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CONSOLIDATED INCOME STATEMENT

For the year ended 31 December 2013

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2013

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

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

CONSOLIDATED BALANCE SHEET

At 31 December 2013

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

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

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

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

CONSOLIDATED CASH FLOW STATEMENT

For the year ended 31 December 2013

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

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

CONSOLIDATED CASH FLOW STATEMENT

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

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

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

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the year ended 31 December 2013

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

1 See accounting policies note 1.

2 Other reserves include a merger reserve of **£3m** (2012 £3m, 2011 £3m) and a translation reserve of **£247m** (2012 £311m, 2011 £430m).

3 At 31 December 2013, **11,960,535** ordinary shares with a net book value of **£91m** (2012 20,365,787, 2011 22,541,187 ordinary shares with net book values of £125m and £116m respectively) were held for the purpose of share-based payment plans and included in retained earnings. During the year, **16,603,840** ordinary shares with a net book value of **£118m** (2012 13,533,646 shares with a net book value of £85m) vested in share-based payment plans. During the year, the Company acquired **298,588** of its ordinary shares via reinvestment of dividends received on its own shares. In addition, the Company issued **7,900,000** new ordinary shares to the Group's share trust for its employees share-based payment plans with a net book value of **£81m**.

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

5 On 2 January 2012, the Group contributed its interest in Bergen Engines AS to Rolls-Royce Power Systems Holding GmbH (RRPSH – previously Engine Holding GmbH), a company jointly held by Rolls-Royce and Daimler AG. Under the terms of agreement with Daimler, Rolls-Royce retained certain rights such that Bergen Engines continued to be classified as a subsidiary and consolidated.

6 As part of the RRPSH shareholders' agreement, Daimler has the option to sell its shares in RRPSH to Rolls-Royce for a period of six years from 1 January 2013. The initial fair value of the exercise price of this option in respect of Bergen Engines AS (£166m) was recognised in 2012 and that amount in respect of RRPS (£1,432m) has been recognised in 2013 and charged to retained earnings. In addition, £45m of the initial recognition of the put option on NCI relating to Bergen Engine AS, recognised in 2012, has been reclassified from NCI to retained earnings. Subsequent movements in the value of this liability are included in the income statement, but excluded from the underlying results.

7 On 1 January 2013, the Group exercised rights in RRPSH that resulted in Rolls-Royce Power Systems AG (RRPS – formerly Tognum AG) being classified as a subsidiary and consolidated – see note 25.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies

The Company

The consolidated financial statements of Rolls-Royce Holdings plc (the 'Company') for the year ended 31 December 2013 consist of the consolidation of the financial statements of the Company and its subsidiaries (together referred to as the 'Group') and include the Group's interest in jointly controlled and associated entities.

Basis of preparation and statement of compliance

In accordance with European Union (EU) regulations, these financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), as adopted for use in the EU effective at 31 December 2013 (Adopted IFRS).

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

These consolidated financial statements have been prepared on the historical cost basis except where Adopted IFRS requires the revaluation of financial instruments to fair value and certain other assets and liabilities on an alternative basis – most significantly post-retirement scheme liabilities are valued on the basis required by IAS 19 *Employee Benefits* – and on a going concern basis as described on page 72.

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

The preparation of financial statements in conformity with Adopted IFRS requires management to make estimates and judgements that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period; the key areas of judgement and key sources of estimation uncertainty are described below. Actual results could differ from those estimates.

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

Amendment to accounting policy

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

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

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

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

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

1 Accounting policies (continued)

Key areas of judgement

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

- Assessing whether or not the Group controls Rolls-Royce Power Systems Holding GmbH (RRPSH) requires judgement. The shares of RRPSH are held equally by the Group and Daimler AG and the rights of each shareholder are encapsulated in shareholder agreements which set out, amongst other things, key matters on which the Group has the casting vote at the Shareholders' Committee of RRPSH. These most important matters subject to casting vote which are relevant to assessing whether RRPSH is controlled include (a) setting the annual budget and operating and financial plan, (b) appointing, removing and setting the remuneration of key management personnel (though removal of the CEO or the CFO requires joint agreement), (c) entering into contracts in the ordinary course of business and (d) establishing management procedures and responsibilities. The Group considers that these provisions are sufficient to give it control over RRPSH. Daimler AG has protective rights covering matters such as: (i) significant changes to the scale, scope and financing of RRPSH's business; (ii) certain significant supplier relationships; and (iii) changes to contractual arrangements between RRPSH and Rolls-Royce. These are not considered sufficient to prevent the Group from directing the activities of RRPSH.
- A large proportion of the Group's activities relate to long-term aftermarket contracts. The determination of appropriate accounting policies for recognising revenue and costs in respect of these contracts requires judgement:
  i) whether a long-term aftermarket contract is linked, for accounting purposes, to the related sale of original equipment – where the long-term aftermarket contract is agreed (or agreed in principle) at the same time as the original equipment contract, these are considered to be linked for accounting purposes and treated as a single contract – or whether it should be treated separately; and
  ii) the appropriate measure of stage of completion of the contract – this will vary depending on the precise nature of the arrangements. Where the service provided is assessed to be continuous, the stage of completion is measured by reference to the flying hours, or equivalent, under the contract. Other aftermarket contracts are overhaul event based and the stage of completion is measured accordingly.
- The Group has significant intangible assets. In deciding whether certain intangible assets should be recognised, judgement is required:
  i) IAS 38 *Intangible Assets* requires that internally-generated development costs should only be recognised if strict criteria are met, in particular relating to technical feasibility and generation of future economic benefits. The directors consider that, due to the complex nature of new equipment programmes, these criteria are not met until relatively late in the programme – Civil aerospace programmes represent 54 per cent of development costs; for these, the criteria are generally satisfied at the time of the initial engine certification;
  ii) on delivery of engines without a linked long-term aftermarket contract, the Group has contractual rights to supply aftermarket parts to the customers and its intellectual rights, warranty arrangements and, where relevant, statutory airworthiness or other regulatory requirements provide reasonable control over this supply. Accordingly the directors consider that these rights meet the definition of an intangible asset in IAS 38. However, the directors do not consider that it is possible to determine a reliable fair value for this intangible asset. Accordingly, an intangible asset (recoverable engine cost or REC) is only recognised on the occasions where the contractual price of the engine is below the cost of manufacture and then only to the extent of this deficit, as this amount is a reliable value.
- RRSAs with key suppliers (workshare partners) are a feature of our Civil aerospace business. Under these contractual arrangements the key commercial objectives are that: (i) during the development phase the workshare partner shares in the risks of developing an engine by performing its own development work, providing development parts and paying a non-refundable cash entry fee; and (ii) during the production phase it supplies components in return for a share of the programme revenues as a 'life of type' supplier. The share of development costs borne by the workshare partner and of the revenues it receives reflect a jointly agreed forecast of the proportionate cost of providing its production parts compared to the overall forecast manufacturing cost of the engine.
  These arrangements are complex and have features that could be indicative of: a collaboration agreement, including sharing of risk and cost in a development programme; a long-term supply agreement; sharing of intellectual property; or a combination of these. There is no directly applicable IFRS to determine an accounting policy for the recognition of entry fees of this nature in the income statement. Consequently, in developing an accounting treatment for such entry fees that best reflects the commercial objectives of the contractual arrangement, the directors have analysed these features in the context of relevant accounting pronouncements (including those of other standard setters where these do not conflict with IFRS) and have weighed the importance of each feature in faithfully representing the overall commercial effect. The most important considerations that need to be balanced are: the transfer of development risk; the workshare partner receiving little standalone value from the payment of the entry fee; and the overall effect being collaboration between the parties which falls short of being a joint venture as the Group control the programme. Also important in the analysis is the fact that, whilst the Group and the workshare partner share risks and rewards through the life of the contract, these risks and rewards are very different during the development and production phases.
  In this context, the entry fee might be considered to represent: an amount paid as an equalisation of development costs; a payment to secure a long-term supply arrangement; a purchase of intellectual property; or some combination thereof. The accounting under these different scenarios could include: recognition of the entry fee to match the associated costs in the income statement; being spread over the life of the programme as a reduction in the cost of supply during production; or being spread over the time period of the access to the intellectual property by the workshare partner.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

The directors consider that the most important features of the arrangement are the risk sharing and that the entry fee represents a contribution to the development costs that the Group incurs in excess of its proportionate programme share. The key judgements taken in reaching this view are: the entry fee is determined by the parties on that basis and the contract specifies that, in the event that a derivative engine is to be developed further, entry fees will also be calculated on this basis; the workshare partners describe the entry fee in this way; although the workshare partner receives little stand-alone value from paying the entry fee, the entry fee together with its own development activities represent its aggregate investment in the collaboration; the amount of the entry fee does not include any amount in excess of that necessary to equalise forecast development costs; the Group is not 'on risk' for the full development costs it incurs but for that amount less the entry fees received; and, as far as can be determined, this appears to be common industry accounting for arrangements of this type, under both Adopted IFRS and US accounting standards (which we believe do not conflict with IFRS in this regard).
The resulting accounting policy (described below) represents the commercial effect of the contractual arrangements in that the Group recognises only those development costs to which it is exposed (and thus reflects the significant transfer of development risk to the workshare partner) and the costs of supply of parts during the production phase is measured at the workshare partner's share of programme revenues (which we consider to be a commercial fair value). The directors do not consider that accounting which would result in entry fees only being recognised in the production phase would appropriately reflect the sharing of development risk. Accordingly, the directors believe that the policy adopted best reflects the commercial objectives of the arrangements, the nature of the relationship with the workshare partner and is in accordance with Adopted IFRS.

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

Key sources of estimation uncertainty

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

Intangible assets arising on consolidation of Rolls-Royce Power Systems AG and put option on Rolls-Royce Power Systems Holding GmbH
The fair value of intangible assets of RRPS at 1 January 2013 involved the use of valuation techniques and the estimation of future cash flows to be generated by RRPS over a considerable period of time. The Group engaged a specialist valuer to assist with these.

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

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

- The assessment of whether the goodwill and other intangible assets (carrying value at 31 December 2013 £1,864 million) arising on the consolidation of RRPSH is impaired is dependent of the present value of the future cash flows expected to be generated by the business. These cash flows are based on the business plan jointly agreed by the shareholders.
- The assessment as to whether there are any indications of impairment of development, participation, certification, recoverable engine costs and customer relationships recognised as intangible assets (carrying values at 31 December 2013 **£2,499 million**, 31 December 2012 £1,457 million) is dependent on estimates of cash flows generated by the relevant assets and the discount rate used to calculate a present value. These estimates include the performance of long-term contractual arrangements as described below, as well as estimates for future market share, pricing and unit cost for uncontracted business. The risk of impairment is generally higher for newer programmes and, for customer specific intangible assets (RECs), for launch customers.

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

1 Accounting policies (continued)

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

Provisions
As described in the accounting policy on page 87, the Group measures provisions (carrying value at 31 December 2013 **£733 million**, 31 December 2012 £461 million) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates take account of information available and different possible outcomes.

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

Basis of consolidation

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

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

A joint venture is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. An associate is an entity, being neither a subsidiary nor a joint venture, in which the Group holds a long-term interest and where the Group has a significant influence. The results of joint ventures and associates are accounted for using the equity method of accounting.

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

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

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

Significant accounting policies

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

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

Sales of services are recognised by reference to the stage of completion based on services performed to date. As described on page 81, the assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on: flying hours or equivalent for long-term aftermarket arrangements where the service is provided on a continuous basis; costs incurred to the extent these relate to services performed up to the reporting date; or achievement of contractual milestones where relevant.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

As described on page 81, **sales of products and services** are treated as though they are a single contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single transaction with an overall profit margin. The total revenue is allocated between the two components such that the total agreed discount to list prices is allocated to revenue for each of the two components pro rata, based on the list prices. This revenue is then recognised for each component on this basis as the products are delivered and services provided, as described above. Where the contractual price of the OE component is below the revenue allocated from the combined arrangement, this will give rise to an asset included in 'amounts recoverable on contracts'. This asset reduces as services are provided, increases as costs are incurred, and reduces to zero by the end of the contract. Where the overall balance is a liability, it is recognised in 'accruals and deferred income'.

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

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

Risk and revenue sharing arrangements (RRSAs)
As described on page 81, the Group enters into arrangements with certain workshare partners under which these suppliers: (i) contribute to the forecast costs of developing an engine by performing their own development work, providing development parts and paying a non-refundable cash entry fee; and (ii) supply components for the production phase for which they receive consideration, which is an agreed proportion of the total programme revenues. Both the suppliers' contributions to the forecast non-recurring development costs and their consideration are determined by reference to their proportionate forecast scopes of supply relative to that of the engine overall. Once the forecast costs and the scopes of supply have been agreed at the inception of the contract, each party is then accountable for its own incurred costs. No accounting entries are recorded when the suppliers undertake development work or when development components are supplied. Cash sums received are recognised in the income statement, as a reduction in research and development costs incurred, to match the expensing of the Group's related costs – where the cash sums are received in advance of the related costs being expensed or where the related costs are capitalised as intangible assets, the recognition of the cash received is deferred (in accruals and deferred income) to match the recognition of the related expense or the amortisation of the related intangible asset respectively. The payments to suppliers of their shares of the programme revenues for their production components are charged to cost of sales as programme revenues arise.

