length of service

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to 31 December 2013 The most recent funding valuations of the main schemes were

Scheme	Valuation date
Rolls-Royce Pension Fund	31 March 2012
Rolls-Royce Group Pension Scheme	5 April 2013
Vickers Group Pension Scheme	31 March 2013

The principal actuarial assumptions used at the balance sheet date were as follows

	2013 %	2012 %
Rate of increase in salaries	4 5	4 1
Discount rate	4 4	4 4
Expected rate of return on scheme assets	4 0	3 1
Inflation assumption [1]	3 5	3 0

[1] For the UK schemes this is the assumptions for the Retail Price Index The Consumer Price Index is assumed to be 1 per cent lower

The discount rates are determined by reference to the market yields on AA rated corporate bonds For the main schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve For less significant schemes the rate is determined as the market yield at the average duration of the forecast benefit payments The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities

The overall expected rate of return is calculated by weighting the individual returns expected from each asset class (see below) in accordance with the actual asset balance in the schemes' investment portfolios

The mortality assumptions adopted for the pension schemes are derived from the SAPS actuarial tables, with 80 per cent of long cohort, published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant scheme's actual experience The resulting range of life expectancies in the principal schemes are as follows

Life expectancy from age 65

	2013	2012
Current male pensioner	22 5	22 6
Future male pensioner currently aged 45	24 2	24 4

Other demographic assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and other relevant data The assumptions are reviewed and updated as necessary as part of the periodic actuarial valuation of the schemes

	2013 £m	2012 £m
Present value of funded obligations	(8,970)	(8 533)
Fair value of scheme assets	9,539	9,734
Unrecognised surplus [1]	(154)	(187)
Surplus	415	1 014
Related deferred tax liability	(83)	(233)
Net asset recognised in the balance sheet	332	781
Analysed as		
Post retirement scheme surpluses	332	796
Post retirement scheme deficits	–	(15)
	332	781

[1] Where a surplus has arisen on a scheme in accordance with FRS 17 *Retirement benefits* the surplus is recognised as an asset only if it represents a future economic benefit available to the Company Any surplus in excess of this benefit is not recognised in the balance sheet Surpluses have arisen largely as a result of differences between the actuarial and FRS 17 valuation assumptions

NOTES TO THE COMPANY FINANCIAL STATEMENTS

13 Post-retirement benefits (continued)

Changes in present value of defined benefit obligations

	2013 £m	2012 £m
At 1 January	**(8,533)**	(7,713)
Current service cost	**(138)**	(122)
Past service credit	**(66)**	(1)
Finance cost	**(370)**	(356)
Contributions by employees	**(3)**	(4)
Benefits paid out	**334**	323
Actuarial losses	**(194)**	(660)
At 31 December	**(8,970)**	(8 533)

Changes in fair value of scheme assets

	2013 £m	2012 £m
At 1 January	**9,734**	9 519
Expected return on assets	**301**	315
Contributions by employer	**235**	250
Contributions by employees	**3**	4
Benefits paid out	**(334)**	(323)
Actuarial gains	**(400)**	(31)
At 31 December	**9,539**	9,734
Actual return on plan assets	**(99)**	284

The fair value of the scheme assets and the expected rates of return at 31 December were as follows

	2013		2012	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
LDI portfolio [1]	**3 6**	**7,592**	2 8	7924
Longevity swap [2]	**4 4**	**(156)**	4 4	(126)
Equities	**6 9**	**1,151**	5 9	1 083
Sovereign debt	**3 6**	**169**	2 7	214
Corporate bonds	**4 1**	**527**	3 6	320
Other	**3 6**	**256**	2 7	319
	4 0	**9,539**	3 2	9 734

[1] A portfolio of gilt and swap contracts backed by LIBOR generating assets that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes obligations

[2] Under the longevity swap the scheme has agreed an average life expectancy with a counterparty If pensioners live longer than expected the counterparty will make payments to the scheme to offset the additional cost of paying pensions If the reverse applies the cost of paying pensions will be reduced but the scheme will be required to make payments to the counterparty

The scheme assets do not include any financial instruments of the Rolls-Royce Holdings plc group, nor any property occupied by, or other assets used by, the group

The expected rate of return for LDI portfolios is determined by the implicit yield on the portfolio at the balance sheet date

The expected rates of return on individual categories of scheme assets are determined by reference to gilt yields Equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3 25 per cent and 0 5 per cent per annum respectively

The expected rates of return above are the weighted average of the rates for each scheme

