

INDEPENDENT AUDITORS' REPORT

to the members of Rolls-Royce Holdings plc

Report on the audit of the financial statements

Opinion

In our opinion:

- Rolls-Royce Holdings plc's Consolidated Financial Statements and Company Financial Statements (the "financial statements") give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2018 and of the Group's loss and cash flows for the year then ended;
- the Consolidated Financial Statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- the Company Financial Statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards, comprising FRS 101 "Reduced Disclosure Framework", and applicable law); and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Consolidated Financial Statements, Article 4 of the IAS Regulation.

We have audited the financial statements, included within the Annual Report, which comprise: the Consolidated and Company Balance Sheets at 31 December 2018; the Consolidated Income Statement and Consolidated Statement of Comprehensive Income; the Consolidated Cash Flow Statement for the year then ended; the

Consolidated and Company Statements of Changes in Equity for the year then ended; and the notes to the Consolidated and Company Financial Statements, which include a description of the significant accounting policies.

Our opinion is consistent with our reporting to the Audit Committee.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, as applicable to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

To the best of our knowledge and belief, we declare that non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Company.

Other than those disclosed in note 7, we have provided no non-audit services to the Group or the Company in the period from 1 January 2018 to 31 December 2018.

	<h3>Our audit approach</h3> <p>Overview</p> <ul style="list-style-type: none"> – Overall Group materiality: £56 million, based on 0.4% of underlying revenue. – Overall Company materiality: £128 million, based on 1.0% of total assets. This exceeds Group materiality as it is determined on a different basis given the nature of the Company's operations. For the purposes of the audit of the Consolidated Financial Statements, our procedures, including those on balances in the Company, are undertaken with reference to the Group materiality. <ul style="list-style-type: none"> – Following our assessment of the risks of material misstatement of the Consolidated Financial Statements we subjected 35 individual components (including 3 joint ventures) to full scope audits for group purposes, which following an element of consolidation, equates to 16 group reporting opinions. In addition 7 components performed targeted specified procedures. – In addition the Group engagement team audited the Company and other centralised functions including those covering the Group treasury operations, corporate taxation, pensions, fair value assessments on acquired entities and goodwill and intangible asset impairment assessments. – The components on which full scope audits, targeted specified procedures and centralised work was performed accounted for 87 % of revenue, 80% of loss before tax and 84% of total assets. – Central audit testing was performed where appropriate for reporting components in Group audit scope supported by the Group's Finance Service Centres (FSCs). – As part of the supervision process, the Group engagement team have visited 12 components as well as the FSCs. Interactions with component auditors also included formal written instructions, meetings and reviewing selected audit papers. <p>Our assessment of the risk of material misstatement also informed our views of the areas of particular focus of our work which are listed below:</p> <ul style="list-style-type: none"> – Long-term contract accounting and associated provisions; – The implementation of IFRS 15; – The valuation of and accounting for the acquisition of Industrial De Turbo Propulsores SA ("ITP Aero"); – The presentation and accuracy of underlying results and disclosure of other one-off items (including exceptional items); – The response of the Group to the Deferred Prosecution and Leniency Agreements in connection with alleged bribery and corruption in overseas markets; – The capitalisation and amortisation of development costs; – The recognition of Deferred tax assets; and – The translation of foreign-currency denominated transactions and balances.
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The scope of our audit

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain.

We gained an understanding of the legal and regulatory framework applicable to the Group and the industries in which it operates, and considered the risk of acts by the Group which were contrary to applicable laws and regulations, including fraud. We designed audit procedures at Group and significant component level to respond to the risk, recognising that the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting one resulting from error, as fraud may involve deliberate concealment by, for example, forgery or intentional misrepresentations, or through collusion. We focused on laws and regulations that could give rise to a material misstatement in the Consolidated and Company Financial Statements, including, but not limited to, financial reporting and related company legislation, taxation, export control, defence contracting, anti-bribery and corruption legislation. Our tests included, but were not limited to, agreement of the financial statement disclosures to underlying supporting documentation, review of correspondence with regulators, review of correspondence with legal advisors, enquiries of management, review of significant component auditors' working papers and review of internal audit reports in so far as they related to the financial statements. There are inherent limitations in the audit procedures described above and the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely we would become aware of it.

We identified the Group's response to deferred prosecution and leniency agreements as a key audit matter, and this is discussed further below. As in all of our audits we also addressed the risk of management override of internal controls, including testing journals and evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

Key audit matters

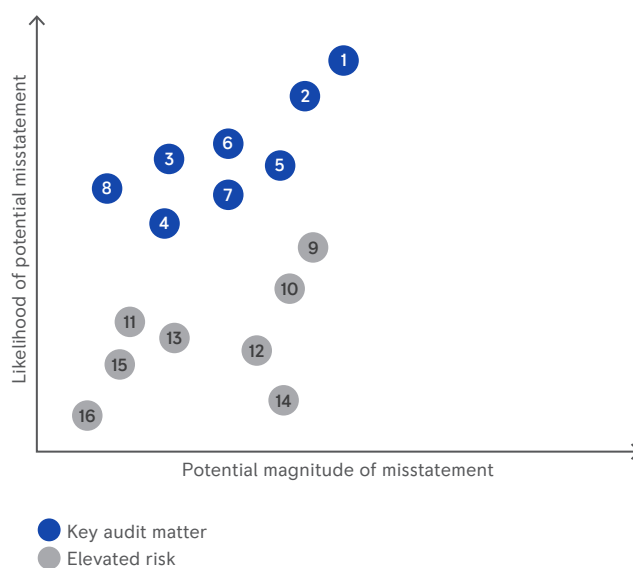
Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key changes in the assessment of audit risks for the current period compared to the assessment made by the prior period auditor that we consider to be key audit matters are:

- Capitalisation and amortisation of development costs is now considered a key audit matter due to a change in the methodology for starting, and subsequently ceasing, the capitalisation of development costs. In addition a change has been made to the basis for amortising those capitalised development costs effective from 1 January 2018;
- Deferred tax asset recognition is now considered a key audit matter due to a significant increase in the value of deferred tax assets and the period over which they are expected to reverse,

requiring the exercise of significant judgement in assessing levels of profitability over an extended period; and

- Translation of foreign currency denominated transactions and balances has been identified as a new significant risk and key audit matter in the current year given the nature of manual adjustments that are needed to retranslate non-monetary assets and liabilities to applicable spot rates and resulting correction recorded in equity at 1 January 2017.