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

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

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

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

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

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

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

1 Accounting policies (continued)

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax is not recognised on taxable temporary differences arising on the initial recognition of goodwill or for temporary differences arising from the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit.

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

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

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

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

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

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

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

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

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

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

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

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

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

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

Business combinations and goodwill

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

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

Certification costs and participation fees

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

Research and development

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

All research phase expenditure is charged to the income statement. Development expenditure is capitalised as an internally generated intangible asset only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits. As described on page 81, the Group considers that it is not possible to distinguish reliably between research and development activities until relatively late in the programme.

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

The fair value of research and development recognised during a business combination relate to the acquired company's technology. Amortisation occurs on a straight-line basis over its useful economic life, up to a maximum of 15 years.

Recoverable engine costs

The Group may sell OE to customers at a price below its cost, on the basis that this deficit will be recovered from the profits of highly probable future aftermarket sales. As described on page 81, this sale is considered to give rise to an intangible asset, which, subject to an impairment review, is recognised at the time of delivery and amortised on a straight-line basis over the period that highly probable aftermarket sales are expected to be earned.

Customer relationships

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

1 Accounting policies (continued)

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

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

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

i) land and buildings, as advised by the Group's professional advisers:
   a) freehold buildings – five to 45 years (average 24 years)
   b) leasehold buildings – lower of adviser's estimates or period of lease
   c) no depreciation is provided on freehold land
ii) plant and equipment – five to 25 years (average 13 years)
iii) aircraft and engines – five to 20 years (average 15 years).

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

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

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

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

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

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

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

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

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies (continued)

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

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

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

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

The cost of shares of Rolls-Royce Holdings plc held by the Group for the purpose of fulfilling obligations in respect of employee share plans is deducted from equity in the consolidated balance sheet. See note 21 for a further description of the share-based payment plans.

Sales financing support
In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers. These arrangements fall into two categories: credit-based guarantees; and asset-value guarantees. In accordance with the requirements of IAS 39 and IFRS 4 *Insurance Contracts*, credit-based guarantees are treated as insurance contracts. The Group considers asset-value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts. As described on page 82, the directors consider the likelihood of crystallisation is assessing whether provision is required for any contingent liabilities.

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

Revisions to Adopted IFRS in 2013
With effect from 1 January 2013, the Group has adopted the amendments to IAS 19 *Employee Benefits* issued by the IASB in June 2011. A description of these amendments and their effect is set out in note 19. In summary, the amendments require:

- recognition of certain administrative costs as operating costs rather than being included in net financing;
- net financing to be calculated on the net asset or liability recognised on the balance sheet using an AA corporate bond rate rather than using an expected rate of return for scheme assets; and
- immediate recognition of previously unrecognised past-service credits.

Had these amendments not been adopted, the results would have been affected as follows:

- profit before financing **£15 million** higher (2012 £22 million higher);
- net post-retirement financing **£107 million** higher (2012 £56 million higher); and
- net assets **£73 million** lower (2012 £100 million lower).

Revisions to IFRS not applicable in 2013
Standards and interpretations issued by the IASB are only applicable if endorsed by the EU.

Under Adopted IFRS, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities* and amendments to IAS 17 *Separate Financial Statements* are effective for 2014. The principal potential effect is that certain entities previously classified as joint ventures might be classified as joint operations, requiring the Group's share of the individual assets and liabilities of these entities to be included in the financial statements rather than the equity accounting method previously applied. The Group has reviewed its material joint ventures and has concluded that none are to be classified as joint operations under the requirements of IFRS 11. If endorsed, IFRS 9 *Financial Instruments* will simplify the classification of financial assets for measurement purposes, but is not anticipated to have a significant impact on the financial statements.

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

2 Segmental analysis

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

Civil aerospace	– development, manufacture, marketing and sales of commercial aero engines and aftermarket services.
Defence aerospace	– development, manufacture, marketing and sales of military aero engines and aftermarket services.
Marine	– development, manufacture, marketing and sales of marine-power propulsion systems and aftermarket services.
Energy	– development, manufacture, marketing and sales of power systems for the offshore oil and gas industry and electrical power generation and aftermarket services.
Power Systems	– development, manufacture, marketing and sales of diesel engines.

Engineering and technology and Operations, discussed in the strategic report, operate on a Group-wide basis across all the above segments.

The operating results reviewed by the Board are prepared on an underlying basis, which the Board considers reflects better the economic substance of the Group's trading during the year. The principles adopted to determine underlying results are:

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

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

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

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

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

Year ended 31 December 2013	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Power Systems £m	Inter-segment £m	Total reportable segments £m
Underlying revenue from sale of original equipment	3,035	1,385	1,438	415	2,004	(72)	8,205
Underlying revenue from aftermarket services	3,620	1,206	1,089	633	827	(75)	7,300
Total underlying revenue	6,655	2,591	2,527	1,048	2,831	(147)	15,505
Underlying operating profit excluding share of results of joint ventures and associates	708	424	281	15	296	2	1,726
Share of results of joint ventures and associates	136	14	–	11	(2)	–	159
Underlying profit before financing and taxation	844	438	281	26	294	2	1,885
Segment assets	9,587	1,437	1,910	1,407	3,927	(744)	17,524
Investments in joint ventures and associates	495	17	6	54	29	–	601
Segment liabilities	(6,243)	(1,660)	(1,312)	(688)	(3,034)	733	(12,204)
Net assets/(liabilities)	3,839	(206)	604	773	922	(11)	5,921
Investment in intangible assets, property, plant and equipment and joint ventures and associates	891	103	37	66	142	–	1,239
Depreciation, amortisation and impairment	349	53	75	51	272	–	800

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis (continued)

Year ended 31 December 2012 (restated – see note 1)	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Power Systems £m	Inter-segment £m	Total reportable segments £m
Underlying revenue from sale of original equipment	2,934	1,231	1,288	344	118	(22)	5,893
Underlying revenue from aftermarket services	3,503	1,186	961	618	169	(121)	6,316
Total underlying revenue	6,437	2,417	2,249	962	287	(143)	12,209
Underlying operating profit excluding share of results of joint ventures and associates	613	382	295	7	32	(11)	1,318
Share of results of joint ventures and associates	130	13	(1)	12	77	–	231
Underlying profit before financing and taxation	743	395	294	19	109	(11)	1,549
Segment assets	8,683	1,434	2,059	1,279	150	(682)	12,923
Investments in joint ventures and associates	440	(22)	4	50	1,328	–	1,800
Segment liabilities	(5,819)	(1,797)	(1,467)	(570)	(282)	671	(9,264)
Net assets/(liabilities)	3,304	(385)	596	759	1,196	(11)	5,459
Investment in intangible assets, property, plant and equipment and joint ventures and associates	581	126	101	94	11	–	913
Depreciation, amortisation and impairment	322	46	55	42	4	–	469

Reconciliation to reported results

Year ended 31 December 2013	**Total reportable segments £m**	**Underlying central items £m**	**Total underlying £m**	**Underlying adjustments £m**	**Group £m**
Revenue from sale of original equipment	**8,205**	**–**	**8,205**	**70**	**8,275**
Revenue from aftermarket services	**7,300**	**–**	**7,300**	**(62)**	**7,238**
Total revenue	**15,505**	**–**	**15,505**	**8**	**15,513**
Operating profit excluding share of results of joint ventures and associates	**1,726**	**(54)**[1]	**1,672**	**(297)**	**1,375**
Share of results of joint ventures and associates	**159**	**–**	**159**	**1**	**160**
Profit on transfer of joint ventures to subsidiaries	**–**	**–**	**–**	**119**	**119**
Profit on disposal of businesses	**–**	**–**	**–**	**216**	**216**
Profit before financing and taxation	**1,885**	**(54)**	**1,831**	**39**	**1,870**
Net financing		**(72)**	**(72)**	**(39)**	**(111)**
Profit before taxation		**(126)**	**1,759**	**–**	**1,759**
Taxation		**(434)**	**(434)**	**54**	**(380)**
Profit for the year		**(560)**	**1,325**	**54**	**1,379**
Ordinary shareholders			**1,224**	**143**	**1,367**
Non-controlling interests			**101**	**(89)**	**12**
Profit for the year			**1,325**	**54**	**1,379**

Year ended 31 December 2012 (restated – see note 1)	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Revenue from sale of original equipment	5,893	–	5,893	41	5,934
Revenue from aftermarket services	6,316	–	6,316	(89)	6,227
Total revenue	12,209	–	12,209	(48)	12,161
Operating profit excluding share of results of joint ventures and associates	1,318	(54)[1]	1,264	(59)	1,205
Share of results of joint ventures and associates	231	–	231	(58)	173
Profit on disposal of businesses	–	–	–	699	699
Profit before financing and taxation	1,549	(54)	1,495	582	2,077
Net financing		(61)	(61)	750	689
Profit before taxation		(115)	1,434	1,332	2,766
Taxation		(317)	(317)	(114)	(431)
Profit for the year		(432)	1,117	1,218	2,335
Ordinary shareholders			1,103	1,218	2,321
Non-controlling interests			14	–	14
Profit for the year			1,117	1,218	2,335

[1] Central corporate costs.

2 Segmental analysis (continued)

Underlying adjustments

	2013				2012*			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**15,505**	**1,831**	**(72)**	**(434)**	12,209	1,495	(61)	(317)
Revenue recognised at exchange rate on date of transaction	**8**	**–**	**–**	**–**	(48)	–	–	–
Realised gains on settled derivative contracts [1]	**–**	**(10)**	**(5)**	**–**	–	(25)	–	–
Net unrealised fair value changes to derivative contracts [2]	**–**	**–**	**250**	**–**	–	–	747	–
Effect of currency on contract accounting	**–**	**(18)**	**–**	**–**	–	(23)	–	–
Put option on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	**–**	**–**	**(251)**	**–**	–	–	11	–
Effect of acquisition accounting [3]	**–**	**(265)**	**–**	**–**	–	(69)	–	–
Profit on reclassification of joint ventures to subsidiaries	**–**	**119**	**–**	**–**	–	–	–	–
Pensions discretionary increase [4]	**–**	**(64)**	**–**	**–**	–	–	–	–
Net post-retirement scheme financing	**–**	**–**	**(26)**	**–**	–	–	(8)	–
Profit on disposal of businesses	**–**	**216**	**–**	**–**	–	–	–	–
Other [5]	**–**	**61**	**(7)**	**–**	–	–	–	–
Related tax effect	**–**	**–**	**–**	**54**	–	–	–	(151)
IAE restructuring	**–**	**–**	**–**	**–**	–	699	–	37
Total underlying adjustments	**8**	**39**	**(39)**	**54**	(48)	582	750	(114)
Reported per consolidated income statement	**15,513**	**1,870**	**(111)**	**(380)**	12,161	2,077	689	(431)

[1] Realised gains on settled derivative contracts include adjustments to reflect (gains)/losses in the same period as the related trading cash flows.
[2] Unrealised fair value changes to derivative contracts: (i) include those included in equity accounted joint ventures; and (ii) exclude those for which the related trading contracts have been cancelled when the fair value changes are recognised immediately in underlying profit.
[3] The adjustment eliminates charges recognised as a result of recognising assets in acquired businesses at fair value.
[4] Discretionary increase of £64m on unindexed pensions – see Chief Financial Officer's review on page 12.
[5] Other includes the exclusion of other operating income of £63m and the revaluation of preference shares in RRPS, which have now been acquired.

The reconciliation of underlying earnings per ordinary share is shown in note 6.

		Restated*	
	2013 £m	31 December 2012 £m	1 January 2012 £m
Reportable segment assets	**17,524**	12,923	12,425
Investments in joint ventures and associates	**601**	1,800	1,680
Cash and cash equivalents and short-term investments	**4,311**	2,596	1,321
Fair value of swaps hedging fixed rate borrowings	**47**	104	106
Income tax assets	**332**	375	407
Post-retirement scheme surpluses	**248**	348	520
Total assets	**23,063**	18,146	16,459
Reportable segment liabilities	**(12,204)**	(9,264)	(9,463)
Borrowings	**(2,371)**	(1,383)	(1,204)
Fair value of swaps hedging fixed rate borrowings	**(48)**	–	–
Income tax liabilities	**(1,096)**	(710)	(583)
Post-retirement scheme deficits	**(1,041)**	(793)	(807)
Total liabilities	**(16,760)**	(12,150)	(12,057)
Net assets	**6,303**	5,996	4,402

* Restated – see note 1.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2 Segmental analysis (continued)

Geographical segments

The Group's revenue by destination is shown below:

	2013 £m	2012 £m
United Kingdom	**1,803**	1,641
Norway	**520**	446
Germany	**977**	319
Switzerland	**871**	63
Spain	**178**	177
Italy	**236**	151
France	**259**	182
Russia	**114**	165
Rest of Europe	**670**	613
USA	**3,972**	3,999
Canada	**507**	351
South America	**393**	303
Saudi Arabia	**547**	308
Rest of Middle East	**426**	389
India	**244**	148
China	**1,087**	1,117
South Korea	**452**	194
Japan	**244**	158
Malaysia	**292**	322
Singapore	**558**	333
Rest of Asia	**772**	376
Africa	**139**	123
Australasia	**174**	240
Other [1]	**78**	43
	15,513	12,161

[1] Other revenue mainly originates from Central America.

