FINANCIAL REVIEW

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

GROUP UNDERLYING INCOME STATEMENT

£ million	2014	2013	Change
Revenue	**14,588**	15,505	(917)
Profit before financing	**1,678**	1,831	(153)
Net financing	**(61)**	(72)	11
Profit before taxation	**1,617**	1,759	(142)
Taxation	**(387)**	(434)	47
Profit for the year	**1,230**	1,325	(95)
Earnings per share (EPS)	**65.31p**	65.59p	(0.28)
Payments to shareholders	**23.1p**	22.0p	1.1p
Gross R&D investment	**1,249**	1,118	131
Net R&D charge	**755**	624	131

SEGMENTAL ANALYSIS

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

GROUP UNDERLYING REVENUE

£14,588m

GROUP UNDERLYING PROFIT BEFORE TAXATION

£1,617m

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

Underlying profit before financing and taxation reduced 8% to £1.7 billion. We saw a negative impact from lower volumes, especially in Defence and Land & Sea, increased R&D investment (£140 million) and higher restructuring charges (£100 million), a one-off Marine charge (£30 million), and adverse FX (£49 million). These factors were offset by an improved trading margin which included approximately £150 million benefit from improved retrospective TotalCare contract profitability (£110 million deterioration in 2013), reflecting lower cost, changing operating patterns and reduced contract risk. Trading margins in Defence also improved, driven by both cost reduction action and an improved mix. In Land & Sea we incurred a loss at our Bergen subsidiary (£33 million), reflecting weaker trading performance. Lower bonus and share incentive costs resulted in a saving of £178 million.

PAGES 32 TO 41
FURTHER DISCUSSION OF TRADING IS INCLUDED IN THE BUSINESS REVIEWS

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

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

PAGE 160
THE GROUP'S TAX PAYMENTS

Underlying EPS was marginally lower at 65.31p, with the impact of the lower underlying profit after tax largely offset by the improvement in the underlying tax rate and a lower non-controlling interest in Power Systems, following Daimler's exercise of the put option in April 2014.

At the Annual General Meeting on 8 May 2015, the directors will recommend an issue of 141 C Shares with a total nominal value of 14.1 pence for each ordinary share. Together with the interim issue on 2 January 2015 of 90 C Shares for each ordinary share with a total nominal value of 9.0 pence, this is the equivalent of a total annual **payment to ordinary shareholders** of 23.1 pence for each ordinary share. Further details are on page 162.

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

PROFIT BEFORE TAXATION

£ million	2014	2013
Underlying	**1,617**	1,759
Mark-to-market adjustments on derivatives	**(1,254)**	217
Movements on other financial instruments	**(87)**	(251)
Effect of acquisition accounting	**(142)**	(265)
Exceptional restructuring	**(39)**	–
Acquisitions and disposals	**8**	335
Post-retirement schemes	**(29)**	(90)
Other (including discontinued operations)	**(7)**	(5)
Reported (2013 restated to exclude discontinued operations)	**67**	1,700

23.1p payment to shareholders

REPORTED PROFIT BEFORE TAX

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

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

Movement on other financial instruments primarily relate to the change in value of the put option on the Power Systems non-controlling interest, which has now been exercised.

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

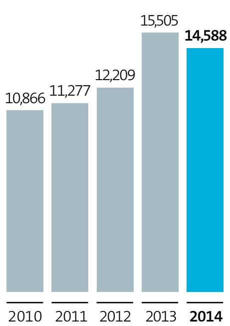
Costs associated with the substantial closure or exit of a site, facility or activity are classified as **exceptional restructuring** and excluded.

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

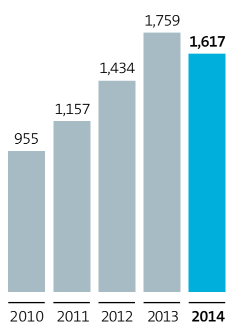
Net financing on **post-retirement schemes** is excluded from underlying profit and, in 2013, the cost of providing a discretionary increase to pensions was also excluded.