Risk ref	Risk description	Change compared to prior year
Key audit matters		
1	Long-term contract accounting and associated provisions	<>
2	Implementation of IFRS 15	<>
3	Valuation of and accounting for the acquisition of ITP Aero	<>
4	Presentation and accuracy of underlying results and disclosure of other one-off items (including exceptional items)	<>
5	Response of the Group to the Deferred Prosecution and Leniency Agreements in connection with alleged bribery and corruption in overseas markets	<>
6	Capitalisation and amortisation of development costs	↑
7	Deferred tax asset recognition	↑
8	Translation of foreign currency denominated transactions and balances	new
Elevated Risk		
9	Accounting for complex treasury instruments	<>
10	Measurement of post-retirement benefits	<>
11	Risk and Revenue Sharing Arrangements	<>
12	Warranties and other provisions	<>
13	Consolidation process and Joint Venture accounting	new
14	Sales financing	<>
15	Carrying value and accounting for disposals and assets held for sale	new
16	Uncertain tax positions	<>

Key audit matter

Long-term contract accounting and associated provisions
(relevant to the Consolidated Financial Statements)

Page 78 (Audit Committee report) and page 115 (Note 1 to the Consolidated Financial Statements – Accounting policies – Revenue recognition)

The Civil Aerospace and Defence businesses operate primarily with long-term customer contracts that span multiple periods. These long-term contracts require a number of assumptions to be made in order to determine the level of revenue and profit that is recognised in each period.

For Civil Aerospace aftermarket contracts, the profitability typically assumes that there will be significant cost improvements over the lifetime (15-25 years) of the contracts. Significant judgement needs to be applied in determining the engine flying hours, time on wing, whether incremental costs should be treated as wastage or are part of the ongoing cost of servicing a contract, and other operating parameters used to calculate the projected life cycle. These future costs are also risk adjusted to take into account forecasting accuracy which represents an additional judgement. Small adjustments can have a significant impact on the results of an individual financial year.

In addition, changes to the operating conditions of engines such as changes in route structure can result in different performance assumptions and hence cost profiles which impact the profitability of a contract.

The Group continues to experience significant in-service issues on the Trent 1000 programme. The assessment of the total cost of delivering this programme, including the cost of the proposed engineering solutions, speed of implementation and the level of customer disruption which was not expected at the inception of the contract are all significant judgements which impact the value and timing of revenue and profit recognition. In addition, we have had to assess the impact of the announcement of the cessation of A380 deliveries after 2021 on the forecast contract profitability and the recoverability of the associated assets.

At the development stage of a programme agreements are entered into with certain suppliers to share in the risk and rewards of the contracts (Risk and Revenue Sharing Partners – 'RRSP'). This can involve upfront participation fees from the RRSP which are amortised over the engine production phase. In addition, specified revenue and costs are recorded in the income statement net of the RRSP's share.

The nature of the Civil Aerospace business gives rise to a number of contractual guarantees, warranties and potential claims. The accounting for these can be complex and judgemental and may impact the Income Statement immediately or over time through the long term contract pack. The valuation of associated amounts may be highly judgemental and needs to be considered on a contract by contract basis.

How our audit addressed the key audit matter

Our procedures over the long term contract accounting applied in the Civil Aerospace and Defence businesses included:

- We attended meetings with Civil Aerospace and Defence programme and contract managers in order to understand the operational matters impacting the performance of specific contracts and any amendments to contractual arrangements;
- We obtained and read the relevant sections of a sample of contracts to understand the key terms including performance obligations and pricing structures;
- We re-performed the calculations used to determine the degree of completion for a sample of contracts and this was also used in assessing the magnitude of any catch-up adjustments;
- We compared the previously forecast results of a sample of contracts with the actual results to assess the performance of the contract and the historical accuracy of forecasting;
- We verified a sample of costs incurred to third party documentation in order to assess the validity of the forecast costs to complete;
- We challenged management's judgement around whether incremental contract costs arising from in-service issues should be accounted for over the expected duration of the underlying contract or recognised immediately;
- We assessed the assumptions relating to life cycle cost reductions to determine the likelihood of realisation and where relevant the speed at which they would be achieved, including validating these assumptions directly with the senior programme engineers. Where the revision of assumptions has resulted in catch-up adjustments we have understood the driver of the adjustments and assessed the appropriateness of the key changes in the estimates and judgements;
- We obtained support for the risk adjustments made in respect of future costs and challenged management's assumptions through assessment against historical performance, known technical issues and the stage of completion of the programme;
- We challenged the assessment of provisions for loss making or onerous contracts to determine the completeness of the unavoidable costs to fulfill the contractual obligations;
- We reviewed a sample of RRSP contracts to assess whether revenue and costs had been appropriately reflected, net of the share attributable to the RRSP in the income statement; and
- We also assessed the adequacy of disclosures in note 1 of the key judgements and estimates involved in long-term contract accounting and the description of changes arising as a result of the adoption of IFRS 15.

Overall we concluded that the key estimates and judgements used by management in the long-term contract accounting to be supportable and the balances recorded in the financial statements to be materially correct.

Key audit matter**Implementation of IFRS 15**

(relevant to the Consolidated Financial Statements)

Pages 78 (Audit Committee report), page 113 (Note 1 to the Consolidated Financial Statements – Accounting policies – IFRS 15 Revenue from Contracts with Customers) and pages 169 to 174 (Note 27 to the Consolidated Financial Statements – Impact of new accounting standards and other adjustments)

IFRS 15 has had a very significant impact on the timing of revenue and cost recognition for the Civil Aerospace and Defence businesses which generally operate large long-term contracts. Revenue on aftermarket arrangements is now recognised based upon the stage of completion of the contract which is assessed by using the actual costs incurred to date compared to the estimated costs to complete the performance obligations.

Judgement is involved in a number of areas impacting revenue and costs such as engine flying hours, time on wing, the operating pattern of the aircraft and the nature and timing of future maintenance activity, which increases the risk of misstatement.

Given the significant adjustments required to the previously reported figures in order to reflect all of the IFRS 15 impacts, there is a risk that other accounting adjustments are inappropriately reported as IFRS 15 impacts.

How our audit addressed the key audit matter

We completed the majority of our procedures on the initial adoption of IFRS 15 by the half year. These procedures were as follows:

- Review of the predecessor auditors' working papers on the impact assessment disclosed in the 2017 financial statements and audit work performed thereon;
- We sampled a number of contracts to understand the terms and how management had assessed the five step process in its IFRS 15 impact assessment for determining the appropriate revenue recognition;
- With assistance from our in-house technical specialists, we critically appraised a number of position papers produced by management, who were assisted by their external technical specialists, on key aspects of its impact assessment and proposed changes to revenue recognition policy;
- We appraised the revisions to the Group's revenue recognition accounting policy under IFRS 15, including both its appropriateness under the new standard and its completeness in reflecting the Group's different activities, including, for example, Original Equipment and long term aftermarket service contracts; and
- We assessed the appropriateness of the methods used to determine the estimated impact of the initial application of IFRS 15 as reflected in the restatements booked at the half year.