In 2012, revenue (included in all reportable segments other than Power Systems) of £1,203 million was received from a single customer. In 2013, no single customer represented ten per cent or more of the Group's revenue.

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

	2013 £m	2012 £m
United Kingdom	**3,649**	3,139
North America	**872**	723
Nordic countries	**823**	889
Germany	**2,739**	2,023
Other	**924**	497
	9,007	7,271

3 Other income and expenses

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

Research and development costs

	2013 £m	2012* £m
Expenditure in the year	(750)	(572)
Capitalised as intangible assets	110	38
Amortisation of capitalised costs	(130)	(55)
Net research and development cost	(770)	(589)
Entry fees received	126	33
Entry fees deferred in respect of charges in future years	(50)	(5)
Recognition of previously deferred entry fees	11	30
Net cost recognised in the income statement	(683)	(531)
Underlying adjustments relating to effects of acquisition accounting and foreign exchange	59	–
Net underlying cost recognised in the income statement	(624)	(531)

* Restated – see note 1.

4 Net financing

	Note	2013 Per consolidated income statement £m	2013 *Underlying financing*[1] £m	2012 Per consolidated income statement £m	2012 *Underlying financing*[1] £m
Financing income					
Interest receivable		15	*15*	10	*10*
Fair value gains on foreign currency contracts[2]	17	287	–	750	–
Put options on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	17	8	–	11	–
Financing income on post-retirement scheme surpluses	19	17	–	26	–
		327	*15*	797	*10*
Financing costs					
Interest payable		(58)	*(58)*	(51)	*(51)*
Fair value losses on foreign currency contracts[2]	17	(3)	–	–	–
Put options on NCI and financial RRSAs – foreign exchange differences and other unrealised changes in value	17	(259)	–	–	–
Financial charge relating to financial RRSAs	17	(9)	*(9)*	(10)	*(10)*
Fair value losses on commodity derivatives[2]	17	(34)	–	(3)	–
Financing costs on post-retirement scheme deficits	19	(43)	–	(34)	–
Net foreign exchange losses		(5)	–	–	–
Other financing charges		(27)	*(20)*	(10)	*(10)*
		(438)	*(87)*	(108)	*(71)*
Net financing		(111)	*(72)*	689	*(61)*
Analysed as:					
Net interest payable		(43)	*(43)*	(41)	*(41)*
Net post-retirement scheme financing		(26)	–	(8)	–
Net other financing		(42)	*(29)*	738	*(20)*
Net financing		(111)	*(72)*	689	*(61)*
[1] See note 2					
[2] Net gain on fair value items through profit or loss		250	–	747	–

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 Taxation

	UK		Overseas		Total	
	2013 £m	2012* £m	2013 £m	2012* £m	2013 £m	2012* £m
Current tax						
Current tax charge/(credit) for the year	**7**	(3)	**290**	218	**297**	215
Less double tax relief	**(1)**	(1)	**–**	–	**(1)**	(1)
	6	(4)	**290**	218	**296**	214
Adjustments in respect of prior years	**2**	(7)	**29**	(18)	**31**	(25)
	8	(11)	**319**	200	**327**	189
Deferred tax						
Charge/(credit) for the year	**224**	216	**(66)**	38	**158**	254
Adjustments in respect of prior years	**(8)**	1	**(37)**	6	**(45)**	7
Credit resulting from reduction in tax rates	**(59)**	(19)	**(1)**	–	**(60)**	(19)
	157	198	**(104)**	44	**53**	242
Recognised in the income statement	**165**	187	**215**	244	**380**	431

Other tax (charges)/credits

	OCI				Equity	
	Items that will not be reclassified		Items that may be reclassified			
	2013 £m	2012* £m	2013 £m	2012 £m	2013 £m	2012 £m
Current tax:						
Share-based payments – direct to equity					**5**	3
Deferred tax:						
Net investment hedge			**1**	(1)		
Movement in post-retirement schemes	**10**	105				
Share-based payments – direct to equity					**8**	6
	10	105	**1**	(1)	**13**	9

Tax reconciliation

	2013 £m	2012* £m
Profit before taxation	**1,759**	2,766
Less share of results of joint ventures and associates (note 11)	**(160)**	(173)
Profit before taxation excluding joint ventures and associates	**1,599**	2,593
Nominal tax charge at UK corporation tax rate 23.25% (2012 24.5%)	**372**	635
UK R&D credit	**(13)**	(26)
Rate differences	**51**	59
Profit on reclassification of joint ventures to subsidiaries	**(27)**	–
Changes in value of put option on NCI	**60**	–
Restructuring of IAE [1]	**–**	(209)
Other permanent differences	**12**	9
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	**(7)**	–
Tax losses in year not recognised in deferred tax	**6**	–
Adjustments in respect of prior years	**(14)**	(18)
Reduction in closing deferred taxes resulting from decrease in tax rates	**(60)**	(19)
	380	431
Underlying items (note 2)	**434**	317
Non-underlying items	**(54)**	114
	380	431

* Restated – see note 1.
[1] Pursuant to the Substantial Shareholdings Exemption, the majority of the upfront proceeds received on the IAE restructuring were not subject to tax.

5 Taxation (continued)

Deferred taxation assets and liabilities

	2013 £m	2012 £m
At 1 January, as previously reported		(77)
Effect of amendments to IAS 19 – see note 19		(43)
Effect of amendment to RRSAs – see note 1		62
At 1 January as restated	**(242)**	(58)
Amount charged to income statement	**(53)**	(242)
Amount credited to other comprehensive income	**11**	104
Amount credited to equity	**8**	6
Acquisition of businesses	**(282)**	(1)
Transferred to assets held for sale	**–**	(46)
Exchange differences	**(8)**	(5)
At 31 December	**(566)**	(242)
Deferred tax assets	**316**	342
Deferred tax liabilities	**(882)**	(584)
	(566)	(242)

The analysis of the deferred tax position is as follows:

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

	Restated*							
	At 1 January 2012 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Transferred to assets held for sale £m	Exchange movements £m	At 31 December 2012 £m
Intangible assets	(243)	58	–	–	–	(46)	(1)	(232)
Property, plant and equipment	(135)	(25)	–	–	1	–	1	(158)
Other temporary differences	1	10	(1)	–	–	–	2	12
Amounts recoverable on contracts	(250)	(101)	–	–	–	–	–	(351)
Pensions and other post-retirement scheme benefits	56	(41)	105	–	(2)	–	(8)	110
Foreign exchange and commodity financial assets and liabilities	121	(177)	–	–	–	–	–	(56)
Losses	328	34	–	6	–	–	1	369
Advance corporation tax	64	–	–	–	–	–	–	64
	(58)	(242)	104	6	(1)	(46)	(5)	(242)

* Restated – see note 1.

	2013 £m	2012 £m
Advance corporation tax	**118**	118
Losses and other unrecognised deferred tax assets	**39**	39
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	**157**	157

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 Taxation (continued)

Deferred taxation assets and liabilities

The 2013 Budget announced that the UK corporation tax rate will reduce to 21 per cent from 1 April 2014 and to 20 per cent from 1 April 2015. These reductions were substantively enacted on 2 July 2013. As the reduction to 20 per cent was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been calculated at this rate. The resulting charges or credits have been recognised in the income statement except to the extent that they relate to items previously charged or credited to OCI or equity. Accordingly, in 2013, £59 million has been credited to the income statement, £1 million has been charged to the OCI and £9 million has been charged directly to equity.

The temporary differences associated with investments in subsidiaries, joint ventures and associates, for which a deferred tax liability has not been recognised, aggregate to **£573 million** (2012 £144 million). No deferred tax liability has been recognised on the potential withholding tax due on the remittance of undistributed profits as the Group is able to control the timing of such remittances and it is probable that consent will not be given in the foreseeable future.

6 Earnings per ordinary share

Basic earnings per ordinary share (EPS) are calculated by dividing the profit attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares held under trust, which have been treated as if they had been cancelled.

Diluted EPS are calculated by adjusting the weighted average number of ordinary shares in issue during the year for the bonus element of share options.

2012 figures have been restated to reflect the adoption of amendments to IAS 19 *Employee Benefits* – see note 19, and the change in the accounting policy for RRSAs – see note 1. The impact of the restatement on the previously reported EPS of 123.23p was an increase of 1.40p relating to the IAS 19 amendments and an increase of 0.75p relating to the change in the accounting policy for RRSAs.

	2013			2012		
	Basic	Potentially dilutive share options	Diluted	Basic	Potentially dilutive share options	Diluted
Profit attributable to ordinary shareholders (£m)	**1,367**		**1,367**	2,321		2,321
Weighted average number of ordinary shares (millions)	**1,866**	**21**	**1,887**	1,851	25	1,876
EPS (pence)	**73.26**	**(0.82)**	**72.44**	125.38	(1.65)	123.73

The reconciliation between underlying EPS and basic EPS is as follows:

	2013		2012*	
	Pence	£m	Pence	£m
Underlying EPS/Underlying profit attributable to ordinary shareholders	**65.59**	**1,224**	59.59	1,103
Total underlying adjustments to profit before tax (note 2)	**–**	**–**	71.96	1,332
Related tax effects	**2.89**	**54**	(6.17)	(114)
Related NCI effects	**4.78**	**89**	–	–
EPS/Profit attributable to ordinary shareholders	**73.26**	**1,367**	125.38	2,321
Excluding IAE restructuring	**73.26**	**1,367**	85.62	1,585
IAE restructuring	**–**	**–**	39.76	736
Diluted underlying EPS	**64.86**		58.80	

* The impact of the restatement on the previously reported underlying EPS of 59.27p was a decrease of 0.71p relating to the IAS 19 amendments and an increase of 1.03p relating to the change in the accounting policy for RRSAs.

7 Employee information

	2013 Number	2012 Number
Average number of employees		
United Kingdom	**24,800**	22,800
United States	**8,500**	7,200
Canada	**1,600**	1,700
Germany	**10,500**	2,800
Rest of world	**9,800**	8,300
	55,200	42,800
Civil aerospace	**23,400**	21,500
Defence aerospace	**7,900**	7,800
Marine	**9,200**	8,800
Energy	**4,000**	3,700
Power Systems	**10,700**	1,000
	55,200	42,800

	£m	£m
Group employment costs [1]		
Wages and salaries	**2,843**	2,163
Social security costs	**374**	265
Share-based payments (note 21)	**79**	55
Pensions and other post-retirement scheme benefits (note 19)	**379**	245
	3,675	2,728

[1] Remuneration of key management personnel is shown in note 24.

8 Auditors' remuneration

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

	2013 £m	2012 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements [1]	**0.2**	0.2
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**5.6**	4.5
Total fees payable for audit services	**5.8**	4.7
Fees payable to the Company's auditors and its associates for other services [2]:		
Audit related assurance services [3]	**0.8**	0.6
Taxation compliance services	**0.8**	0.3
Taxation advisory services	**0.1**	0.2
Internal audit services [4]	**0.2**	0.6
Information technology services [4]	**–**	0.4
All other services	**1.0**	0.1
	8.7	6.9
Fees payable in respect of the Group's pension schemes:		
Audit	**0.2**	0.2
Taxation compliance services	**0.1**	0.1

[1] The level of fees payable to the Company's auditors for the audit of the Company's annual financial statements reflects the fact that limited incremental work is required in respect of the audit of these financial statements. Rolls-Royce plc, a subsidiary of the Company, is also required to prepare consolidated financial statements and the fees payable to the Company's auditors for the audit of those financial statements, including the audit of the sub-consolidation, is included in the audit of the Company's subsidiaries pursuant to legislation.

[2] As described on page 46, in 2013, fees for other services to KPMG in respect of Rolls-Royce Power Systems AG (RRPS) were £2.1m. Following the consolidation of RRPS on 1 January 2013, the audit committee approved the continuation of engagements already in progress at that date.

[3] This includes **£0.3m** (2012 £0.3m) for the review of the half-year report.

[4] In 2012, as part of the Group's IT modernisation programme, KPMG provided specialist internal audit support while the Group recruited its own personnel. In addition, consulting services were provided by a firm which was acquired by KPMG after being engaged by the Group.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

9 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure[1] £m	Recoverable engine costs £m	Customer relationships[1] £m	Software[1] £m	Other[1] £m	Total £m
Cost:								
At 1 January 2012	1,106	720	998	464	45	267	134	3,734
Exchange differences	(4)	(2)	(1)	–	–	(1)	(3)	(11)
Additions	–	28	38	35	–	119	5	225
Acquisitions of businesses	10	–	–	–	–	2	7	19
Transferred from subsidiary to associate	–	–	(1)	–	–	–	–	(1)
Disposals	(1)	(6)	(6)	–	–	(2)	(1)	(16)
At 1 January 2013	**1,111**	**740**	**1,028**	**499**	**45**	**385**	**142**	**3,950**
Exchange differences	(18)	3	5	–	(3)	(1)	17	3
Additions	–	185	110	52	–	69	87	503
Acquisitions of businesses	773	–	508	–	433	–	286	2,000
Disposals of businesses	(5)	–	(5)	–	–	–	–	(10)
At 31 December 2013	**1,861**	**928**	**1,646**	**551**	**475**	**453**	**532**	**6,446**
Accumulated amortisation:								
At 1 January 2012	7	197	274	231	7	104	32	852
Charge for the year[2]	–	34	55	64	5	41	10	209
Impairment	3	–	–	–	–	–	–	3
Disposals	(1)	(6)	(6)	–	–	(1)	(1)	(15)
At 1 January 2013	**9**	**225**	**323**	**295**	**12**	**144**	**41**	**1,049**
Exchange differences	(1)	–	(7)	–	(8)	–	5	(11)
Charge for the year[2]	–	40	130	28	61	54	91	404
Impairment	17	–	3	–	4	–	–	24
Disposal of businesses	(2)	–	(5)	–	–	–	–	(7)
At 31 December 2013	**23**	**265**	**444**	**323**	**69**	**198**	**137**	**1,459**
Net book value:								
At 31 December 2013	**1,838**	**663**	**1,202**	**228**	**406**	**255**	**395**	**4,987**
At 31 December 2012	1,102	515	705	204	33	241	101	2,901
At 1 January 2012	1,099	523	724	233	38	163	102	2,882

[1] Following the acquisition of RRPS on 1 January 2013, intangible assets relating to R&D, customers relationships and software have been reclassified from 'other' into their respective categories from 1 January 2012 onwards.
[2] Charged to cost of sales except development costs, which are charged to research and development costs.