Appropriate tax rates are applied to these adjustments, the net effect of which was

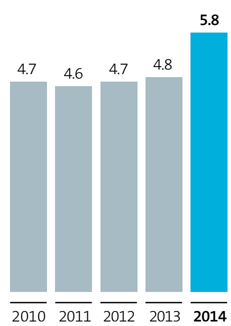
UNDERLYING REVENUE (£m)



UNDERLYING PROFIT BEFORE TAXATION (£m)



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



FINANCIAL REVIEW
CONTINUED

SUMMARY BALANCE SHEET

£ million	2014	Other changes	Energy disposal (note 25)	2013
Intangible assets	**4,804**	(77)	(106)	4,987
Property, plant and equipment	**3,446**	241	(187)	3,392
Joint ventures and associates	**539**	(6)	(56)	601
Net working capital	**(1,134)**	229	(393)	(970)
Net funds	**666**	(1,269)	(4)	1,939
Provisions	**(807)**	(108)	34	(733)
Net post-retirement scheme surpluses/(deficits)	**555**	1,348	–	(793)
Net financial assets and liabilities	**(855)**	732	–	(1,587)
Other net assets and liabilities	**(827)**	(294)	–	(533)
Net assets	**6,387**	796	(712)	6,303
Other items				
USD hedge book US$ billion	**25.6**			24.7
TotalCare assets	**2,492**			1,901
TotalCare liabilities (2013 includes £245m not previously included)	**(687)**			(559)
Net TotalCare assets	**1,805**			1,342
Customer financing contingent commitments:				
Gross	**388**			356
Net	**59**			59

a £239 million reduction in the reported tax charge (2013 £54 million reduction). The adjustment includes a £64 million reduction in the value of recoverable advance corporation tax recognised. A reconciliation of the tax charge is included in note 5.

BALANCE SHEET

Intangible assets (note 9) represent long-term assets of the Group. These assets decreased by £77 million with additional development, contractual aftermarket rights, certification and software costs being more than offset by annual amortisation charges.

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

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

Property, plant and equipment (note 10) increased by £241 million due to the ongoing development and refreshment of facilities and tooling as the Group prepares for increased production volumes.

Investments in joint ventures and associates (note 11) remain stable as the share of retained profit was offset by dividends received.

Provisions (note 18) largely relate to warranties and guarantees provided to secure the sale of OE and services. The increase is largely a result of the recognition of restructuring costs.

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

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

Net financial assets and liabilities (note 17) include the fair value of derivatives, financial RRSAs, the put option on the non-controlling interest of Power Systems and C Shares. The reduction primarily reflects the settlement of the put option (£1,937 million) offset by a reduction in value of the foreign exchange derivatives (£1,137 million) due to the strengthening of the US dollar.

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

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

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

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

FUNDS FLOW

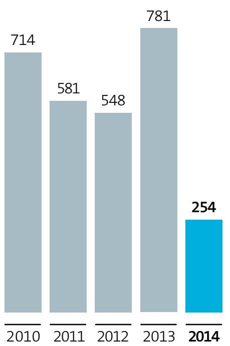
Movement in working capital – the increase reflects the growth of the net TotalCare asset offset by a reduction in the amount of customer deposits. This increase compares to a modest decrease in the previous year which is primarily a result of the phasing of customer deposit utilisation.

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

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

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

FREE CASH FLOW
(£m)



Shareholder payments – the increase reflects the C Share issues in 2014 (£51 million increase) and the Power Systems dividend to Daimler (£14 million increase).

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

SUMMARY FUNDS FLOW

£ million	2014	2013	Change
Opening net funds	**1,939**	1,317	
Closing net funds	**666**	1,939	
Change in net funds	**(1,273)**	622	
Underlying profit before tax	**1,617**	1,759	(142)
Depreciation and amortisation	**600**	608	(8)
Movement in net working capital	**(509)**	91	(600)
Expenditure on property, plant and equipment and intangible assets	**(1,114)**	(1,172)	58
Other	**88**	(231)	319
Trading cash flow	**682**	1,055	(373)
Contributions to defined benefit post-retirement schemes in excess of PBT charge	**(152)**	(36)	(116)
Tax	**(276)**	(238)	(38)
Free cash flow	**254**	781	(527)
Shareholder payments	**(482)**	(417)	(65)
Share buyback	**(69)**	–	(69)
Acquisitions and disposals	**(965)**	265	(1,230)
Net funds of businesses acquired	**(30)**	36	(66)
Foreign exchange	**19**	(43)	62
Change in net funds	**(1,273)**	622	
Average net funds	**(38)**	350	(388)

KEY PERFORMANCE INDICATORS

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

Financial performance indicators are shown below. The key objectives of the Board and its committees are described on pages 59 to 75, non-financial performance indicators are shown in the Sustainability section on pages 44 to 47.