We instructed in-scope component audit teams with significant revenue streams to perform:

- audit procedures on a sample basis to test the accuracy and completeness of the application of IFRS 15 on local contracts;
- an assessment of any material new contracts or contract amendments where revenue recognition under IFRS 15 is complex; and
- substantive testing to support the new additional quantitative information disclosed in the Consolidated Financial Statements.

We found that the changes required by IFRS 15 were well embedded in the business and we reviewed key changes that impact the Group's more significant contracts. We also considered the adequacy of the Group's disclosures on the impact of the adoption of IFRS 15 as set out in notes 1, 2 and 27. No material uncorrected misstatements or disclosure exceptions arose from these procedures.

Key audit matter	How our audit addressed the key audit matter
<p>Valuation of and accounting for the acquisition of ITP Aero <i>(relevant to the Consolidated Financial Statements)</i></p> <p>Pages 78 (Audit Committee report), page 119 (Note 1 to the Consolidated Financial Statements – Accounting policies – Business combinations and goodwill) and page 164 (Note 25 to the Consolidated Financial Statements – Acquisitions and disposals)</p> <p>Following the acquisition of the remaining 53.1% of ITP in December 2017, the fair value of the assets and liabilities acquired was assessed on a provisional basis in the 2017 Annual Report. The purchase price allocation exercise was finalised during the year.</p> <p>Calculating the fair value of the intangible assets of ITP at the date of acquisition involves the use of complex valuation techniques and significant judgements in relation to the future profitability of its long term programmes. Management utilised an expert to perform this exercise.</p> <p>In addition, the existing risk-sharing arrangements between ITP and the Civil Aerospace business are complex and the consolidated position needs to be carefully considered to ensure that the post acquisition recognised revenues and profits are appropriate.</p>	<p>We obtained the updated purchase price allocation performed by management's valuation experts and considered their methodology and assumptions using our own valuation experts.</p> <p>Our work focused on the appropriateness of the valuation models used for each of the significant acquired intangible assets and consideration paid (including the fair value of the existing shareholding). We also assessed the competence and objectivity of management's expert.</p> <p>In light of the bargain purchase gain arising on the transaction, we considered whether all identifiable liabilities and assets had been recognised by comparing the intangible assets recognised to those recognised in other similar acquisitions.</p> <p>We understood the drivers of the change in the fair value of net assets acquired compared to the provisional purchase price allocation disclosed in the 2017 Annual Report, which was predominantly driven by changes in cash flow forecasts and the availability of more up to date information. We challenged the cash flow projections that underpinned each of these valuations, by comparing them to historical cash flows and understanding the reasons for the growth profile in those projections. Where applicable we reconciled the cash flow projections to those used elsewhere in the business including for long-term contract accounting or for the recognition of deferred tax assets.</p> <p>We considered whether adjustments were required to the purchase price allocation for the settlement of pre-existing relationships between Rolls-Royce and ITP, by comparing the contracted programme share to actual experience.</p> <p>Overall we found the disclosures in respect of the transaction and updated purchase price allocation and resultant adjustments to the opening balance sheet to be in line with the results of our audit work with no material exceptions arising.</p>
<p>Presentation of underlying results and disclosure of other one-off items (including exceptional items) <i>(relevant to the Consolidated Financial Statements)</i></p> <p>Page 123 (Note 1 to the Consolidated Financial Statements – Accounting policies – Presentation of underlying results)</p> <p>In addition to the performance measures prescribed by International Financial Reporting Standards, the Group also presents the results on an "underlying" basis, as the Directors believe this better reflects the performance of the Group during the year.</p> <p>The most significant adjustment between the statutory results and the underlying results relates to the foreign exchange rates used to translate foreign currency transactions. The underlying results reflect the achieved rate on foreign currency contracts settled in the period and retranslates assets and liabilities at the foreign currency rates expected to be achieved in the future. As the Group can influence which contracts are settled in each reporting period it has the ability to influence the achieved rate and hence the underlying result.</p> <p>The underlying results differ significantly from the reported statutory results and are used extensively to explain performance to the shareholders. Alternative performance measures can provide investors with a better understanding of the Group's performance if properly used and presented. However, when improperly used and presented, these kinds of measures can mislead investors by masking the real financial performance and position.</p>	<p>We considered the judgements by management to determine what should be treated as a one-off or exceptional item and the translation of foreign currency amounts and obtained corroborative evidence for these.</p> <p>We also considered whether there were items that were recorded within underlying profit that we consider are exceptional in nature and should be reported as an exceptional item. No such material items were identified. As part of this assessment we challenged management's rationale for the designation of certain items as exceptional or one-off and assessed such items against the Group's accounting policy considering the nature and value of those items.</p> <p>We tested management's calculation to translate foreign currency transactions to reflect the achieved foreign exchange rates based on foreign currency contracts settled in the year, and to translate year end assets and liabilities at foreign currency rates that are expected to be achieved in the future. We corroborated these rates to the Group's hedging contracts. We also assessed whether the discretion used by management over the date on which forward foreign exchange contracts are settled indicated any evidence of bias.</p> <p>Overall we found that the classification judgements made by management were in line with their policy for underlying results and exceptional items, had been consistently applied and found no material exceptions from our testing. We also assessed the appropriateness and completeness of the disclosures of the impact of one-off or non-underlying items in note 1 and note 2 and other related notes to the Consolidated Financial Statements and found them to be appropriate.</p>

Key audit matter

Response to deferred prosecution and leniency agreements in connection with alleged bribery and corruption in overseas markets*(relevant to the Consolidated and Company Financial Statements)**Pages 101 (Safety & Ethics Committee report – Ethics and compliance) and page 163 (Note 23 to the Consolidated Financial Statements – Contingent liabilities)*

In January 2017 the Group became party to deferred prosecution agreements with the UK Serious Fraud Office (“SFO”) and the US Department of Justice (“DOJ”) and a leniency agreement with the Brazilian Federal Prosecution Service (“MPF”) (collectively the “Agreements”) as a consequence of allegations of fraudulent payments to overseas intermediaries and prosecution was deferred provided that the Group fulfils certain requirements, including the settlement of a financial penalty.