Goodwill

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

Cash-generating unit (CGU) or group of CGUs

	Primary reporting segment	2013 £m	2012 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**230**	223
Commercial marine – arising from the acquisitions of Vinters Limited and Scandinavian Electric Holding AS	Marine	**620**	649
Commercial marine – arising from the acquisition of ODIM ASA	Marine	**88**	115
Rolls-Royce Power Systems AG	Power Systems	**785**	–
Other	Various	**115**	115
		1,838	1,102

9 Intangible assets (continued)

Goodwill has been tested for impairment during 2013 on the following basis:

- The carrying value of goodwill has been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long-term and established nature of many of the Group's products (product lives are often measured in decades), these forecast the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates (2.0 – 2.75 per cent) that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate.
- The key assumptions for the impairment tests are the discount rate and, in the cash flow projections, the programme assumptions, the growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs. Impairment tests are performed using prevailing exchange rates.
- The pre-tax cash flow projections have been discounted at **13 per cent** (2012 13 per cent), based on the Group's weighted average cost of capital, adjusted for specific risk where appropriate.

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

- **Rolls-Royce Power Systems AG** – Volume of equipment deliveries, pricing achieved and cost escalation. These are based on current and known future programmes, estimates of capture of market share and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into euros. For the purposes of the impairment only, cash flows beyond the ten-year forecasts are assumed to grow at two per cent. Following the recognition of RRPS at fair value on 1 January 2013, reasonably possible changes in the key assumptions could cause the value of goodwill to fall below its carrying value, such as a reduction in the level of cash generation of nine per cent, a reduction in the assumed long-term growth rate to 0.8 per cent or an increase in the assumed discount rate of 0.7 per cent.
- **Rolls-Royce Deutschland Ltd & Co KG** – Volume of engine deliveries, flying hours of installed fleet and cost escalation. These are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposure is on translating US dollar income into euros. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at **2.5 per cent** (2012 2.5 per cent). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 85 per cent to cause an impairment of this balance.
- **Vinters Limited** – Volume of equipment deliveries, capture of aftermarket and cost escalation. These are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into Norwegian kroner. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at **2.5 per cent** (2012 2.5 per cent). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 75 per cent to cause an impairment of this balance.

Other intangible assets

Certification costs and participation fees, customer relationships, technology, patents and licences, order backlog, trademark, development costs and recoverable engine costs have been reviewed for impairment in accordance with the requirements of IAS 36 *Impairment of Assets*. Where an impairment test was considered necessary, it has been performed on the following basis:

- The carrying values have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions over the lives of the respective programmes.
- The key assumptions underlying cash flow projections are assumed market share, programme timings, unit cost assumptions, discount rates, and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at **11 per cent** (2012 11 per cent), based on the Group's weighted average cost of capital.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Group's control (discount rate, exchange rate and airframe delays), could result in impairment in future years.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

10 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At 1 January 2012	981	2,646	216	454	4,297
Exchange differences	(14)	(25)	(1)	(9)	(49)
Additions	50	124	18	299	491
Acquisitions of businesses	–	45	–	–	45
Disposals of businesses	–	(4)	–	–	(4)
Reclassifications	60	168	4	(232)	–
Disposals/write-offs	(5)	(65)	(14)	(1)	(85)
At 1 January 2013	**1,072**	**2,889**	**223**	**511**	**4,695**
Exchange differences	(11)	(28)	(2)	(8)	(49)
Additions	17	150	83	437	687
Acquisitions of businesses	202	300	–	44	546
Disposals of businesses	–	(1)	–	–	(1)
Reclassifications	19	242	21	(282)	–
Disposals/write-offs	(2)	(62)	(1)	(2)	(67)
At 31 December 2013	**1,297**	**3,490**	**324**	**700**	**5,811**
Accumulated depreciation:					
At 1 January 2012	315	1,598	44	2	1,959
Exchange differences	(3)	(13)	–	–	(16)
Charge for the year [1]	39	196	20	–	255
Reclassifications	7	(7)	–	–	–
Disposals of businesses	–	(2)	–	–	(2)
Disposals/write-offs	(3)	(58)	(2)	(2)	(65)
At 1 January 2013	**355**	**1,714**	**62**	**–**	**2,131**
Exchange differences	(9)	(22)	(1)	–	(32)
Charge for the year [1]	48	301	23	–	372
Reclassifications	(8)	8			–
Disposals of businesses	–	(1)	–	–	(1)
Disposals/write-offs	–	(51)	–	–	(51)
At 31 December 2013	**386**	**1,949**	**84**	**–**	**2,419**
Net book value:					
At 31 December 2013	**911**	**1,541**	**240**	**700**	**3,392**
At 31 December 2012	717	1,175	161	511	2,564
At 1 January 2012	666	1,048	172	452	2,338

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

Property, plant and equipment includes:

	2013 £m	2012 £m
Net book value of finance leased assets:		
Land and buildings	**7**	7
Plant and equipment	**4**	4
Assets held for use in operating leases:		
Cost	**320**	242
Depreciation	**(79)**	(65)
Net book value	**241**	177
Capital expenditure commitments	**317**	258
Cost of fully depreciated assets	**899**	721

The Group's share of equity accounted entities' capital commitments is **£150 million** (2012 £31 million).

11 Investments

	Equity accounted			Other
	Joint ventures £m	Associates £m	Total £m	Unlisted £m
At 1 January 2012	1,680	–	1,680	10
Exchange differences	(58)	–	(58)	–
Additions	191	–	191	–
Taxation paid by the Group	6	–	6	–
Transfer to subsidiary	(5)	–	(5)	–
Impairment	(2)	–	(2)	–
Share of retained profit	44	–	44	–
Transferred from subsidiary to associate	–	2	2	–
Disposals	–	–	–	(4)
Share of OCI – will not be reclassified to profit and loss	(46)	–	(46)	–
Share of OCI – may be reclassified to profit or loss	(12)	–	(12)	–
At 1 January 2013	**1,798**	**2**	**1,800**	**6**
Exchange differences	(4)	–	(4)	1
Additions	43	–	43	1
Taxation paid by the Group	6	–	6	–
Transfers to subsidiaries[1]	(1,327)	–	(1,327)	–
Acquisition of businesses	30	–	30	20
Share of retained profit	61	–	61	–
Disposals	(2)	–	(2)	(1)
Share of OCI – will not be reclassified to profit and loss	–	–	–	–
Share of OCI – may be reclassified to profit or loss	(6)	–	(6)	–
At 31 December 2013	**599**	**2**	**601**	**27**

[1] At 31 December 2012, Rolls-Royce Power Systems GmbH (a 50:50 joint holding company with Daimler AG) held 99 per cent of the RRPS AG shares. As part of the shareholders' agreement, certain conditions allowed the Group to classify RRPS AG as a subsidiary and consolidate it. These conditions were fulfilled and the rights exercised on 1 January 2013, resulting in £1,328m being transferred to subsidiaries.

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

	Joint ventures				Associates		Total	
	2013 Other £m	2012 Power Systems £m	2012 Other £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m
Assets:								
Non-current assets	**1,839**	1,590	1,717	3,307	**1**	1	**1,840**	3,308
Current assets	**852**	718	818	1,536	**2**	2	**854**	1,538
Liabilities:								
Current liabilities	**(623)**	(421)	(655)	(1,076)	**(1)**	(1)	**(624)**	(1,077)
Non-current liabilities	**(1,469)**	(559)	(1,410)	(1,969)	**–**	–	**(1,469)**	(1,969)
	599	1,328	470	1,798	**2**	2	**601**	1,800
Liabilities include borrowings of:	**(1,291)**	(103)	(1,271)	(1,374)	**–**	–	**(1,291)**	(1,374)
Revenue	**2,343**	1,223	2,827	4,050	**1**	3	**2,344**	4,053
Profit before financing and taxation	**188**	33	189	222	**–**	–	**188**	222
Net financing	**(16)**	(10)	(22)	(32)	**–**	–	**(16)**	(32)
Taxation	**(12)**	(1)	(16)	(17)	**–**	–	**(12)**	(17)
Results recognised in the consolidated income statement	**160**	22	151	173	**–**	–	**160**	173
Dividends received	**(99)**	(28)	(101)	(129)	**–**	–	**(99)**	(129)
Retained profit	**61**	(6)	50	44	**–**	–	**61**	44

The principal joint ventures at 31 December 2013 are listed on pages 128 and 129.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12 Inventories

	2013 £m	2012 £m
Raw materials	593	336
Work in progress	1,177	1,056
Long-term contracts work in progress	15	10
Finished goods	1,426	1,282
Payments on account	108	42
	3,319	2,726
Inventories stated at net realisable value	447	136
Amount of inventory write-down	89	64
Reversal of inventory write-down	5	1

13 Trade and other receivables

	2013 £m	2012 £m
Trade receivables	1,601	1,182
Amounts recoverable on contracts	2,239	1,902
Amounts owed by joint ventures and associates	380	351
Other receivables	637	479
Prepayments and accrued income	235	205
	5,092	4,119
Analysed as:		
Financial instruments (note 17):		
Trade receivables and similar items	2,118	1,662
Other non-derivative financial assets	527	364
Non-financial instruments	2,447	2,093
	5,092	4,119
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	51	40
Amounts recoverable on contracts	1,751	1,473
Amounts owed by joint ventures and associates	–	3
Other receivables	41	63
Prepayments and accrued income	84	32
	1,927	1,611

14 Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	982	674
Money-market funds	1,157	408
Short-term deposits	1,851	1,503
	3,990	2,585
Overdrafts (note 15)	(3)	–
Cash and cash equivalents per cash flow statement (page 77)	3,987	2,585
Cash held as collateral against third-party obligations (note 18)	50	64

Cash and cash equivalents at 31 December 2013 includes **£286 million** (2012 £78 million) that is not available for general use by the Group. This balance relates to cash held in non-wholly owned subsidiaries and the Group's captive insurance company.

15 Borrowings

	Current		Non-current		Total	
	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m
Unsecured						
Overdrafts	**3**	–	**–**	–	**3**	–
Bank loans	**204**	2	**412**	404	**616**	406
7$^3/_8$% Notes 2016 £200m	**–**	–	**200**	200	**200**	200
6.38% Notes 2013 US$230m [1]	**–**	147	**–**	–	**–**	147
6.55% Notes 2015 US$83m [1]	**–**	–	**55**	58	**55**	58
6.75% Notes 2019 £500m [2]	**–**	–	**535**	571	**535**	571
2.125% Notes 2021 €750m [1]	**–**	–	**611**	–	**611**	–
3.375% Notes 2026 £375m [2]	**–**	–	**350**	–	**350**	–
Secured						
Obligations under finance leases [3]	**–**	–	**1**	1	**1**	1
	207	149	**2,164**	1,234	**2,371**	1,383

[1] These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge.
[2] These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest which form a fair value hedge.
[3] Obligations under finance leases are secured by related leased assets.

16 Trade and other payables

	Current		Non-current		Total	
	2013 £m	2012* £m	2013 £m	2012* £m	2013 £m	2012* £m
Payments received on account [1]	**1,594**	1,361	**750**	609	**2,344**	1,970
Trade payables	**1,370**	1,109	**16**	–	**1,386**	1,109
Amounts owed to joint ventures and associates	**191**	202	**–**	1	**191**	203
Other taxation and social security	**101**	107	**–**	–	**101**	107
Other payables	**1,820**	1,574	**143**	95	**1,963**	1,669
Accruals and deferred income	**1,969**	2,048	**1,229**	967	**3,198**	3,015
	7,045	6,401	**2,138**	1,672	**9,183**	8,073
[1] Includes payments received on account from joint ventures and associates	**180**	262	**151**	162	**331**	424

Included within trade and other payables are government grants of **£100 million** (2012 £89 million). During the year, **£26 million** (2012 £16 million) of government grants were released to the income statement.

Included in accruals and deferred income are deferred receipts from RRSA workshare partners of **£260 million** (2012 £221 million).