CUSTOMER

ORDER BOOK

+3%

+5% excluding Energy

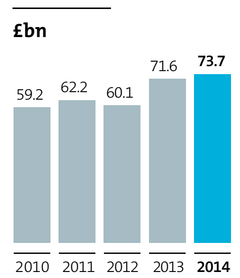
WHY WE MEASURE IT

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

HOW WE HAVE PERFORMED

The order book grew in all businesses except Marine and Nuclear.

The disposal of the Energy business in 2014 reduced the order book by £0.9bn.



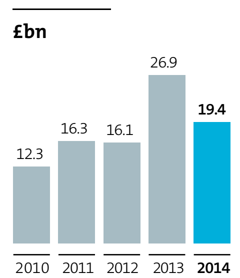
ORDER INTAKE

-28%

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

The reduction mainly reflects lower order intake in Civil aerospace from a high in 2013 and includes the cancellation of Emirates' A350 XWB order.

Defence aerospace order intake increased by 55%.



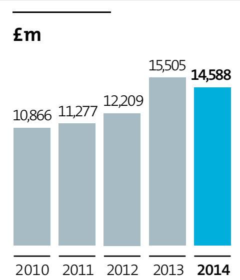
UNDERLYING REVENUE

-6%

-3% excluding FX

Monitoring of revenues provides a measure of business growth. Underlying revenue is used as it reflects the impact of our FX hedging policy by valuing foreign currency revenue at the actual exchange rates achieved as a result of settling FX contracts. This provides a clearer measure of the year-on-year trend.

The reduction reflects an 8% fall in OE revenue and a 3% decline in services revenue.



PAGE 23
STRATEGY

PAGES 24 AND 25
BUSINESS MODEL

PAGES 44 TO 47
SUSTAINABILITY

INNOVATION

NET R&D EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE

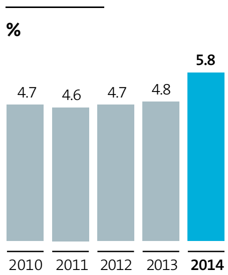
5.8%

WHY WE MEASURE IT

This measure reflects the need to generate current returns as well as to invest for the future. We measure R&D as the self-funded expenditure before both amounts capitalised in the year and amortisation of previously-capitalised balances. We expect to spend approximately 5% of underlying revenues on R&D although this proportion will fluctuate depending on the stage of development of current programmes. We expect this proportion will reduce modestly over the medium term.

HOW WE HAVE PERFORMED

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

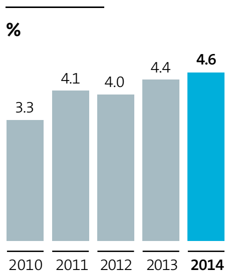


CAPITAL EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE

4.6%

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

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



PROFITABLE GROWTH

UNDERLYING PROFIT BEFORE FINANCING

-8%

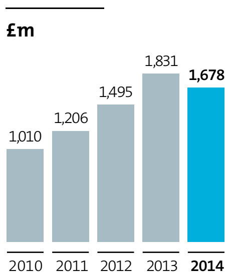
-5% excluding FX

WHY WE MEASURE IT

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

HOW WE HAVE PERFORMED

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



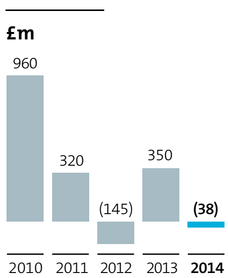
AVERAGE CASH/DEBT

-£38m

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

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

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

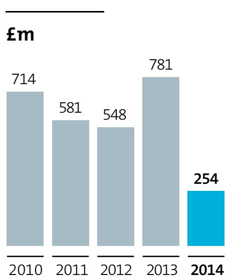


FREE CASH FLOW

£254m

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

The reduction mainly reflects lower profits and movements in customer deposits.



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

PRINCIPAL RISKS

Managing our risks to deliver better power for a changing world

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

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

RISK GOVERNANCE

The review of our risk management framework has been conducted alongside the governance review described on page 56. The Board has decided that, from January 2015, the principal risks will be reviewed by the Board or the most appropriate board committees to make sure that there is sufficient focus and independent oversight on the risks. During the year, the relevant committees will carry out 'deep dives' to review their allocated risks in detail and then report to the Board. This will ensure that we are in a good position to assess how far controls and actions are effective.