The Group operates in industries which are characterised by competition for individually significant contracts with customers which are often directly or indirectly associated with governments, and in a number of territories where the use of intermediaries is viewed as normal practice. This means that the risk of future instances of corruption remains present.

The possible implications of these high profile and sensitive Agreements on the future business if the terms are not met, including additional fines and prosecution, are significant.

How our audit addressed the key audit matter

We planned and designed our audit approach to this area in conjunction with our in-house forensic specialists and after reading the Agreements and compliance reports made to the SFO and DoJ during the year. Where applicable, we vouched the assertions made by management to objective evidence.

We assessed the overall control environment and ‘tone at the top’, including understanding and assessing the Group’s internal investigations processes which identify and assess possible non-compliance, such as whistle-blowing hotlines. We evaluated key controls over the appointment, monitoring and payments made to intermediaries.

We made inquiries of the Safety and Ethics Committee and the Audit Committee as to whether the Group is in compliance with laws and regulations relating to bribery and corruption. We met with management including the head of ethics and compliance to assess the risk of occurrence of inappropriate activities, the status of the ongoing control improvement process, and the possibility of further fines or penalties.

We independently circularised and spoke with the Group’s external legal counsel to obtain their views about the status of the Agreements and to test management’s assertions of the likely outcome.

We tested journals and other transactions with unusual characteristics, including searching for transactions with previously rejected intermediaries and for words that could indicate that inappropriate commercial payments have been made.

We designed additional inquiries to be performed in certain markets not otherwise included in the Group audit scope to assess the risk of arrangements being in place in those markets, which may require follow-up procedures to be performed.

Taking into account the findings from our audit procedures we then assessed the appropriateness of the contingent liability disclosure in note 23 of the Consolidated Financial Statements, and found it to be reasonable and consistent with the information we obtained during the course of our audit.

Capitalisation and amortisation of development costs
*(relevant to the Consolidated Financial Statements)**Pages 119 to 120 (Note 1 to the Consolidated Financial Statements – Accounting policies – Research and development, and pages 136 to 138 (Note 9 to the Consolidated Financial Statements – Intangible assets)*

The value of development costs (including participation payments) on the balance sheet is financially significant. In addition, there is a high degree of judgement involved in determining the point at which capitalisation should commence and cease and when subsequent expenditure which enhances the performance of an engine should be capitalised.

The basis for amortising capitalised development costs also represents an area of judgement, as is the carrying value in light of overall programme performance.

We reviewed projects where development costs are recognised for ongoing viability and considered management’s assessment of the carrying value for those assets which may be impaired. Our focus was on those assets with a higher risk of impairment, including the Trent 900 programme following the announcement of the cessation of A380 deliveries after 2021.

We tested a sample of additions in the year to assess the appropriateness of capitalisation and the amortisation period set based on an assessment of the point at which technical feasibility and commercial viability have been reached. This also included underlying testing of standard labour and material rates used to determine the value of the capitalised amounts.

We performed a review of changes to amortisation rates in the year and assessed whether these were appropriate based on our understanding of the underlying programmes or other explanations from management.

We also assessed the consistency of assumptions across programmes and customers with reference to publically available data where available.

Key audit matter	How our audit addressed the key audit matter
<p>Capitalisation and amortisation of development costs (continued)</p>	<p>For capitalised programme assets our procedures included the following:</p> <ul style="list-style-type: none"> - We obtained the Directors' trigger assessment which is performed at a programme level to identify whether any programme assets should be subject to an impairment assessment; - Specific focus was placed on the Trent 900 programme given the announcement of the cessation of A380 deliveries after 2021; - We obtained the impairment models prepared by management and assessed the key assumptions used and agreed the underlying cash flows with respect to aftermarket contracts to underlying books and records that support the long-term contract results. We also challenged management on the key estimates, such as the pre-tax discount rate used and evidence to support forecast profits from engines in the secondary market, following the completion of the initial aftermarket contract; - For the Trent 900 programme we also agreed the updated cash flows to the latest delivery forecast; and - We challenged management as not all programme dedicated assets were initially included in the impairment models. In addition, we challenged the inclusion of the Joint Venture overhaul base profits given these are separate cash generating units. Models were subsequently updated to reflect both of these points. <p>We did not identify any uncorrected material exceptions from our audit work.</p>
<p>Deferred tax asset recognition (relevant to the Consolidated Financial Statements)</p> <p>Page 78 (Audit Committee report), page 117 (Note 1 to the Consolidated Financial Statements – Accounting policies – Taxation), and pages 131 to 134 (Note 5 to the Consolidated Financial Statements – Taxation)</p> <p>The Group has recognised significant deferred tax assets on the basis of future levels of profitability in the relevant tax jurisdictions. The magnitude of the assets recognised necessitates the need for significant judgement in assessing the levels of profitability over an extended period.</p> <p>The recent increase in the assets recognised and hence the forecasting period presents a heightened risk that deferred tax assets are recognised inappropriately and there is an inherent increased level of uncertainty in the forecasting process over an extended period.</p>	<p>We evaluated management's assessment as to whether there will be sufficient taxable profits in future periods to support the recognition of deferred tax assets by tax jurisdiction. We assessed the future cash flow forecasts and the assumptions which underpinned them in light of the extended period.</p> <p>Where applicable we reconciled the forecasts used to justify the recognition of deferred tax assets to those used elsewhere in the business including for long-term contract accounting or for the Directors' viability and going concern statements.</p> <p>The right of offset of certain deferred tax liabilities and deferred tax assets was also assessed which led to the identification of a correction to the opening balance sheet which has been reflected in the Consolidated Financial Statements. We also assessed the adequacy of disclosures over this area.</p> <p>We note that the period of time over which this asset will be utilised is estimated at between 20 to 30 and this has been disclosed in note 5. Given this time period for utilisation the balance will need to be constantly re-assessed against the Group's future performance.</p> <p>We did not identify any uncorrected material exceptions from our audit work.</p>

Key audit matter**Translation of foreign currency denominated transactions and balances***(relevant to the Consolidated Financial Statements)**Page 117 (Note 1 to the Consolidated Financial Statements – Accounting policies – Foreign currency translation)*

Foreign exchange rate movements influence the reported income statement, the cash flow and closing net funds balance. One of the Group's primary accounting systems translates transactions denominated in foreign currencies at a fixed rate. Foreign currency denominated transactions and balances are then re-translated to actual average and spot rates through manual adjustments.

Due to the manual nature and significance of the recurring adjustment there is a risk that transactions and balances denominated in foreign currencies are inappropriately translated in the Consolidated Financial Statements.