Trade and other payables are analysed as follows:

	2013 £m	2012* £m
Financial instruments (note 17):		
Trade payables and similar items	**2,989**	2,571
Other non-derivative financial liabilities	**806**	704
Non-financial instruments	**5,388**	4,798
	9,183	8,073

* Restated – see note 1.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 Financial instruments

Carrying values and fair values of financial instruments

	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
At 31 December 2013									
Unlisted non-current asset investments	11	A	–	27	–	–	–	–	27
Trade receivables and similar items	13	B	–	2,118	–	–	–	–	2,118
Other non-derivative financial assets	13	B	–	527	–	–	–	–	527
Derivative financial assets		C	748	–	–	–	–	–	748
Short-term investments		B	–	321	–	–	–	–	321
Cash and cash equivalents	14	B	–	1,851	1,157	982	–	–	3,990
Borrowings	15	D	–	–	–	–	–	(2,371)	(2,371)
Derivative financial liabilities		C	–	–	–	–	(295)	–	(295)
Exercise prices of put options on NCI		E	–	–	–	–	–	(1,858)	(1,858)
Financial RRSAs		F	–	–	–	–	–	(167)	(167)
C Shares		B	–	–	–	–	–	(16)	(16)
Trade payables and similar items	16	B	–	–	–	–	–	(2,989)	(2,989)
Other non-derivative financial liabilities	16	B	–	–	–	–	–	(806)	(806)
			748	4,844	1,157	982	(295)	(8,207)	(771)
At 31 December 2012									
Unlisted non-current asset investments	11	A	–	6	–	–	–	–	6
Trade receivables and similar items	13	B	–	1,662	–	–	–	–	1,662
Other non-derivative financial assets	13	B	–	364	–	–	–	–	364
Derivative financial assets		C	707	–	–	–	–	–	707
Short-term investments		B	–	11	–	–	–	–	11
Cash and cash equivalents	14	B	–	1,503	408	674	–	–	2,585
Borrowings	15	D	–	–	–	–	–	(1,383)	(1,383)
Derivative financial liabilities		C	–	–	–	–	(360)	–	(360)
Exercise price of put option on NCI		E	–	–	–	–	–	(167)	(167)
Financial RRSAs		F	–	–	–	–	–	(193)	(193)
C Shares		B	–	–	–	–	–	(10)	(10)
Trade payables and similar items	16	B	–	–	–	–	–	(2,571)	(2,571)
Other non-derivative financial liabilities	16	B	–	–	–	–	–	(704)	(704)
			707	3,546	408	674	(360)	(5,028)	(53)

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

	2013 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. These financial instruments are included on the balance sheet at fair value, derived from observable market prices (Level 2 as defined by IFRS 13 *Fair Value Measurement*).
D Borrowings are carried at amortised cost. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date (Level 2 as defined by IFRS 13).
E The value of the put option on NCI is determined in accordance with the contractual terms, which requires averaging three valuations, covering forecasts of the business performance and external metrics of comparable business and transactions.
F The fair value of RRSAs is estimated by discounting expected future cash flows. The contractual cash flows are based on future trading activity, which is estimated based on latest forecasts (Level 3 as defined by IFRS 13).
IFRS 13 defines a three-level valuation hierarchy:
Level 1 – quoted prices for similar instruments;
Level 2 – directly observable market inputs other than Level 1 inputs; and
Level 3 – inputs not based on observable market data.

17 Financial instruments (continued)

Carrying values of other financial assets and liabilities

	Derivatives							
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Exercise price of put options on NCI £m	Financial RRSAs £m	C Shares £m	Total £m
At 31 December 2013								
Non-current assets	**631**	**–**	**43**	**674**	**–**	**–**	**–**	**674**
Current assets	**72**	**2**	**–**	**74**	**–**	**–**	**–**	**74**
	703	**2**	**43**	**748**	**–**	**–**	**–**	**748**
Current liabilities	**(63)**	**(16)**	**(1)**	**(80)**	**(1,858)**	**(22)**	**(16)**	**(1,976)**
Non-current liabilities	**(142)**	**(25)**	**(48)**	**(215)**	**–**	**(145)**	**–**	**(360)**
	(205)	**(41)**	**(49)**	**(295)**	**(1,858)**	**(167)**	**(16)**	**(2,336)**
	498	**(39)**	**(6)**	**453**	**(1,858)**	**(167)**	**(16)**	**(1,588)**
At 31 December 2012								
Non-current assets	498	4	90	592	–	–	–	592
Current assets	104	6	5	115	–	–	–	115
	602	10	95	707	–	–	–	707
Current liabilities	(97)	(8)	–	(105)	(167)	(30)	(10)	(312)
Non-current liabilities	(233)	(15)	(7)	(255)	–	(163)	–	(418)
	(330)	(23)	(7)	(360)	(167)	(193)	(10)	(730)
	272	(13)	88	347	(167)	(193)	(10)	(23)

Derivative financial instruments

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

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

	Foreign exchange instruments £m	Commodity instruments £m	Interest rate instruments £m	Total £m
At 1 January 2012	(447)	(12)	81	(378)
Movements in fair value hedges [1]	(8)	–	6	(2)
Movements in cash flow hedges	(4)	–	–	(4)
Movements in other derivative contracts [2]	750	(3)	1	748
Contracts settled [3]	(19)	2	–	(17)
At 1 January 2013	**272**	**(13)**	**88**	**347**
Business acquisitions	4	(1)	–	3
Movements in fair value hedges [1]	3	–	(91)	(88)
Movements in other derivative contracts [2]	284	(34)	–	250
Contracts settled [3]	(65)	9	(3)	(59)
At 31 December 2013	**498**	**(39)**	**(6)**	**453**

[1] Gain on related hedged items **£88m** (2012 £2m net gain).
[2] Included in financing.
[3] Includes contracts settled in fair value hedges **£17m** (2012 nil) and cash flow hedges **£nil** (2012: £4m loss).

Exercise price of put option on non-controlling interests and financial RRSAs

The Group has agreed a put option with Daimler AG, such that Daimler can sell its interest in Rolls-Royce Power Systems Holding GmbH (RRPSH) to the Group. The exercise price of this option is included as a financial liability.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 Financial instruments (continued)

Movements in the carrying values were as follows:

	Put options on NCI		Financial RRSAs	
	2013 £m	2012 £m	2013 £m	2012 £m
At 1 January	**(167)**	–	**(193)**	(230)
Cash paid to partners	**–**	–	**33**	35
Business acquisitions	**(2)**	–	**–**	–
Additions	**(1,432)**	(167)	**–**	–
Exchange adjustments included in OCI	**–**	–	**(4)**	1
Financing charge [1]	**–**	–	**(9)**	(10)
Excluded from underlying profit:				
Changes in put options exercise prices [1]	**(212)**	(5)		
Exchange adjustments [1]	**(45)**	5	**4**	9
Changes in forecast payments [1]			**2**	2
At 31 December	**(1,858)**	(167)	**(167)**	(193)

[1] Included in financing.

Risk management policies and hedging activities

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

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

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

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

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

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

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

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

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

17 Financial instruments (continued)

Derivative financial instruments

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

		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**	–
Other	**–**	–

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17 Financial instruments (continued)

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

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2013					
Assets					
Unlisted non-current investments	**–**	**–**	**26**	**1**	**27**
Trade receivables and similar items	**199**	**995**	**829**	**95**	**2,118**
Other non-derivative financial assets	**289**	**48**	**89**	**101**	**527**
Short-term investments	**282**	**–**	**4**	**35**	**321**
Cash and cash equivalents	**1,619**	**1,080**	**980**	**311**	**3,990**
	2,389	**2,123**	**1,928**	**543**	**6,983**
Liabilities					
Borrowings	**(1,490)**	**(55)**	**(826)**	**–**	**(2,371)**
Exercise prices of put options on NCI	**–**	**–**	**(1,858)**	**–**	**(1,858)**
Financial RRSAs	**–**	**(114)**	**(53)**	**–**	**(167)**
C Shares	**(16)**	**–**	**–**	**–**	**(16)**
Trade payables and similar items	**(1,501)**	**(641)**	**(653)**	**(194)**	**(2,989)**
Other non-derivative financial liabilities	**(208)**	**(328)**	**(158)**	**(112)**	**(806)**
	(3,215)	**(1,138)**	**(3,548)**	**(306)**	**(8,207)**
	(826)	**985**	**(1,620)**	**237**	**(1,224)**
At 31 December 2012					
Assets					
Unlisted non-current investments	1	–	4	1	6
Trade receivables and similar items	234	1,176	169	83	1,662
Other non-derivative financial assets	121	75	40	128	364
Short-term investments	5	–	–	6	11
Cash and cash equivalents	495	1,038	606	446	2,585
	856	2,289	819	664	4,628
Liabilities					
Borrowings	(1,173)	(205)	(5)	–	(1,383)
Exercise price of put option on NCI	–	–	(167)	–	(167)
Financial RRSAs	–	(139)	(54)	–	(193)
C Shares	(10)	–	–	–	(10)
Trade payables and similar items	(1,254)	(825)	(289)	(203)	(2,571)
Other non-derivative financial liabilities	(250)	(320)	(17)	(117)	(704)
	(2,687)	(1,489)	(532)	(320)	(5,028)
	(1,831)	800	287	344	(400)

Currency exposures

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

Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At 31 December 2013					
Sterling [1]	**–**	**13**	**(1,855)**	**12**	**(1,830)**
US dollar	**8**	**–**	**–**	**7**	**15**
Euro	**(1)**	**(2)**	**–**	**–**	**(3)**
Other	**(5)**	**41**	**(11)**	**(4)**	**21**
At 31 December 2012					
Sterling [1]	–	22	(166)	4	(140)
US dollar	4	–	(6)	5	3
Euro	(1)	(2)	–	–	(3)
Other	6	1	(5)	1	3

[1] Included in the **£1,855m** liability (2012 £166m liability) euro currency exposure is a **£1,858m** liability (2012 £167m liability) relating to the put option on Daimler's interest in RRPSH – see page 105.

17 Financial instruments (continued)

Ageing beyond contractual due date of financial assets

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
At 31 December 2013					
Unlisted non-current asset investments	**27**	**–**	**–**	**–**	**27**
Trade receivables and similar items	**1,769**	**240**	**90**	**19**	**2,118**
Other non-derivative financial assets	**523**	**1**	**1**	**2**	**527**
Derivative financial assets	**748**	**–**	**–**	**–**	**748**
Short-term investments	**321**	**–**	**–**	**–**	**321**
Cash and cash equivalents	**3,990**	**–**	**–**	**–**	**3,990**
	7,378	**241**	**91**	**21**	**7,731**
At 31 December 2012					
Unlisted non-current asset investments	6	–	–	–	6
Trade receivables and similar items	1,470	132	43	17	1,662
Other non-derivative financial assets	343	18	1	2	364
Derivative financial assets	707	–	–	–	707
Short-term investments	11	–	–	–	11
Cash and cash equivalents	2,585	–	–	–	2,585
	5,122	150	44	19	5,335

Contractual maturity analysis of financial liabilities

	Gross values					
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
At 31 December 2013						
Borrowings	**(290)**	**(140)**	**(609)**	**(1,894)**	**562**	**(2,371)**
Derivative financial liabilities	**(87)**	**(76)**	**(146)**	**(90)**	**104**	**(295)**
Exercise prices of put options on NCI	**(1,858)**	**–**	**–**	**–**	**–**	**(1,858)**
Financial RRSAs	**(33)**	**(34)**	**(65)**	**(75)**	**40**	**(167)**
C Shares	**(16)**	**–**	**–**	**–**	**–**	**(16)**
Trade payables and similar items	**(2,972)**	**(17)**	**–**	**–**	**–**	**(2,989)**
Other non-derivative financial liabilities	**(751)**	**(28)**	**(16)**	**(11)**	**–**	**(806)**
	(6,007)	**(295)**	**(836)**	**(2,070)**	**706**	**(8,502)**
At 31 December 2012						
Borrowings	(210)	(257)	(403)	(778)	265	(1,383)
Derivative financial liabilities	(108)	(103)	(138)	(14)	3	(360)
Exercise price of put option on NCI	(167)	–	–	–	–	(167)
Financial RRSAs	(35)	(32)	(75)	(100)	49	(193)
C Shares	(10)	–	–	–	–	(10)
Trade payables and similar items	(2,568)	(1)	(1)	(1)	–	(2,571)
Other non-derivative financial liabilities	(694)	(10)	–	–	–	(704)
	(3,792)	(403)	(617)	(893)	317	(5,388)

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17 Financial instruments (continued)

Interest rate risk

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

2013	Effective interest rate %	Total £m	Period in which interest rate reprices: 6 months or less £m	6–12 months £m
Short-term investments [1]		321	318	3
Cash and cash equivalents [2]		3,990	3,990	–
Unsecured bank loans				
Other borrowings		(10)	(5)	–
Interest rate swaps	5.3225%	–	5	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–
€125m fixed rate loan	2.6000%	(104)	–	–
€75m fixed rate loan	2.0600%	(63)	–	–
€50m fixed rate loan	2.3500%	(42)	–	–
Unsecured bond issues				
7 3/8% Notes 2016 £200m	7.3750%	(200)	–	–
6.55% Notes 2015 US$83m	6.5500%	(55)	–	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(55)	–
6.75% Notes 2019 £500m	6.7500%	(535)	–	–
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(535)	–
2.125% Notes 2021 €750m	2.1250%	(611)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.7005	–	(611)	–
3.375% Notes 2026 £375m	3.3750%	(350)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.8330	–	(350)	–
Other secured				
Obligations under finance leases	5.0000%	(1)	(1)	–
		1,940		

2012	Effective interest rate %	Total £m	Period in which interest rate reprices: 6 months or less £m	6–12 months £m
Short-term investments [1]		11	9	2
Cash and cash equivalents [2]		2,585	2,585	–
Unsecured bank loans				
Other borrowings		(6)	(4)	
Interest rate swaps	5.3225%	–	7	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–
£200m floating rate loan	GBP LIBOR + 1.26	(200)	(200)	–
Unsecured bond issues				
7 3/8% Notes 2016 £200m	7.3750%	(200)	–	–
6.38% Notes 2013 US$230m	6.3800%	(147)	–	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(147)	–
6.55% Notes 2015 US$83m	6.5500%	(58)	–	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(58)	–
6.75% Notes 2019 £500m	6.7500%	(571)	–	–
Effect of interest rate swaps	GBP LIBOR + 2.9824	–	(571)	–
Other secured				
Obligations under finance leases	5.0000%	(1)	–	–
		1,213		

[1] Interest on the short-term investments are at fixed rates.
[2] Cash and cash equivalents comprise bank balances and demand deposits and earn interest at rates based on daily deposit rates.