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

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

OUR RISK MANAGEMENT ACTIVITIES

The Board is responsible for the Group's system of internal control and for maintaining and reviewing its effectiveness from a financial, operational and compliance perspective. This system of internal control is designed to identify and manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss. Our risk management process is a key element of the Group's internal control system and will develop in line with our activities, and in response to the risks and uncertainties that arise.

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

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

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

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

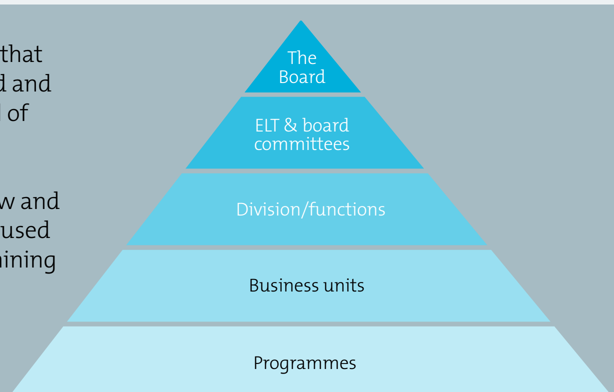
Joint ventures constitute an increasingly large part of the Group's activities. Responsibility for internal control procedures in joint ventures lies with the managers of those operations. We seek to exert influence over such joint ventures through board representation. Management and internal audit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

PAGE 62
DIRECTORS' REPORT

PAGES 71 AND 72
AUDIT COMMITTEE

Our risk framework ensures that risks are identified, managed and communicated at every level of the Group.

Key risks are subject to review and challenge by the ELT and are used to assist the Board in determining our principal risks.



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

PRINCIPAL RISKS

During the year, the ELT and Board focused on the principal risks and the actions being taken to manage them. This involved: discussing changes to the risk register; considering key risk thresholds and agreeing changes to limits; reviewing the risk indicators for principal risks; and, hearing from management how risks that exceed the revised thresholds will be managed.

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

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
PRODUCT FAILURE Product not meeting safety expectations, or causing significant impact to customers or the environment through failure in quality control.	• Operating a safety first culture • Applying our engineering design and validation process from initial design, through production and into service • The Safety and Ethics Committee reviewing the scope and effectiveness of the Group's product safety policies to ensure that they operate to the highest industry standards (see Safety and Ethics Committee on page 66) • Operating a safety management system (SMS), governed by the product safety review board, and subject to continual improvement based on experience and industry best practice. Product safety training is an integral part of our SMS • Improving our supply chain quality • Crisis management team chaired by the Director – Engineering and Technology or General Counsel as appropriate **This principal risk is subject to review by the Safety and Ethics Committee**
BUSINESS CONTINUITY Breakdown of external supply chain or internal facilities that could be caused by destruction of key facilities, natural disaster, regional conflict, financial insolvency of a critical supplier or scarcity of materials which would reduce the ability to meet customer commitments, win future business or achieve operational results.	• Continuing investment in adequate capacity, and modern equipment and facilities (see Aerospace Business review on page 33) • Identifying and assessing points of weakness in our internal and external supply chain, our IT systems and our people skills • Selecting and developing stronger suppliers • Developing dual sources or dual capability • Developing and testing incident management and business continuity plans • Crisis management team chaired by Director – Engineering and Technology or General Counsel as appropriate • Customer excellence centres providing improved response to supply chain disruption **This principal risk is subject to review by the Audit Committee**

STRATEGIC PRIORITIES Customer Innovation Profitable growth

PRINCIPAL RISKS
CONTINUED

RISK OR UNCERTAINTY AND POTENTIAL IMPACT | **HOW WE MANAGE IT**

COMPETITOR ACTION

The presence of large, financially strong competitors in the majority of our markets means that the Group is susceptible to significant price pressure for original equipment or services even where our markets are mature or the competitors are few. Our main competitors have access to significant government funding programmes as well as the ability to invest heavily in technology and industrial capability.

How we manage it:

- Accessing and developing key technologies and service offerings which differentiate us competitively (see Innovation and Technology on page 21)
- Focusing on being responsive to our customers and improving the quality, delivery and reliability of our products and services
- Partnering with others effectively
- Driving down cost and improving margins (see Chief Executive's review on page 17 and Chief Financial Officer's review on pages 26 and 27)
- Protecting credit lines
- Investing in innovation, manufacturing and production, and continuing governance of technology programmes
- Understanding our competitors

This principal risk is subject to review by the Board

POLITICAL RISK

Geopolitical factors that lead to an unfavourable business climate and significant tensions between major trading parties or blocs which could impact the Group's operations. For example: explicit trade protectionism, differing tax or regulatory regimes, potential for conflict, or broader political issues.