How our audit addressed the key audit matter

In addition to our testing in other areas of the various financial statement line items we performed the following specific audit procedures over this area:

- Obtained an understanding of the process employed by management to correct the translation of foreign currency balances and transactions;
- Tested system reports identifying transactions and balances in source currency by agreeing these to general ledger balances;
- Reperformed manual calculations of the adjustment needed to correct the translation of the foreign currency denominated transactions and balances;
- Where assumptions are used to calculate the adjustment necessary, for example, assumptions that certain categories of transactions, revenue or costs, are foreign currency denominated, we assessed the reasonableness of this and then reperformed management's calculation;
- We reconciled the balances and transactions requiring adjustment by source currency to source data and assessed the completeness of these balances and transactions;
- For exchange rates used in management's calculations for the translation adjustments we agreed these to an independent source; and
- For each adjustment sampled we assessed whether the foreign currency denominated balance or transaction was translated at the appropriate exchange rate depending on its nature.

We did not identify any material uncorrected exceptions from this work.

How we tailored the audit scope

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the structure of the Group and the parent Company, the accounting processes and controls, and the industry in which they operate.

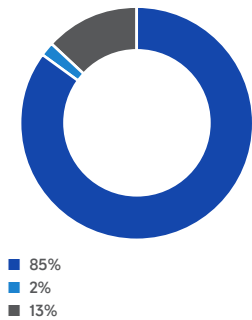
Our scoping is based on the Group's consolidation structure. We define a component as a single reporting unit which feeds into the Group consolidation. Of the Group's 362 reporting components, 35 individual components (including 3 joint ventures) were subject to full scope audits for group purposes, which following an element of consolidation, equates to 16 group reporting opinions; and 7 components performed targeted specified procedures.

In order to achieve audit coverage over the financial statements, under our audit methodology, we test both the design and operation of relevant business process controls and perform substantive testing over each financial statement line item.

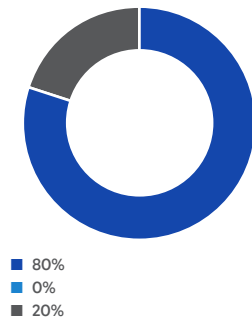
The Group operates Finance Service Centres (FSCs) to bulk process financial transactions in Derby (UK), Indianapolis (US) and Bangalore (India). Based on our assessment with management it is not possible to fully test revenue and profit centrally as certain key processes, such as long-term contracting, remain within the business due to their nature.

Our audit covered 87% of revenue, 80% of loss before tax and 84% of total assets. All entities that contribute in excess of 3% of the Group's revenue were included in full scope.

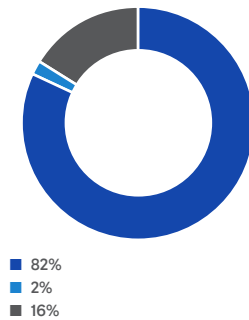
Revenue



Loss before tax



Total assets



Further specific audit procedures over central functions, the Group consolidation and areas of significant judgement (including taxation, goodwill, intangible assets, treasury and post-retirement benefits) were directly led by the Group audit team.

Where work was performed by component auditors, we determined the level of involvement we needed to have in the audit work at those reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the Consolidated Financial Statements.

We issued formal written instructions to all component auditors setting out the audit work to be performed by each of them and maintained regular communication with the component auditors throughout the audit cycle. These interactions included attending certain component clearance meetings and holding regular conference calls, as well as reviewing and assessing any matters

reported. The Group engagement team also reviewed selected audit working papers for certain component teams.

In addition, senior members of the Group engagement team visited component teams across all group segments in the United Kingdom, United States of America, Germany, Spain, Norway and Singapore. These visits included meetings with local management and with the component auditors.

Materiality

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Consolidated Financial Statements	Company Financial Statements
Overall materiality	£56 million	£128 million
How we determined it	0.4% of total underlying revenue	1.0% of total assets
Rationale for benchmark applied	The benchmark used has changed compared to that used in prior years by the predecessor auditors. Historically a benchmark based on a three-year average of profit before tax, adjusted for exchange impacts was used. The reason for our change is that there has been considerable volatility in this profit before tax figure which has been further exacerbated by the impact of IFRS 15. Underlying revenue is much less volatile and remains a key focus for investors as evidenced by its inclusion as a key performance indicator.	We determined our materiality based on total assets, which is more applicable than a performance-related measure as the company is an investment holding company for the Group.

For each component in the scope of our Group audit, we allocated a materiality that is less than our overall group materiality and set a performance materiality threshold lower than the allocated materiality that was used to determine the nature, timing and extent of audit procedures on individual accounts or balances at a component level. This was set so as to reflect the risk of misstatements and experience of audit adjustments arising from our work. The range of performance materiality thresholds determined for components was between £4 million and £32 million. Certain components were audited to a local statutory audit materiality that was also less than our overall Group materiality.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £2 million as well as misstatements below those amounts that, in our view, warranted reporting for qualitative reasons.

Going concern

In accordance with ISAs (UK) we report as follows:

Reporting obligation	Outcome
We are required to report if we have anything material to add or draw attention to in respect of the Directors' statement in the financial statements about whether the Directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements and the Directors' identification of any material uncertainties to the Group's and the parent Company's ability to continue as a going concern over a period of at least twelve months from the date of approval of the financial statements.	We have nothing material to add or to draw attention to. As not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and parent Company's ability to continue as a going concern. For example, the terms on which the United Kingdom may withdraw from the European Union, which is currently due to occur on 29 March 2019, are not clear, and it is difficult to evaluate all of the potential implications on the Group's and Company's trade, customers, suppliers and the wider economy.
We are required to report if the directors' statement relating to Going Concern in accordance with Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit.	We have nothing to report.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The Directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are

required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report and Directors' Report, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, the Companies Act 2006 (CA06), ISAs (UK) and the Listing Rules of the Financial Conduct Authority (FCA) require us also to report certain opinions and matters as described below (required by ISAs (UK) unless otherwise stated).