17 Financial instruments (continued)

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

In addition, the Group has undrawn committed borrowing facilities available as follows:

	2013 £m	2012 £m
Expiring in one to two years	–	–
Expiring after two years	1,250	1,000
	1,250	1,000

Sensitivity analysis

Sensitivities at 31 December (all other variables held constant) – impact on profit after tax and equity	2013 £m	2012 £m
Sterling 10% weaker against the US dollar	(1,177)	(1,073)
Sterling 10% stronger against the US dollar	963	878
Euro 10% weaker against the US dollar	(128)	(146)
Euro 10% stronger against the US dollar	100	118
Sterling 10% weaker against the Euro	(95)	–
Sterling 10% stronger against the Euro	78	–
Commodity prices 10% lower	(16)	(20)
Commodity prices 10% higher	16	20

At 31 December 2013 the Group had no material sensitivity to changes in interest rates on that date. The main interest rate sensitivity for the Group arises as a result of the gross up of net cash and this is mitigated as described under the interest rate risk management policies on page 106.

C Shares and payments to shareholders

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. C Shares in respect of a year are issued in the following year. Shareholders are able to redeem any number of their C Shares for cash. Any C Shares retained attract a dividend of 75 per cent of LIBOR on the 0.1 pence nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. The Company has the option to compulsorily redeem the C Shares, at any time, if the aggregate number of C Shares in issue is less than ten per cent of the aggregate number of C Shares issued, or on the acquisition or capital restructuring of the Company.

Movements in the C Shares during the year were as follows:

	2013		2012	
	Millions	Nominal value £m	Millions	Nominal value £m
Issued and fully paid				
At 1 January	10,418	10	6,371	6
Issued	366,041	366	327,643	328
Redeemed	(360,173)	(360)	(323,596)	(324)
At 31 December	16,286	16	10,418	10

Payments to shareholders in respect of the year represent the value of C Shares to be issued in respect of the results for the year. Issues of C Shares were declared as follows:

	2013		2012	
	Pence per share	£m	Pence per share	£m
Interim	8.6	162	7.6	142
Final	13.4	252	11.9	223
	22.0	414	19.5	365

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 Provisions for liabilities and charges

	At 1 January 2013 £m	Exchange differences £m	Acquisitions of businesses £m	Disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At 31 December 2013 £m
Warranty and guarantees	**247**	1	201	(2)	(39)	150[1]	(139)[1]	**419**
Contract loss	**54**	–	27	–	(13)	24	(25)	**67**
Restructuring	**4**	–	4	9	(6)	17	(3)	**25**
Customer financing	**82**	–	–	–	(11)	23	(21)	**73**
Insurance	**47**	–	–	–	(7)	31	(9)	**62**
Other	**27**	1	48	–	(11)	48	(26)	**87**
	461	2	280	7	(87)	293	(223)	**733**
Current liabilities	**220**							**348**
Non-current liabilities	**241**							**385**

[1] The amount of warranty and guarantee provision charged to the income statement and utilised by RRPS was £86m and £78m respectively.

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

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

In connection with the sale of its products the Group will, on some occasions, provide financing support for its customers – generally in respect of civil aircraft. The Group's commitments relating to these financing arrangements are spread over many years, relate to a number of customers and a broad product portfolio and are generally secured on the asset subject to the financing. Customer financing provisions cover guarantees provided for asset value and/or financing. These guarantees, the risks arising and the process used to assess the extent of the risk are described under the heading 'Customer financing' in the Chief Financial Officer's review on page 13. It is estimated that the provision will be utilised as follows:

	2013 £m	2012 £m
Potential claims with specific claim dates:		
In one year or less	**29**	30
In more than one year but less than five years	**38**	43
In more than five years	**5**	8
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	**1**	–
Up to five years	**–**	1
	73	82

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

	2013 £m	2013 $m	2012 £m	2012 $m
Gross commitments	**356**	***589***	569	*925*
Value of security[1]	**(217)**	***(360)***	(381)	*(620)*
Indemnities	**(80)**	***(132)***	(118)	*(191)*
Net commitments	**59**	***97***	70	*114*
Net commitments with security reduced by 20%[2]	**78**	***129***	133	*216*
[1] Security includes unrestricted cash collateral of:	**50**	***83***	64	*104*

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

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

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

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

19 Post-retirement benefits

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

- UK defined benefit schemes are funded, with the assets held in separate trustee administered funds. Employees are entitled to retirement benefits based on either their final or career average salaries and length of service; and
- overseas defined benefit schemes are a mixture of funded and unfunded plans and provide benefits in line with local practice. Additionally in the US, and to a lesser extent in some other countries, the Group's employment practices include the provision of healthcare and life insurance benefits for retired employees. These schemes are unfunded.

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

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

The Group has adopted amendments to IAS 19 *Employee Benefits* with effect from 1 January 2013. The impact is described further below. 2012 figures have been restated to put them on a comparable basis.

Amounts recognised in the income statement

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost and administrative expenses	153	55	208	129	42	171
Past-service cost	66	5	71	2	–	2
	219	60	279	131	42	173
Defined contribution schemes	30	44	74	23	41	64
Operating cost	249	104	353	154	83	237
Net financing (income)/charge in respect of defined benefit schemes	(12)	38	26	(17)	25	8
Total income statement charge	237	142	379	137	108	245

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2013 £m	2012 £m	2013 £m	2012 £m	2013 £m	2012 £m
Cost of sales – included in underlying profit	144	124	49	46	193	170
Commercial and administrative costs	106	38	15	14	121	52
Research and development	29	11	10	4	39	15
	279	173	74	64	353	237

The Group operates a PaySave scheme in the UK. This is a salary sacrifice scheme under which employees elect to stop making employee contributions and the Group makes additional contributions in return for a reduction in gross contractual pay. As a result, there is a decrease in wages and salaries and a corresponding increase in pension costs of **£37 million** (2012 £36 million) in the year.

Net financing comprises:

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Financing on scheme obligations	371	59	430	354	47	401
Financing on scheme assets	(431)	(21)	(452)	(444)	(22)	(466)
Financing on unrecognised surpluses and minimum funding liability	48	–	48	73	–	73
Net financing (income)/charge in respect of defined benefit schemes	(12)	38	26	(17)	25	8
Financing income on scheme surpluses	(16)	(1)	(17)	(26)	–	(26)
Financing costs on scheme deficits	4	39	43	9	25	34

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19 Post-retirement benefits (continued)

Amounts recognised in OCI in respect of defined benefit schemes

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Actuarial gains and losses arising from demographic assumptions	(87)	(12)	(99)	(27)	(1)	(28)
Actuarial gains and losses arising from financial assumptions	(200)	116	(84)	(639)	(104)	(743)
Actuarial gains and losses arising from experience adjustments	65	31	96	7	(13)	(6)
Return on scheme assets excluding financing income	(363)	(42)	(405)	(155)	26	(129)
Movement in unrecognised surplus and related finance cost	407	–	407	529	–	529
Movement in minimum funding liability and related finance cost	133	–	133	72	–	72
	(45)	93	48	(213)	(92)	(305)

Amounts recognised in the balance sheet in respect of defined benefit schemes

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(9,046)	(558)	(9,604)	(8,569)	(609)	(9,178)
Fair value of scheme assets	9,776	504	10,280	9,794	534	10,328
Net asset/(liability) on funded schemes	730	(54)	676	1,225	(75)	1,150
Present value of unfunded obligations	–	(935)	(935)	–	(569)	(569)
Unrecognised surplus [1]	(488)	–	(488)	(853)	–	(853)
Minimum funding liability [2]	(46)	–	(46)	(173)	–	(173)
Net asset/(liability) recognised in the balance sheet	196	(989)	(793)	199	(644)	(445)
Post-retirement scheme surpluses	242	6	248	336	12	348
Post-retirement scheme deficits	(46)	(995)	(1,041)	(137)	(656)	(793)

[1] Where a surplus has arisen on a scheme, in accordance with IAS 19 and IFRIC 14, the surplus is recognised as an asset only if it represents an unconditional economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet.
[2] A minimum funding liability arises where the statutory funding requirements require future contributions in respect of past service that will result in a future unrecognisable surplus.

Overseas schemes are located in the following countries:

	2013			2012		
	Assets £m	Obligations £m	Net £m	Assets £m	Obligations £m	Net £m
Canada	135	(181)	(46)	139	(200)	(61)
Germany	–	(500)	(500)	–	(86)	(86)
US pension schemes	347	(420)	(73)	369	(449)	(80)
US healthcare schemes	–	(352)	(352)	–	(399)	(399)
Other	22	(40)	(18)	26	(44)	(18)
Net asset/(liability) recognised in the balance sheet	504	(1,493)	(989)	534	(1,178)	(644)

Defined benefit schemes

Assumptions

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

		2013	2012
Discount rate		4.4%	4.4%
Inflation assumption [1]		3.5%	3.0%
Rate of increase in salaries		4.5%	4.1%
Male life expectancy	– current pensioner	22.5	22.6
	– future pensioner currently aged 45	24.2	24.4

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

Discount rates are determined by reference to the market yields on AA rated corporate bonds. The rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve.

19 Post-retirement benefits (continued)

The inflation assumption is determined by the market implied assumption based on the yields on long-term indexed linked government securities and increases in salaries are based on actual experience, allowing for promotion, of the real increase above inflation.

The mortality assumptions adopted for the UK pension schemes are derived from the SAP actuarial tables, with future improvements in line with the CMI 2013 core projections and long-term improvements of 1.25 per cent. Where appropriate, these are adjusted to take account of the relevant scheme's actual experience.

Other assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and the assumptions used in the most recent funding valuation. The rate of increase of pensions in payment is based on the rules of the relevant scheme, combined with the inflation assumption where the increase is capped.

Assumptions for overseas schemes are less significant and are based on advice from local actuaries. The principal assumptions are the discount rate, **4.5 per cent** (2012 3.9 per cent) and inflation, **2.3 per cent** (2012 2.4 per cent).