How we manage it:

- Where possible, locating our domestic facilities and supply chain in countries with a low level of political risk and/or ensuring that we maintain dual capability
- Diversifying global operations to avoid excessive concentration of risks in particular areas
- The international network of Rolls-Royce and its business units proactively monitoring local situations
- Maintaining a balanced business portfolio with high barriers to entry and a diverse customer base (see Chief Executive's review on pages 15 and 16 and business model on pages 24 and 25)
- Proactively influencing regulation where it affects us (see Sustainability on page 45)

This principal risk is subject to review by the Board

MAJOR PROGRAMME DELIVERY

Failure to deliver a major programme on time, within budget to specification or technical performance falling significantly short of customer expectations, or not delivering the planned business benefits, would have potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation.

How we manage it:

- Major programmes are subject to Board approval (see Additional financial information on page 160)
- Reviewing major programmes at levels and frequencies appropriate to their performance against key financial and non-financial deliverables and potential risks throughout the programme's life cycle (see Additional financial information on page 160)
- Conducting technical audits at pre-defined points and performed by a team that is independent from the programme
- Requiring programmes to address the actions arising from reviews and audits and monitoring and controlling progress through to closure
- Applying knowledge management principles to provide benefit to current and future programmes

This principal risk is subject to review by the Board

STRATEGIC PRIORITIES Customer Innovation Profitable growth

RISK OR UNCERTAINTY AND POTENTIAL IMPACT	HOW WE MANAGE IT
COMPLIANCE Non-compliance by the Group with legislation or other regulatory requirements in the heavily regulated environment in which it operates (for example: export controls, use of controlled chemicals and substances, and anti-bribery and corruption legislation) compromising the ability to conduct business in certain jurisdictions and exposing the Group to potential reputational damage, financial penalties, debarment from government contracts for a period of time, and/or suspension of export privileges or export credit financing, any of which could have a material adverse effect.	• Taking an uncompromising approach to compliance • Operating an extensive compliance programme. This programme and the Global Code of Conduct are disseminated throughout the Group and are updated and reinforced from time-to-time to ensure their continued relevance, and to ensure that they are complied with both in spirit and to the letter. The Global Code of Conduct and the Group's compliance programme are supported by appropriate training (see Safety and Ethics Committee on page 67) • A legal and compliance team is in place to manage our compliance programme and any ongoing regulatory investigations (see Safety and Ethics Committee on page 68) • Lord Gold has reviewed the Group's current compliance procedures and the Group has continued to implement an improvement plan • Implementing a comprehensive REACH compliance programme. This includes establishing appropriate data systems and processes, working with our suppliers, customers and trade associations and conducting research on alternative materials **This principal risk is subject to review by the Safety and Ethics Committee**
MARKET SHOCK The Group is exposed to a number of market risks, some of which are of a macro-economic nature. For example, oil price or foreign currency exchange rates, and some which are more specific to the Group, such as liquidity and credit risks, reduction in air travel or disruption to other customer operations. Significant extraneous market events could also materially damage the Group's competitiveness and/or creditworthiness. This would affect operational results or the outcomes of financial transactions.	• Maintaining a strong balance sheet, through healthy cash balances and a continuing low level of debt • Providing financial flexibility by maintaining high levels of liquidity and an investment grade 'A' credit rating (see Additional financial information on page 161) • Sustaining a balanced portfolio through earning revenue both from the sale of original equipment and aftermarket services, providing a broad product range and addressing diverse markets that have differing business cycles • Deciding where and what currencies to source in, and where and how much credit risk is extended or taken. The Group has a number of treasury policies that are designed to hedge residual risks using financial derivatives (foreign exchange, interest rate and commodity price risk – see Additional financial information on page 160 and note 17) **This principal risk is subject to review by the Audit Committee**
IT VULNERABILITY Breach of IT security causing controlled or critical data to be lost, made inaccessible, corrupted or accessed by unauthorised users impacting the Group's operations or reputation.	• Establishing 'defence in depth' through deployment of multiple layers of software protection and processes including web gateways, filtering, firewalls, intrusion, and advanced persistent threat detectors and integrated reporting (see Audit Committee report on pages 71 and 72) • Running security and network operations centres • Actively sharing IT Security information through industry, government and security forums **This principal risk is subject to review by the Audit Committee**

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

PAMELA COLES
Company Secretary