Strategic Report and Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 December 2018 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements. (CA06)

In light of the knowledge and understanding of the Group and parent Company and their environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' Report. (CA06)

The directors' assessment of the prospects of the Group and of the principal risks that would threaten the solvency or liquidity of the Group

We have nothing material to add or draw attention to regarding:

- The directors' confirmation on page 64 of the Annual Report that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity.
- The disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.
- The directors' explanation on page 55 of the Annual Report as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We have nothing to report having performed a review of the directors' statement that they have carried out a robust assessment of the principal risks facing the Group and statement in relation to the longer-term viability of the Group. Our review was substantially less in scope than an audit and only consisted of making inquiries and considering the directors' process supporting their statements; checking that the statements are in alignment with the relevant provisions of the UK Corporate Governance Code (the "Code"); and considering whether the statements are consistent with the knowledge and understanding of the Group and parent Company and their environment obtained in the course of the audit. (*Listing Rules*)

Other Code Provisions

We have nothing to report in respect of our responsibility to report when:

- The statement given by the directors, on page 105, that they consider the Annual Report taken as a whole to be fair, balanced and understandable, and provides the information necessary for the members to assess the Group's and parent Company's position and performance, business model and strategy is materially inconsistent with our knowledge of the Group and parent Company obtained in the course of performing our audit.
- The section of the Annual Report on pages 76 to 81 describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.
- The directors' statement relating to the parent Company's compliance with the Code does not properly disclose a departure from a relevant provision of the Code specified, under the Listing Rules, for review by the auditors.

Directors' Remuneration

In our opinion, the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006. (CA06)

Responsibilities for the financial statements and the audit**Responsibilities of the directors for the financial statements**

As explained more fully in the Statement of the Directors' Responsibilities set out on page 105, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the parent Company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the parent Company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the parent Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Other required reporting**Companies Act 2006 exception reporting**

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the parent Company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Appointment

Following the recommendation of the audit committee, we were appointed by the members on 3 May 2018 to audit the financial statements for the year ended 31 December 2018 and subsequent financial periods. This is therefore our first year of uninterrupted engagement.

Ian Chambers (Senior Statutory Auditor)

for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
28 February 2019

SUSTAINABILITY ASSURANCE STATEMENT

To the stakeholders of Rolls-Royce Holdings plc

Independent limited assurance statement

Introduction and objectives of work

Bureau Veritas UK Limited (Bureau Veritas) has been engaged by Rolls-Royce Holdings plc (the Company) to provide limited assurance over selected sustainability performance indicators for inclusion in its 2018 Annual Report for the year ended 31 December 2018 (the Report) and on its website. This Assurance Statement applies to the related information included within the scope of work described below.

Scope of work

The scope of our work was limited to assurance over the following information included within the Report (the 'Selected Information'):

- energy consumption;
- scope 1 & 2 greenhouse gases (GHG) emissions;
- total reportable injury; and
- the number of people reached through the STEM education outreach programmes.

Reporting criteria

The Selected Information is reported according to the Rolls-Royce 'Basis of Reporting', a copy of which can be found in the sustainability section at www.rolls-royce.com/sustainability.

Limitations and exclusions

Excluded from the scope of our work is verification of any information relating to:

- activities outside the defined verification period; and
- other information included in the Report.

This limited assurance engagement relies on a risk-based selected sample of sustainability data and the associated limitations that this entails. This independent statement should not be relied upon to detect all errors, omissions or misstatements that may exist.

Responsibilities

This preparation and presentation of the Selected Information in the Report are the sole responsibility of the management of the Company.

Bureau Veritas was not involved in the drafting of the Report or of the Reporting Criteria. Our responsibilities were to:

- obtain limited assurance about whether the Selected Information has been prepared in accordance with the Reporting Criteria;
- form an independent conclusion based on the assurance procedures performed and evidence obtained; and
- report our conclusions to the management of the Company.

Assessment standard

We performed our work in accordance with the International Standard on Assurance Engagements (ISAE) 3000 Revised, Assurance Engagements Other than Audits or Reviews of Historical Financial Information (effective for assurance reports dated on or after 15 December 2015), and in accordance with the main requirements of ISO 14064:2006 Part 3 – Specification with Guidance for the Validation and Verification of Greenhouse Gas Assertions.

Summary of work performed

As part of its independent verification, Bureau Veritas undertook the following activities:

- assessed the appropriateness of the Reporting Criteria for the Selected Information;
- conducted interviews with relevant personnel;
- carried out nine site visits, selected employing a risk-based approach, in the UK, US, France, Spain and Poland;
- reviewed the data collection and consolidation processes used to compile the Selected Information, including assessing assumptions made, the data scope and reporting boundaries;
- reviewed documentary evidence produced by the Group;
- agreed a sample of the Selected Information to the corresponding source documentation; and
- re-performed aggregation calculations of the Selected Information.

Conclusion

On the basis of our methodology and the activities described above, nothing has come to our attention to indicate that the Selected Information has not been properly prepared, in all material respects, in accordance with the Reporting Criteria.

Statement of independence, integrity and competence

Bureau Veritas is an independent professional services company that specialises in quality, environmental, health, safety and social accountability with over 185 years history. Its assurance team has extensive experience in conducting verification over environmental, social, ethical and health and safety information, systems and processes.

Bureau Veritas operates a certified¹ Quality Management System which complies with the requirements of ISO 9001:2008, and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Bureau Veritas has implemented and applies a Code of Ethics, which meets the requirements of the International Federation of Inspections Agencies (IFIA)² across the business to ensure that its employees maintain integrity, objectivity, professional competence and due care, confidentiality, professional behaviour and high ethical standards in their day-to-day business activities.

The assurance team for this work does not have any involvement in any other Bureau Veritas projects with the Group.

Bureau Veritas UK Limited
London
18 February 2019



¹ Certificate of Registration FS 34143 issued by BSI Assurance UK Limited

² International Federation of Inspection Agencies – Compliance Code – Third Edition

OTHER FINANCIAL INFORMATION

Foreign exchange

Foreign exchange rate movements influence the reported income statement, the cash flow and closing net funds balance. The average and spot rates for the principal trading currencies of the Group are shown in the table below:

		2018	2017	Change
USD per GBP	Year-end spot rate	1.28	1.35	-5%
	Average spot rate	1.33	1.29	+4%
EUR per GBP	Year-end spot rate	1.12	1.13	-1%
	Average spot rate	1.13	1.14	-1%

The Group's global corporate income tax contribution

The Group's total corporation tax payments in 2018 were £248m. Around 85% of this was paid in the US, Germany, UK and Singapore which reflects the fact that the majority of the Group's business is undertaken, and employees are based, in these countries. The balance was paid in around 40 other countries.

In common with most multinational groups the total of all profits in respect of which corporate income tax is paid is not the same as the consolidated loss before tax reported on page 107. The main reasons for this are:

- (i) the consolidated income statement is prepared under Adopted IFRS, whereas tax is paid on the profits of each Group company, which are determined by local accounting rules;
- (ii) accounting rules require certain income and costs relating to our commercial activities to be eliminated from, or added to, the aggregate of all the profits of the Group companies when preparing the consolidated income statement ('consolidation adjustments'); and
- (iii) specific tax rules including exemptions or incentives as determined by the tax laws in each country.