Changes in present value of defined benefit obligations

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January, as previously reported				(7,713)	(1,052)	(8,765)
Effect of amendments to IAS 19				17	(1)	16
At 1 January, as restated	(8,569)	(1,178)	(9,747)	(7,696)	(1,053)	(8,749)
Exchange differences	–	16	16	–	42	42
Current service cost	(147)	(53)	(200)	(122)	(40)	(162)
Past-service cost	(66)	(4)	(70)	(2)	–	(2)
Finance cost	(371)	(59)	(430)	(354)	(47)	(401)
Contributions by employees	(4)	(4)	(8)	(4)	(2)	(6)
Benefits paid out	334	63	397	322	38	360
Acquisition of businesses	(1)	(402)	(403)	(54)	–	(54)
Actuarial (losses)/gains	(222)	134	(88)	(659)	(118)	(777)
Settlement/curtailment	–	–	–	–	2	2
Other movements	–	(6)	(6)			
At 31 December	(9,046)	(1,493)	(10,539)	(8,569)	(1,178)	(9,747)
Funded schemes	(9,046)	(558)	(9,604)	(8,569)	(609)	(9,178)
Unfunded schemes	–	(935)	(935)	–	(569)	(569)
The defined benefit obligations are in respect of:						
Active plan participants	(3,492)	(849)	(4,341)	(3,129)	(915)	(4,044)
Deferred plan participants	(1,647)	(74)	(1,721)	(1,583)	(15)	(1,598)
Pensioners	(3,907)	(570)	(4,477)	(3,857)	(248)	(4,105)
Weighted average duration of obligations	16	13	16			

Changes in fair value of scheme assets

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January	9,794	534	10,328	9,519	497	10,016
Exchange differences	–	(19)	(19)	–	(18)	(18)
Administrative expenses	(6)	(2)	(8)	(7)	(2)	(9)
Financing	431	21	452	444	22	466
Return on plan assets excluding financing	(363)	(42)	(405)	(155)	26	(129)
Contributions by employer	249	66	315	252	47	299
Contributions by employees	4	4	8	4	2	6
Benefits paid out	(334)	(63)	(397)	(322)	(38)	(360)
Acquisition of businesses	1	5	6	59	–	59
Settlements/curtailment	–	–	–	–	(2)	(2)
At 31 December	9,776	504	10,280	9,794	534	10,328
Total return on scheme assets	68	(21)	47	289	48	337

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

19 Post-retirement benefits (continued)

Fair value of scheme assets at 31 December

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Sovereign debt	5,929	231	6,160	6,088	–	6,088
Derivatives on sovereign debt	(987)	2	(985)	(1,225)	–	(1,225)
Corporate debt instruments	1,045	190	1,235	969	–	969
Interest rate swaps	1,361	–	1,361	1,922	–	1,922
Inflation swaps	(13)	–	(13)	(289)	–	(289)
Cash and similar instruments	257	44	301	429	–	429
Liability driven investment (LDI) portfolios [1]	7,592	467	8,059	7,894	–	7,894
Longevity swap [2]	3	–	3	(126)	–	(126)
Listed equities	994	3	997	1,126	119	1,245
Unlisted equities	172	–	172	–	–	–
Sovereign debt	215	4	219	245	313	558
Corporate debt instruments	540	4	544	334	74	408
Cash	253	4	257	–	–	–
Other	7	22	29	321	28	349
	9,776	504	10,280	9,794	534	10,328

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

[2] Under the longevity swap, the Rolls-Royce Pension Fund (RRPF) has agreed an average life expectancy of pensioners with a counterparty. If pensioners live longer than expected the counterparty will make payments to the RRPF to offset the additional cost of paying pensioners. If the reverse applies the cost of paying pensioners will be reduced but the scheme will be required to make payments to the counterparty. Following the adoption of the amendments to IAS 19 and the interaction with IFRS 13 from 2013 the longevity swap has been valued on an external fair market basis, rather than using the same assumptions as used for the valuation of the scheme's liabilities. As the surplus on the RRPF is restricted, this has had no impact on the net surplus/deficit recognised in the balance sheet. Had the longevity swap been valued on the same basis as 2012, its value would have been a liability of £156m, the movement since 2012 largely reflecting the changes in mortality and discount rate assumptions. The valuation is based on an estimate of the assumptions that a hypothetical third party would use for the future mortality and premium.

The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group. The longevity swap is valued by the scheme actuaries based on the difference between the agreed longevity assumptions at inception and actual longevity experience. All other fair values are provided by the fund managers. Where available, the fair values are quoted prices (eg listed equity, sovereign debt and corporate bonds). Unlisted investments (private equity) are included at values provided by the fund manager in accordance with relevant guidance. Other significant assets are valued based on observable inputs such as yield curves.

Movements in unrecognised surplus and minimum liability

	2013			2012		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At 1 January, as previously reported				(1,554)	(94)	(1,648)
Effect of amendments to IAS 19				–	94	94
At 1 January, as restated	(1,026)	–	(1,026)	(1,554)	–	(1,554)
Movements in unrecognised surplus through OCI	407	–	407	529	–	529
Movements in minimum funding liability through OCI	133	–	133	72	–	72
Related finance costs	(48)	–	(48)	(73)	–	(73)
At 31 December	(534)	–	(534)	(1,026)	–	(1,026)

Future contributions

The Group expects to contribute approximately £325 million to its defined benefit schemes in 2014.

In the UK, the funding is set on the basis of a triennial funding valuation by the actuaries for which the assumptions may differ from those above. In particular, the discount rate used to value the obligations takes account of the investment strategy, rather than being based on market yields of AA corporate bonds. As a result of these valuations, the Group and the scheme trustees agree a Schedule of Contributions (SoC), which sets out the required contributions from the employer and employees for current service. Where the scheme is in deficit, the SoC also includes required contributions from the employer to eliminate the deficit. The most recent agreed triennial valuations for the principal schemes are:

	Obligations at 31 December 2013 £m	Valuation date
Rolls-Royce Pension Fund	6,543	31 March 2012
Rolls-Royce Group Pension Scheme	1,540	5 April 2013
Vickers Group Pension Scheme	637	31 March 2013

19 Post-retirement benefits (continued)

Sensitivities

The calculations of the defined benefit obligations are sensitive to the assumptions set out on page 114. The following table summarises the estimated impact of a change in the assumption on the UK defined benefit obligation at 31 December 2013, while holding all other assumptions constant. This sensitivity analysis may not be representative of the actual change in the defined benefit obligation as it is unlikely that the change in assumptions would occur in isolation of one another as some of the assumptions may be correlated.

For the most significant funded schemes, the investment strategies are designed to hedge the risks from interest rates, inflation on an economic basis and in the Rolls-Royce Pension Fund in the UK, the longevity of pensioners. Where appropriate, the table also includes the corresponding movement in the value of the plan assets.

		£m
Reduction in the discount rate of 0.25%[1]	Obligations	**(412)**
	Plan assets (LDI portfolio)	**465**
Increase in inflation of 0.25%	Obligations	**(201)**
	Plan assets (LDI portfolio)	**185**
Increase in real increase in salaries of 0.25%	Obligations	**(88)**
One year increase in life expectancy	Obligations	**(212)**
	Plan assets (longevity swap)	**86**

1 The difference arises largely due to differences in the methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is approximately 97 per cent.

Amendments to IAS 19

Prior period figures have been restated to reflect the adoption of the amendments to IAS 19. Consequential tax effects have been reflected in deferred tax.

		As previously reported			Amendments			As restated		
	Notes	UK £m	Overseas £m	Total £m	UK £m	Overseas £m	Total £m	UK £m	Overseas £m	Total £m
At 1 January 2012	A	252	(649)	(397)	17	93	110	269	(556)	(287)
Exchange adjustments		–	24	24	–	–	–	–	24	24
Current service cost and administrative expenses	B	(123)	(38)	(161)	(6)	(4)	(10)	(129)	(42)	(171)
Past-service cost	A	(2)	12	10	–	(12)	(12)	(2)	–	(2)
Net financing	C	(41)	(23)	(64)	58	(2)	56	17	(25)	(8)
Contributions by employer		250	47	297	2	–	2	252	47	299
Acquisition of business		5	–	5	–	–	–	5	–	5
Actuarial losses	C	(659)	(118)	(777)	–	–	–	(659)	(118)	(777)
Return on plan assets excluding financing	C	(30)	20	(10)	(125)	6	(119)	(155)	26	(129)
Movement in unrecognised surplus	C	465	–	465	64	–	64	529	–	529
Movement on minimum funding liability	C	63	–	63	9	–	9	72	–	72
At 31 December 2012		180	(725)	(545)	19	81	100	199	(644)	(445)
Post-retirement scheme surpluses		317	12	329				336	12	348
Post-retirement scheme deficits		(137)	(737)	(874)				(137)	(656)	(793)

A An unrecognised past-service credit related to the restructuring of certain overseas healthcare schemes in 2011. This has now been recognised in full at 1 January 2012. As a consequence, the amortisation of this past-service credit in 2012 is eliminated. In addition, an adjustment has been made in the calculation of the defined benefit obligation on one of the UK schemes to put it on a consistent basis with the other schemes.

B Previously all administrative costs were offset against the expected return on scheme assets. The amendments only allow this in respect of the costs of managing scheme assets; other administrative expenses are now included in the current service cost.

C Previously net financing comprised the actual expected return on scheme assets based on the underlying assets and a financing charge on scheme liabilities calculated using a 'AA' corporate bond rate. The amendments require net financing to be calculated on the net asset or liability recognised on the balance sheet using an AA corporate bond rate. This has a consequential impact on amounts recognised in OCI: (i) the change in assumed return on scheme assets affects the related actuarial gains or losses; and (ii) implicit financing on movements in the unrecognised surplus and the minimum funding liability is not included in the income statement.

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20 Share capital

	Non-equity		Equity	
	Special Share of £1	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid				
At 1 January 2012	**1**	**–**	**1,872**	**374**
Proceeds from shares issued for share option schemes			–	–
At 31 December 2012	**1**	**–**	**1,872**	**374**
Proceeds from shares issued for share option schemes			8	2
At 31 December 2013	**1**	**–**	**1,880**	**376**

The rights attaching to each class of share are set out on page 70.

During 2013, the Group also received £30 million from participants in ShareSave schemes. Shares to satisfy these options were issued from those already held by the Group for this purpose, as described on page 79.

In accordance with IAS 32 *Financial Instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 17.

21 Share-based payments

Effect of share-based payment transactions on the Group's results and financial position

	2013 £m	2012 £m
Total expense recognised for equity-settled share-based payments transactions	**61**	49
Total expense recognised for cash-settled share-based payments transactions	**18**	6
Share-based payments recognised in the consolidated income statement	**79**	55
Liability for cash-settled share-based payment transactions	**19**	18

A description of the share-based payment plans is included in the remuneration report on pages 57 to 58.

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

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at 1 January 2012	27.5	447	0.5	100	19.5	3.3
Granted	–	–	–	–	4.3	2.0
Additional entitlements arising from TSR performance	–	–	–	–	2.8	–
Forfeited	(0.6)	446	–	–	(0.8)	(0.1)
Exercised	(0.1)	409	(0.4)	103	(11.8)	(1.2)
Outstanding at 1 January 2013	**26.8**	**447**	**0.1**	**77**	**14.0**	**4.0**
Granted	10.0	961	–	–	2.8	1.6
Additional entitlements arising from TSR performance	–	–	–	–	0.6	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(0.6)	483	–	–	(0.6)	(0.1)
Exercised	(10.2)	404	(0.1)	77	(4.8)	(2.5)
Outstanding at 31 December 2013	**16.0**	**660**	**–**	**–**	**12.0**	**3.1**
Exercisable at 31 December 2013	**–**	**–**	**–**	**–**	**–**	**–**
Exercisable at 31 December 2012	–	–	0.1	77	–	–

As share options are exercised throughout the year, the weighted average share price during the year of **1123 pence** (2012 836 pence) is representative of the weighted average share price at the date of exercise. The closing price at 31 December 2013 was **1275 pence** (2012 873.5 pence).

There were no exercisable options as at 31 December 2013. The average remaining contractual life of the exercisable options as at 31 December 2012 was 0.2 years.

21 Share-based payments (continued)

Fair values of share-based payment plans

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

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

PSP

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

ShareSave

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

APRA

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

22 Operating leases

Leases as lessee

	2013 £m	2012 £m
Rentals paid – hire of plant and machinery	**134**	94
– hire of other assets	**55**	34
Non-cancellable operating lease rentals are payable as follows:		
Within one year	**179**	147
Between one and five years	**545**	490
After five years	**507**	526
	1,231	1,163

Leases as lessor

	2013 £m	2012 £m
Rentals received – credited within revenue from aftermarket services	**56**	30
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	**19**	2
Between one and five years	**48**	7
After five years	**23**	1
	90	10

The Group acts as lessee and lessor for both land and buildings and gas turbine engines, and acts as lessee for some plant and equipment.

- Sublease payments of **£1 million** (2012 £4 million) and sublease receipts of **£27 million** (2012 £17 million) were recognised in the income statement in the year.
- Purchase options exist on aero engines, land and buildings and plant and equipment with the period to the purchase option date varying from one to eight years.
- Renewal options exist on aero engines, land and buildings and plant and equipment with the period to the renewal option varying between one to 28 years at terms to be negotiated upon renewal.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total future minimum sublease payments expected to be made is **£8 million** (2012 £10 million) and sublease receipts expected to be received is **£42 million** (2012 £9 million).

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23 Contingent liabilities

On 6 December 2012, the Company announced that it had passed information to the SFO relating to concerns in overseas markets. Since that date the Company has continued its investigations and is engaging with the SFO and other authorities in the UK, the USA and elsewhere.

In December 2013, the Company announced that it had been informed by the SFO that it had commenced a formal investigation. The consequence of these disclosures will be decided by the regulatory authorities. It remains too early to predict the outcomes, but these could include the prosecution of individuals and of the Group. Accordingly, the potential for fines, penalties or other consequences (including debarment from government contracts, suspension of export privileges and reputational damage) cannot currently be assessed. As the investigation is ongoing, it is not yet possible to identify the timescale in which these issues might be resolved.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Group has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Group is no longer fully insured against known and potential claims from employees who worked for certain of the Group's UK-based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group. The Group's share of equity-accounted entities' contingent liabilities is **£13 million** (2012 £48 million).

Contingent liabilities in respect of customer financing commitments are described in note 18.

24 Related party transactions

	2013 £m	2012 £m
Sales of goods and services to joint ventures and associates	**3,149**	2,937
Purchases of goods and services from joint ventures and associates	**(3,269)**	(3,082)
Operating lease payments to joint ventures and associates	**(69)**	(57)
Guarantees of joint ventures' and associates' borrowings	**7**	12
Dividends received from joint ventures and associates	**99**	129
RRSA receipts from joint ventures and associates	**4**	13
Other income received from joint ventures and associates	**1**	2

The aggregated balances with joint ventures are shown in notes 13 and 16. Transactions with Group pension schemes are shown in note 19.

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

Key management personnel are deemed to be the directors and the members of the ELT as set out on page 38. Remuneration for key management personnel is shown below:

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

More detailed information regarding the directors' remuneration, shareholdings, pension entitlements, share options and other long-term incentive plans is shown in the remuneration report on pages 53 to 69.