NOTES TO THE COMPANY FINANCIAL STATEMENTS

13 Post-retirement benefits (continued)

Future contributions

The Company expects to contribute approximately £250 million to its defined benefit schemes in 2014

Sensitivities

The investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis The impacts of the principal sensitivities are

	2013 £m	2012 £m
Defined benefit obligations – 0 25% reduction in discount rate[1]	**(406)**	(315)
Defined benefit assets – 0 25% reduction in interest rates[1]	**461**	453
Defined benefit obligations – 0 25% increase in inflation	**(196)**	–
Defined benefit assets – 0 25% increase in inflation	**181**	–
Defined benefit obligations – longevity increases by one year	**(210)**	(198)
Defined benefit longevity swap – longevity increases by one year	**86**	68
Defined benefit obligations – 0 25% increase in rate of increase in salaries	**(80)**	(193)

History of defined benefit schemes

The history of the schemes for the current and prior years is as follows

	2013 £m	2012 £m	2011 £m	2010 £m	2009 £m
Balance sheet					
Present value of defined benefit obligations	**(8,970)**	(8,533)	(7,713)	(7039)	(6,714)
Fair value of scheme assets	**9,539**	9 734	9,519	7,783	7048
Unrecognised surplus	**(154)**	(187)	(696)	(164)	(75)
Asset	**415**	1 014	1 110	580	259
Experience gains/(losses)					
Actuarial gains/(losses) on scheme assets	**(400)**	(31)	1,407	444	(311)
Experience (losses)/gains on scheme liabilities	**(194)**	(660)	(617)	(142)	(865)
Movement in unrecognised surplus	**33**	509	(532)	(89)	491
Total amount recognised in the statement of total recognised gains and losses	**(561)**	(182)	258	213	(685)
Cumulative amount recognised in the statement of total recognised gains and losses [1]	**(765)**	(204)	(22)	(280)	(493)

[1] Since January 1 2002

Defined contribution schemes

The Company operates a number of defined contribution schemes The total expense recognised in the profit and loss account was **£23 million** (2012 £18 million)

14 Share capital

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At 1 January and 31 December 2013	**2,000**	**400**
Issued and fully paid		
At 1 January and 31 December 2013	**1,631**	**326**

NOTES TO THE COMPANY FINANCIAL STATEMENTS

15 Movements in capital and reserves

	Non distributable reserves					
	Share capital £m	Share premium £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m	Total equity £m
At 1 January 2013	**326**	**631**	**29**	**167**	**1,605**	**2,758**
Total recognised gains relating to the year	–	–	–	–	36	36
Dividend paid	–	–	–	–	(900)	(900)
Transfers between reserves	–	–	(3)	–	3	–
Share based payments – direct to equity	–	–	–	–	29	29
At 31 December 2013	**326**	**631**	**26**	**167**	**773**	**1,923**

16 Operating lease annual commitments

	2013 £m	2012 £m
Leases of land and buildings which expire		
Within one year	**1**	–
Between one and five years	**2**	1
After five years	**10**	3
Other leases which expire		
Within one year	**2**	1
Between one and five years	**5**	5
After five years	**–**	–

17 Share-based payments

Effect of share-based payment transactions on the Company's results

	2013 £m	2012 £m
Total expense recognised for equity-settled share based payment transactions	**37**	30

Share-based payment plans in operation during the year
During the year, the Company participated in the following share-based payment plans operated by Rolls-Royce Holdings plc

Performance Share Plan (PSP)
This plan involves the award of shares to participants subject to performance conditions Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market based performance condition (Total Shareholder Return – TSR) over a three-year period

ShareSave share option plan
Based on a three or five year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into Vesting of the options is not subject to the achievement of a performance target The plan is HM Revenue & Customs approved

Executive Share Option Plan (ESOP)
This plan involved the grant of market value share options to participants It terminated in 2009 and no further grants may be made Remaining options under the plan are subject to a non-market based performance condition (growth in EPS) and have a maximum contractual life of ten years

Annual Performance Related Award (APRA) plan deferred shares
A proportion of the APRA annual incentive scheme is delivered in the form of a deferred share award The release of deferred share awards is not dependent on the achievement of any further performance conditions other than that participants remain employed by the Company for two years from the date of the award in order to retain the full number of shares During the two year deferral period, participants are entitled to receive dividends, or equivalent, on the deferred shares