The level of tax paid in each country is impacted by the above. In most cases, (i) and (ii) are only a matter of timing and therefore tax will be paid in an earlier or later year. As a result they only have a negligible impact on the Group's underlying tax rate. The core underlying tax rate can be found on page 19. This is due to deferred tax accounting, details of which can be found in note 5 to the Consolidated Financial Statements. The impact of (iii) will often be permanent depending on the relevant tax law.

Further information on the tax position of the Group can be found as follows:

- Audit Committee Report (page 77) - The group tax director gave a presentation to the Audit Committee during the year which covered various matters including tax risks and how they are managed;
- note 1 to the Consolidated Financial Statements (pages 114 and 117) - Details of key areas of uncertainty and accounting policies for tax; and
- note 5 to the Consolidated Financial Statements (pages 131 to 134) - Details of the tax balances in the Consolidated Financial Statements together with a tax reconciliation. This explains the main drivers of the tax rate.

At this stage we expect these items to continue to influence the underlying tax rate. The reported tax rate is more difficult to forecast due to the impact of significant adjustments to reported profits, in particular the net unrealised fair value changes to derivative contracts and the recognition of advance corporation tax.

Information on the Group's approach to managing its tax affairs can be found at www.rolls-royce.com/sustainability.

Investments and capital expenditure

The Group subjects all major investments and capital expenditure to a rigorous examination of risks and future cash flows to ensure that they create shareholder value. All major investments, including the launch of major programmes, require Board approval.

The Group has a portfolio of projects at different stages of their lifecycles. All of our major investments and projects are assessed using a range of financial metrics, including discounted cash flow and return on investment.

Financial risk management

The Board has established a structured approach to financial risk management. The Financial risk committee (Frc) is accountable for managing, reporting and mitigating the Group's financial risks and exposures. These risks include the Group's principal counterparty, currency, interest rate, commodity price, liquidity and credit rating risks outlined in more depth in note 17. The Frc is chaired by the Chief Financial Officer or Group Controller. The Group has a comprehensive financial risk policy that advocates the use of financial instruments to manage and hedge business operations risks that arise from movements in financial, commodities, credit or money markets. The Group's policy is not to engage in speculative financial transactions. The Frc sits quarterly to review and assess the key risks and agree any mitigating actions required.

Capital structure

£m	2018	2017
Total equity	(1,052)	933
Cash flow hedges	106	112
Group capital	946	1,045
Net funds	611	(305)

Operations are funded through various shareholders' funds, bank borrowings, bonds and notes. The capital structure of the Group reflects the judgement of the Board as to the appropriate balance of funding required. Funding is secured by the Group's continued access to the global debt markets. Borrowings are funded in various currencies using derivatives where appropriate to achieve a required currency and interest rate profile. The Board's objective is to retain sufficient financial investments and undrawn facilities to ensure that the Group can both meet its medium-term operational commitments and cope with unforeseen obligations and opportunities.

The Group holds cash and short-term investments which, together with the undrawn committed facilities, enable it to manage its liquidity risk.

During the year, the Group replaced the £1,500m and £500m committed bank borrowing facilities with a new £2,500m facility with a maturity date of 2023. This facility was undrawn at the period end. Also during 2018, the Group issued €1,100m of bond notes of which €550m mature in 2024 and €550m in 2028. At the year end, the Group retained aggregate liquidity of £7.5bn, including cash and cash equivalents of £5.0bn and undrawn borrowing facilities of £2.5bn. Circa £858m of drawn borrowings mature in 2019.

The maturity profile of the borrowing facilities is regularly reviewed to ensure that refinancing levels are manageable in the context of the business and market conditions. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating. The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This debt is further outlined in note 11.

Credit rating

	Rating	Outlook	Grade
Moody's Investors Service	A3	Negative	Investment
Standard & Poor's	BBB+	Negative	Investment
Fitch	A-	Stable	Investment

The Group subscribes to Moody's, Standard & Poor's and Fitch for independent long-term credit ratings. At the date of this report, the Group maintained investment-grade rating from all three agencies.

As a capital-intensive business making long-term commitments to its customers, the Group attaches significant importance to maintaining or improving the current investment-grade credit ratings.

Accounting

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU.

IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments* were adopted from 1 January 2018 and the impacts are described in note 1 and note 27 of the Consolidated Financial Statements. In particular, IFRS 15 has had a material impact, with a reductions of net assets of £4.5bn and £5.2bn at 31 December 2016 and 2017 respectively.

IFRS 16 *Leases* is effective from 1 January 2019 and the estimated impact is set out in note 1 of the financial statements.

Share price

During the year, the share price reduced by 2% from 847p to 830p, compared to a 13% reduction in the FTSE aerospace and defence sector and a 11% reduction in the FTSE 100. The Company's share price ranged from 759p in December 2018 to 1094p in August 2018.

OTHER STATUTORY INFORMATION

Share capital

On 31 December 2018, the Company's issued share capital comprised of:

1,895,710,451	Ordinary shares	20p each
29,071,130,784	C Shares	0.1p each
1	Special Share	£1

The ordinary shares are listed on the London Stock Exchange.

Payment to shareholders

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

Shareholders can choose to:

- redeem all C Shares for cash;
- redeem all C Shares for cash and reinvest the proceeds in the C Share Reinvestment Plan (CRIP); or
- keep the C Shares.

The CRIP is operated by Computershare Investor Services PLC (the Registrar). The Registrar will purchase ordinary shares in the market for shareholders electing to reinvest their C Share proceeds. Shareholders wishing to participate in the CRIP or redeem their C Shares in July 2019 must ensure that their instructions are lodged with the Registrar no later than 5.00pm (BST) on 3 June 2019 (CREST holders must submit their election in CREST before 3.00pm (BST) on 3 June 2019). Redemption will take place on 4 July 2019.

At the 2019 AGM, the Directors will recommend an issue of 71 C Shares with a total nominal value of 7.1p for each ordinary share. The C Shares will be issued on 1 July 2019 to shareholders on the register on 26 April 2019 and the final day of trading with entitlement to C Shares is 25 April 2019. Together with the interim issue on 3 January 2019 of 46 C Shares for each ordinary share with a total nominal value of 4.6p, this is the equivalent of a total annual payment to ordinary shareholders of 11.7p for each ordinary share.

Further information for shareholders is on pages 204 and 205.

Share class rights

The full share class rights are set out in the Company's Articles of Association (Articles), which are available at www.rolls-royce.com. The rights are summarised below.