25 Acquisitions and disposals

Acquisitions

Rolls-Royce Power Systems AG (RRPS – formerly Tognum AG)

From 25 August 2011 to 31 December 2012 the Group's interest in RRPS was classified as a joint venture and equity accounted. On 1 January 2013, conditions were fulfilled which gave the Group certain rights that result in RRPS being classified as a subsidiary and consolidated. Accordingly, the Group's joint venture interest in Rolls-Royce Power Systems Holding GmbH (RRPSH) has been reclassified as a subsidiary. The fair values of the identifiable assets and liabilities assumed are £1,339 million, giving rise to goodwill of £773 million, as set out in the table below. Rolls-Royce and Daimler AG (Daimler) each hold 50 per cent of the shares of RRPSH, which itself held over 99 per cent of the shares of RRPS. During 2013, RRPSH acquired the remaining 1 per cent of shares of RRPS. RRPS is a premium supplier of engines, propulsion systems and components for marine, energy, defence, and other industrial applications (often described as 'off-highway' applications).

Other

On 30 April 2013, the Group acquired 100 per cent of the issued share capital of Hyper-Therm High-Temperature Composites, Inc., a producer of state-of-the-art composite materials, including ceramic matrix composites, engineered coatings and thermal-structural components.

On 15 August 2013, the Group acquired 100 per cent of SmartMotor AS, a leading specialist in the development of permanent magnet technology.

On 24 December 2013, the Group acquired the remaining 49 per cent of shares not held in Composite Technology and Applications Limited, a business engaged in the development of composite fan blades and containment cases for the next generation of advanced turbofan engines.

For each of the other acquisitions noted, the acquisition cost (net of cash and borrowings acquired) has been allocated to identifiable assets and liabilities – principally technology, patents and licences, customer relationships, trademark, order backlog and other intangible assets.

Recognised amounts of identifiable assets acquired and liabilities assumed

	RRPS £m	Other £m	Total £m
Intangible assets	1,192	35	**1,227**
Property, plant and equipment	545	1	**546**
Investments in joint ventures, associates and other unlisted investments	50	–	**50**
Inventory	737	–	**737**
Trade and other receivables	487	2	**489**
Taxation recoverable	48	–	**48**
Cash and cash equivalents	240	5	**245**
Trade and other payables	(693)	(3)	**(696)**
Current tax payables	(77)	–	**(77)**
Borrowings	(203)	(1)	**(204)**
Other financial assets and liabilities	(27)	–	**(27)**
Deferred tax	(283)	1	**(282)**
Provisions	(280)	–	**(280)**
Post-retirement schemes	(397)	–	**(397)**
Total identifiable assets and liabilities	**1,339**	**40**	**1,379**
Goodwill arising	773	–	**773**
Total consideration	**2,112**	**40**	**2,152**
Exercise price of put option on NCI	(1,432)	–	**(1,432)**
	680	**40**	**720**
Consideration satisfied by:			
Cash consideration	–	37	**37**
Existing shareholding	1,443	3	**1,446**
NCI	669	–	**669**
	2,112	**40**	**2,152**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

25 Acquisitions and disposals (continued)

	RRPS £m	Other £m	Total £m
Net cash outflow arising on acquisition:			
Cash consideration	–	37	**37**
Less: cash and cash equivalents acquired	(240)	(5)	**(245)**
Cash (inflow)/outflow per cash flow statement	**(240)**	**32**	**(208)**
Identifiable intangible assets comprise:			
Technology, patents and licences	420	35	**455**
Customer relationships	433	–	**433**
Trademark	105	–	**105**
Order backlog	94	–	**94**
In-process development	53	–	**53**
Other	87	–	**87**
	1,192	**35**	**1,227**

In accordance with the provisions of IFRS 3 *Business Combinations*, the Group has opted not to recognise goodwill in respect of the non-controlling interest in RRPS. The previous joint venture investment holding in RRPSH of £1,328 million was revalued, giving rise to a gain of £115 million.

As part of the RRPSH shareholders' agreement, Daimler AG has the option to sell its shares in RRPSH to Rolls-Royce for a period of six years from 1 January 2013. The initial fair value of the exercise price of this option in respect of RRPS has been recognised as a liability (£1,432 million), which has been charged to NCI and retained earnings.

The goodwill arising on the acquisition of RRPS amounting to £773 million (which is not tax deductible) consists of anticipated synergies and the assembled workforce. The anticipated synergies principally arise from:

- increases in revenue from the combination of the routes to market; and
- cost savings from the combination of the supply chain and central functions.

The gross contractual value of trade receivables acquired is £446 million. At the acquisition date, it was estimated that contractual cash flows of £24 million would not be collected.

The acquisition of the controlling interest in RRPS contributed £2,593 million of revenue and profit before tax of £10 million (including amortisation of intangible assets arising on acquisition) to the Group's results for the year.

Disposals

On 29 January 2013, Alstom acquired Tidal Generation Limited.

On 2 September 2013, Turbomeca (a Safran company) acquired the Group's 50 per cent shareholding and interest in the RTM322 helicopter engine programme for which it has received a cash consideration of €293 million. Rolls-Royce will progressively transfer its operational responsibilities in the engine programme to Turbomeca over a multi-year period.

Assets and liabilities disposed

	RTM322 £m	Tidal Generation £m	Total £m
Intangible assets – goodwill	–	3	**3**
Investment in joint venture	2	–	**2**
Cash and cash equivalents	–	2	**2**
Trade and other payables	–	(2)	**(2)**
Provisions for liabilities and charges	(2)	–	**(2)**
Net assets	**–**	**3**	**3**
Profit on disposal of businesses	194	22	**216**
Disposal costs	3	–	**3**
Proceeds deferred in respect of transitional services and retained obligations	53	–	**53**
Disposal proceeds	**250**	**25**	**275**
Cash and cash equivalents disposed	–	(2)	**(2)**
Cash inflow per cash flow statement	**250**	**23**	**273**

25 Acquisitions and disposals (continued)

During 2012, the Group acquired:

- on 19 June 2012, Superstructure Capital Limited, a business engaged in marketing and sale of safety and risk management software to the aerospace industry;
- on 13 July 2012, PFW Aerospace UK, a business engaged in the manufacture of precision components for the aerospace industry;
- on 13 December 2012, Rolls-Royce Goodrich Engine Control Systems Limited (acquisition of 50 per cent not already held), a business engaged in the development and manufacture of aero-engine controls; and
- 27 December 2012, PKMJ Technical Services, Inc., a nuclear engineering services business in the US.

and disposed of:

- on 27 June 2012, Rolls-Royce Fuel Cell Systems Inc. (dilution of existing shareholding to 49 per cent); and
- on 29 June 2012, for US$1.5 billion, the equity, programme share and related goodwill of IAE International Aero Engines AG, which gave rise to a profit before tax of £699 million.

26 Segmental analysis from 1 January 2014

As described in the Chief Financial Officer's review on page 13, the management structure of the business has been revised and the internal reporting structure has been developed to reflect this. These changes will be reflected in the segmental analysis with effect from 1 January 2014. Had they been in place during 2013, the segmental analysis shown in note 2 would be as follows:

	Aerospace			MIPS						
	Civil £m	Defence £m	Total £m	Marine £m	Power Systems £m	Nuclear & Energy £m	Intra-segment £m	Total £m	Inter-segment £m	Total reportable segments £m
Year ended 31 December 2013										
Underlying revenue from sale of original equipment	3,035	1,385	4,420	1,236	2,004	617	(72)	3,785	–	8,205
Underlying revenue from aftermarket services	3,620	1,206	4,826	801	827	921	(75)	2,474	–	7,300
Total underlying revenue	6,655	2,591	9,246	2,037	2,831	1,538	(147)	6,259	–	15,505
Underlying operating profit excluding share of results of joint ventures and associates	708	424	1,132	233	296	63	2	594	–	1,726
Share of results of joint ventures and associates	136	14	150	–	(2)	11	–	9	–	159
Underlying profit before financing and taxation	844	438	1,282	233	294	74	2	603	–	1,885
Segment assets	9,587	1,437	11,024	1,701	3,927	1,616	(10)	7,234	(734)	17,524
Investments in joint ventures and associates	495	17	512	5	29	55	–	89	–	601
Segment liabilities	(6,243)	(1,660)	(7,903)	(985)	(3,034)	(1,015)	–	(5,034)	733	(12,204)
Net assets	3,839	(206)	3,633	721	922	656	(10)	2,289	(1)	5,921
Investment in intangible assets, property, plant and equipment and joint ventures and associates	891	103	994	23	142	80	–	245		1,239
Depreciation, amortisation and impairment	349	53	402	63	272	63	–	398		800

COMPANY BALANCE SHEET

At 31 December 2013

	Notes	2013 £m	2012 £m
Fixed assets			
Investments – subsidiary undertakings	2	**12,000**	11,954
Creditors – amounts falling due within one year			
Financial liabilities	3	**(16)**	(10)
Amounts owed to subsidiary undertakings due within one year		**(995)**	(595)
Net current liabilities		**(1,011)**	(605)
Total assets less current liabilities		**10,989**	11,349
Capital and reserves			
Called-up share capital	4	**376**	374
Share premium account	5	**80**	–
Merger reserve	5	**8,203**	8,569
Capital redemption reserve	5	**857**	497
Other reserve	5	**109**	63
Profit and loss account	5	**1,364**	1,846
Equity shareholders' funds		**10,989**	11,349

The financial statements on pages 124 to 126 were approved by the Board on 12 February 2014 and signed on its behalf by:

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

Company's registered number: 7524813

RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

For the year ended 31 December 2013

	£m
At 1 January 2013	**11,349**
Profit for the year	(1)
Arising on issue of ordinary shares	82
Issue of C Shares	(366)
Share-based payments – direct to equity	(75)
At 31 December 2013	**10,989**

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 Accounting policies

Basis of accounting

The financial statements have been prepared in accordance with applicable UK Accounting Standards on the historical cost basis.

As permitted by section 408 of the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements. As permitted by the audit fee disclosure regulations, disclosure of non-audit fees information is not included in respect of the Company. As permitted by FRS 1 *Cash flow statements*, no cash flow statement for the Company has been included. As permitted by FRS 8 *Related party disclosures*, no related party disclosures in respect of transactions between the Company and its wholly owned subsidiaries have been included.

Investments in subsidiary undertakings

Investments in subsidiary undertakings are reported at cost less any amounts written off.

Share-based payments

As described in the remuneration report on pages 53 to 69, the Company grants awards of its own shares to employees of its subsidiary undertakings, (see note 21 of the consolidated financial statements). The costs of share-based payments in respect of these awards are accounted for, by the Company, as an additional investment in its subsidiary undertakings. The costs are determined in accordance with FRS 20 *Share-based payment*. Any payments made by the subsidiary undertakings in respect of these arrangements are treated as a return of this investment.

Financial instruments

In accordance with FRS 25 *Financial instruments*: *Presentation*, the Company's C Shares are classified as financial liabilities and held at amortised cost from the date of issue until redeemed.

2 Investments – subsidiary undertakings

	£m
Cost:	
At 1 January 2013	**11,954**
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	46
At 31 December 2013	**12,000**

3 Financial liabilities

C Shares

Movements in C Shares during the year were as follows:

	C Shares of 0.1p Millions	Nominal value £m
Issued and fully paid		
At 1 January 2013	**10,418**	**10**
Shares issued	366,041	366
Shares redeemed	(360,173)	(360)
At 31 December 2013	**16,286**	**16**

The rights attaching to C Shares are set out on page 70.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

4 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid					
At 1 January 2013	**1**	**–**	**–**	**1,872**	**374**
Proceeds from shares issued for share options schemes	–	–	–	8	2
At 31 December 2013	**1**	**–**	**–**	**1,880**	**376**

The rights attaching to each class of share are set out on page 70.

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 3.

5 Movements in capital and reserves

	Non-distributable reserves						
	Share capital £m	Share premium	Merger reserve £m	Capital redemption reserve £m	Other reserve[1] £m	Profit and loss account £m	Total £m
At 1 January 2013	**374**	**–**	**8,569**	**497**	**63**	**1,846**	**11,349**
Profit for the year	–	–	–	–	–	(1)	(1)
Proceeds from shares issued for share option schemes	–	–	–	–	–	–	–
Shares issued to share trust	2	80	–	–	–	–	82
Issue of C Shares	–	–	(366)	–	–	–	(366)
Redemption of C Shares	–	–	–	360	–	(360)	–
Share-based payments – direct to equity	–	–	–	–	46	(121)	(75)
At 31 December 2013	**376**	**80**	**8,203**	**857**	**109**	**1,364**	**10,989**

[1] The 'Other reserve' represents the value of share-based payments in respect of employees of subsidiary undertakings for which payment has not been received.

6 Contingent liabilities

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee.

At 31 December 2013, these guarantees amounted to **£1 billion** (2012 £nil).

7 Other information

Emoluments of directors
The remuneration of the directors of the Company is shown in the directors' remuneration report on pages 62 to 69.

Employees
The Company had no employees in 2013.

Share-based payments
Shares in the Company have been granted to employees of the Group as part of share-based payment plans, and are charged in the employing company.