NOTES TO THE COMPANY FINANCIAL STATEMENTS

17 Share-based payments (continued)

Movements in the Company's share-based payment plans during the year

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2012	16 9	445p	0 2	106p	11 3	1 8
Granted	–	–	–	–	2 4	1 1
Additional entitlements arising from TSR perfromance	–	–	–	–	1 7	–
Forfeited	(0 2)	454p	–	–	(0 5)	–
Exercised	(0 1)	409p	(0 1)	133p	(7 0)	(0 7)
Outstanding at 31 December 2012	16 6	445p	0 1	77p	7 9	2 2
Outstanding at 31 December 2012	–	–	0 1	77p	–	–
Outstanding at 31 December 2012	**16 6**	**445p**	**0 1**	**77p**	**7 9**	**2 2**
Granted	5 7	961p	–	–	1 4	1 0
Additional entitlements arising from TSR perfromance	–	–	–	–	0 6	–
Forfeited	(0 3)	499p	–	–	(0 3)	(0 1)
Exercised	(6 3)	405p	(0 1)	77p	(2 8)	(1 3)
Outstanding at 31 December 2013	**15 7**	**646p**	**–**	**–**	**6 8**	**1 8**

As share options are exercised throughout the year, the weighted average share price during the year of **1123p** (2012 836p) is representative of the weighted average share price at the date of exercise The middle market closing price at 31 December 2013 was **1275p** (2011 873 5p)

There were no exercisable options as at 31 December 2013 The average remaining contractual life of exercisable options as at 31 December 2013 is **0** years (2012 0 2 years)

Fair values of share-based payment plans

The weighted average fair values per share of equity-settled share-based payment plans granted during the year, estimated at the date of grant are as follows

	2013	2012
PSP – 25% TSR uplift	**1128p**	885p
PSP – 50% TSR uplift	**1254p**	985p
ShareSave – 3 year grant	**287p**	n/a
ShareSave – 5 year grant	**349p**	n/a
APRA	**1027p**	809p

Expected volatility is based on the historical volatility of Rolls-Royce Holdings plc's share price over the seven years prior to the grant or award date Expected dividends are based on Rolls-Royce Holdings plc's payments to shareholders in respect of the previous year

PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting This adjustment increases the fair value of the award relative to the share price at the date of grant

ShareSave

The fair value of the options granted under the ShareSave plan is calculated using a binomial pricing model that assumes that participants will exercise their options at the beginning of the six month window if the share price is greater than the exercise price Otherwise it assumes that options are held until the expiration of their contractual term This results in an expected life that falls somewhere between the start and end of the exercise window

APRA

The fair value of shares awarded under APRA is calculated as the share price on the date of the award, excluding expected dividends

NOTES TO THE COMPANY FINANCIAL STATEMENTS

18 Contingent liabilities

In connection with the sale of its products the Company will, on some occasions, provide financing support for its customers The Company's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio

Contingent liabilities are disclosed on a discounted basis As the directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a value that is expected to crystallise However, the amounts are discounted at the Company's borrowing rate to reflect better the time span over which these exposures could arise The contingent liabilities are denominated in US dollars As the Company does not adopt cash flow hedge accounting for forecast foreign exchange transactions, this amount is reported together with the sterling equivalent at the reporting date spot rate

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions were

	2013		2012	
	£m	$m	£m	$m
Gross contingent liabilities	356	589	569	925
Value of security[1]	(217)	(360)	(381)	(620)
Indemnities	(80)	(132)	(118)	(192)
Net commitments	59	97	70	113
Net commitments with security reduced by 20%[2]	78	129	133	216
[1] Security includes cash collateral of	50	83	64	104

[2] Although sensitivity calculations are complex the reduction of the relevant security by 20% illustrates the sensitivity of the contingent liability to this assumption

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

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 Company in the ordinary course of business for product delivery, performance and reliability The Company has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items The Company is party to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts As a consequence of the insolvency of an insurer as previously reported, the Company is no longer fully insured against known and potential claims from employees who worked for certain of the Company's UK based businesses for a period prior to the acquisition of those businesses by the Company While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Company

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee At 31 December 2013, there were Company guarantees in respect of joint ventures amounting to **£7m** (2012 £12m)

The Company participates in a Cash Pooling Arrangement Under the Pooling Arrangement the Company benefits from more favourable interest rates than would be available outside of the Pooling Arrangement as well as more streamlined treasury functions As part of the Pooling Arrangement, the Company cross-guarantees the borrowings of other pooling participants At 31 December 2013 these guarantees amounted to **£8m** (2012 £24m)

NOTES TO THE COMPANY FINANCIAL STATEMENTS

19 Related party transactions

The Company is a wholly owned subsidiary of Rolls-Royce Group plc and therefore has taken advantage of the exemption in FRS 8 *Related party disclosures* not to disclose related party transactions with its parent company and other wholly owned group companies

