CHIEF FINANCIAL OFFICER'S REVIEW

Summary

	2013	Restated* 2012	Change
Order book £m	**71,612**	60,146	+19%
Underlying revenue £m	**15,505**	12,209	+27%
Underlying profit before tax £m	**1,759**	1,434	+23%
Underlying earnings per share	**65.59p**	59.59p	+10%
Full year payment to shareholders	**22.0p**	19.5p	+13%
Reported revenue £m	**15,513**	12,161	+28%
Reported profit before tax £m	**1,759**	2,766	-36%
Reported earnings per share	**73.26p**	125.38p	-42%
Net cash £m	**1,939**	1,317	
Average net cash/(debt) £m	**350**	(145)	

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

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

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

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

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

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

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

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

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

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

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

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

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

Cost and cash remain areas of intense focus going forward.

In terms of financial reporting, please note the following:

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

Mark Morris
Chief Financial Officer

2. Consistent with past practice and IFRS accounting standards, the Group provides both reported and underlying figures. We believe underlying figures are more representative of the trading performance, by excluding the impact of year end mark-to-market adjustments, principally the GBP/USD hedge book. In addition, post-retirement financing and the effects of acquisition accounting are excluded. The adjustments between the underlying income statement and the reported income statement are set out in more detail in note 2 to the financial statements. This basis of presentation has been applied consistently since the transition to IFRS in 2005.
3. The Group has changed its accounting policy in respect of entry fees arising from Risk and Revenue Sharing Arrangements (RRSAs) following discussions with the Conduct Committee of the Financial Reporting Council (FRC). This is covered further in note 1 to the financial statements.

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

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

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

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

The FRC Conduct Committee's view is that the RRSA contract cannot be divided into separate development and production phases, as the fees and development components received by the Group during the development phase are exchanged for the obligation to pay the supplier a pre-determined share of any sales receipts during the production phase. On this basis the entry fees received would be deferred in their entirety and recognised over the period of production.

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

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

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

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

[1] Consistent with FRC Conduct Committee's view

CHIEF FINANCIAL OFFICER'S REVIEW

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

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

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

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

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

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

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

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

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

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

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain: reductions in assumed market share; programme timings; increases in unit cost assumptions; and adverse movements in discount rates. There have been no significant impairments in 2013.

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

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

Underlying income statement

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

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

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

Overall funding across the schemes has improved in recent years as the Group has adopted a lower risk investment strategy that reduces volatility going forward and enables the funding position to remain stable: interest rate and inflation risks are largely hedged, and the exposure to equities is around 11 per cent of scheme assets.

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

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

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

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

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

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

Net TotalCare® assets relate to Long-Term Service Agreement (LTSA) contracts in the Civil aerospace business, including the flagship services product TotalCare. These assets represent the timing difference between the recognition of income and costs in the income statement and cash receipts and payments.

Balance sheet

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

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

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

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

Segmental reporting

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

Aerospace, comprising Civil aerospace and Defence aerospace; and

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

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

Group 2014 guidance

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

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

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