There are no significant related party transactions with non wholly owned group companies

The aggregated balances with joint ventures are shown in notes 7 and 10

20 Ultimate holding company

The ultimate holding company is Rolls-Royce Holdings plc, incorporated in Great Britain The financial statements for Rolls-Royce Holdings plc may be obtained from the Company Secretary, Rolls-Royce Holdings plc, 65 Buckingham Gate, London SW1E 6AT

SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

At 31 December 2013

Subsidiaries incorporated within the UK – directly held unless marked *

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 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

Subsidiaries incorporated overseas – directly held unless marked *

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
India	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%)
Italy	Europea Microfusioni Aerospaziali S p A	Manufacture of gas turbine engine castings
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 Iberica Propulsión y Energia 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 Turbin Sanayi ve Tic A S*	Production of diesel engines and manufacturer of control systems (50%)
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

SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES

Subsidiaries incorporated overseas –directly held unless marked * (continued)

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 Marine North America Inc.*	Design and manufacture of marine equipment and marine aftermarket services
US	MTU America Inc *	Sales and service of engines and systems (50%)

The above companies 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 – directly held unless marked *

	Class	% of class held	% of total equity held
Airtanker Holdings Limited Strategic tanker aircraft PFI project	Ordinary	20	20
Airtanker Holdings 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-Royce Turbomeca Limited (UK & France) Adour and RTM 322 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 & Italy) RB199 engine collaboration	Ordinary A Shares	40 375	40

The above companies are incorporated and operate in the UK unless otherwise stated

Jointly controlled entities and associates incorporated overseas – directly held unless marked *

		Class	% of class held	% of total equity held
Australia	MTU Detroit Diesel Australia Pty Limited* Sales and servicing of diesel engines (effective interest 25%)	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* Manufacture and sale of MTU engines (effective interest 24 5%)	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	75
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 – held by subsidiary undertaking

US	Light Helicopter Turbine Engine Company (LHTEC) Rolls-Royce Corporation has a 50 per cent 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 107 to 109 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 plc

We have audited the financial statements of Rolls-Royce plc for the year ended 31 December 2013 set out on pages 40 to 106 The financial reporting framework that has been applied in the preparation of the group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice)

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006 Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members, as a body, for our audit work, for this report, or for the opinions we have formed

Respective responsibilities of directors and auditor
As explained more fully in the directors' responsibilities statement set out on page 38, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors

Scope of the audit of the financial statements
A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www frc org uk/auditscopeukprivate

Opinion on financial statements
In our opinion

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 December 2013 and of the group's loss for the year then ended,
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU,
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice,
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006

Opinion on other matter prescribed by the Companies Act 2006
In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements

Matters on which we are required to report by exception
We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us, or
- the parent company financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit

Jimmy Daboo (Senior Statutory Auditor)
for and on behalf of KPMG Audit Plc, Statutory Auditor

Chartered Accountants
15 Canada Square,
London,
E14 5GL
12 February 2013

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%

Taxation

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 76 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 10) 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 an established and structured approach to financial risk management The Financial risk committee (Frc) is accountable for managing, reporting and mitigating the Group's financial risks and exposures These risks include the Group's principal counterparty, currency, interest rate, commodity price, liquidity and credit rating risks outlined in more depth in note 16 The Frc is chaired by the Chief Financial Officer The Group has a comprehensive financial risk policy that advocates the use of financial instruments to manage and hedge business operations risks that arise from movements in financial, commodities, credit or money markets The Group's policy is not to engage in speculative financial transactions The Frc sits quarterly to review and assess the key risks and agree any mitigating actions required

Capital structure

Capital summary – £ million	2013 £m	2012 £m
Total equity	**8,134**	6 716
Cash flow hedges	**68**	63
Group capital	**8,202**	6,779
Net funds	**1,939**	1 316

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

ADDITIONAL FINANCIAL INFORMATION

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 10

Credit Rating

Rating Agency	Rating	Outlook	Grade
Moody s Investors Service	A3	Stable	Investment
Standard & Poor's	A	Stable	Investment

The Group's holding company, Rolls-Royce Holdings plc, subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings At 31 December 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 these 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

The following changes in accounting policy have been applied retrospectively

- as described in the Chief Financial Officer's review and in note 1, the Group has revised its accounting for risk and revenue sharing arrangements, and
- 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

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 has been 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 adversely affect the Group's future funding requirements and make cash flow more volatile

The final EMIR rules have now been released, which exempt non-financial institutions engaged in hedging activity from this requirement

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