Ordinary shares

Each member has one vote for each ordinary share held. Holders of ordinary shares are entitled to: receive the Company's Annual Report; attend and speak at general meetings of the Company; appoint one or more proxies or, if they are corporations, corporate representatives; and exercise voting rights. Holders of ordinary shares may receive a bonus issue of C Shares or a dividend and on liquidation may share in the assets of the Company.

C Shares

C Shares have limited voting rights and attract a preferential dividend of 75% of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis. The Company has the option to redeem the C Shares compulsorily, at any time if: the aggregate number of C Shares in issue is less than 10% of the aggregate number of all C Shares issued on or prior to that time or the event of a capital restructuring of the Company; the introduction of a new holding company; the acquisition of the Company by another company; or a demerger from the Group.

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

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

Special Share

Certain rights attach to the special rights non-voting share (Special Share) issued to the UK Secretary of State for Business, Energy & Industrial Strategy (Special Shareholder). These rights are set out in the Articles. Subject to the provisions of the Companies Act 2006 (the Act), the Treasury Solicitor may redeem the Special Share at par value at any time. The Special Share confers no rights to dividends but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

Certain Articles (in particular those relating to the foreign shareholding limit, disposals and the nationality of the Company's Directors) that relate to the rights attached to the Special Share may only be altered with the consent of the Special Shareholder. The Special Shareholder is not entitled to vote at any general meeting or any other meeting of any class of shareholders.

Restrictions on transfer of shares and limitations on holdings

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

Shareholder agreements and consent requirements

The Company and Bradley Singer are party to a relationship agreement with ValueAct (a summary of which can be found at www.rolls-royce.com).

No disposal may be made to a non-Group member which, alone or when aggregated with the same or a connected transaction, constitutes a disposal of the whole or a material part of either the nuclear propulsion business or the assets of the Group as a whole, without the consent of the Special Shareholder.

Authority to issue shares

At the AGM in 2018, authority was given to the Directors to allot new C Shares up to a nominal value of £500m as an alternative to a cash dividend.

In addition, an ordinary resolution was passed authorising the Directors to allot new ordinary shares up to a nominal value of £123,347,889 equivalent to one-third of the issued share capital of the Company. This resolution also authorised the Directors to allot up to two thirds of the total issued share capital of the Company, but only in the case of a rights issue.

A further special resolution was passed to effect a disapplication of pre-emption rights for a maximum of 5% of the issued share capital of the Company.

These authorities are valid until the AGM in 2019 or 2 August 2019, whichever is earlier, and the Directors propose to renew each of them at the 2019 AGM. The Board believes that these authorities will allow the Company to retain flexibility to respond to circumstances and opportunities as they arise.

ITP Aero

Following approval from the relevant authorities in Spain, on 19 December 2017 the Group acquired a 53.1% shareholding in ITP Aero from SENER resulting in ITP Aero becoming a wholly-owned subsidiary of the Company. The consideration of €718m will be settled over a two-year payment period, payable in eight equal instalments, and the agreement with SENER allows the Company flexibility to settle up to 100% of the consideration in the form of ordinary shares. Five payments were settled in 2018, all in the form of ordinary shares, as follows:

Instalment	No. of ordinary shares	Date
1st	9,612,581	15 January 2018
2nd	9,624,396	19 March 2018
3rd	9,719,544	19 June 2018
4th	8,398,166	19 September 2018
5th	10,202,227	19 December 2018

Final consideration as to whether the remaining three instalments will be settled in the form of cash or ordinary shares will be determined by the Company during the remaining payment period.

Authority to purchase own shares

At the AGM in 2018, the Company was authorised by shareholders to purchase up to 185,021,833 of its own ordinary shares representing 10% of its issued ordinary share capital.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2019 or 2 August 2019, whichever is the earlier. A resolution to renew the authority will be proposed at the 2019 meeting.

Deadlines for exercising voting rights

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

Voting rights for employee share plan shares

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

Change of control

Contracts and joint venture agreements

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

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At 31 December 2018, these facilities were less than 19% drawn (2017: 22%).

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

Employee share plans

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

- PSP – awards would vest pro rata to service in the performance period, subject to Remuneration Committee judgement of Group performance.
- APRA deferred shares – the shares would be released from trust immediately.
- Sharesave – options would become exercisable immediately. The new controlling company might offer an equivalent option in exchange for cancellation of the existing option.
- Share Incentive Plan (SIP) – consideration received as shares would be held within the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.
- LTIP – awards would vest on the change of control, subject to the Remuneration Committee's judgement of performance and may be reduced pro rata to service in the vesting period. Any applicable holding period will cease in the event of a change in control.

Accounting policies, financial instruments and risk

Details of the Group's accounting policies, together with details of financial instruments and risk, are provided in notes 1 and 17 to the Consolidated Financial Statements on pages 117 and 144.

Employment of disabled people

Rolls-Royce is an inclusive employer committed to building a diverse workforce. We give full and fair consideration to all applications for employment by disabled persons together with the continued employment of any employee who suffers disability whilst employed by the Group. All employees are able to take advantage of our training programmes in developing their careers and promotion opportunities are open to employees regardless of disability. For more information please see page 44.

Major shareholdings

At 31 December 2018, the following shareholders had notified an interest in the issued ordinary share capital of the Company in accordance with the DTR:

Shareholder	Date notified	% of issued ordinary share capital *
ValueAct Capital Master Fund, L.P.	1 February 2018	10.94
The Capital Group Companies, Inc	13 October 2017	5.07
Credit Suisse Group AG	3 May 2017	3.91

* Percentages are shown as a percentage of the Company's issued share capital when the Company was notified of the change in holding.

On 4 January 2019, in accordance with the DTR, BlackRock, Inc. disclosed an increase in their shareholding to 5.01%*. As at 28 February 2019, no further changes had been notified.

Directors

The names of the Directors who held office during the year are set out on page 63.

Directors' Indemnities

The Directors have the benefit of an indemnity provision contained in the Company's Articles of Association. In addition, the Directors have been granted a qualifying third party indemnity provision which was in force throughout the financial year and remains in force. Also, throughout the year, the Company purchased and maintained Directors' and Officers' liability insurance in respect of itself and for its Directors and Officers.

Disclosures in the Strategic Report

The Board has taken advantage of Section 414C(11) of the Act to include disclosures in the Strategic Report including:

- employee involvement;
- the future development, performance and position of the Group;
- the financial position of the Group;
- R&D activities;
- the principal risks and uncertainties; and
- particulars of important events affecting the Company since the financial year end.

Political donations

The Company's policy is that it does not, directly or through any subsidiary, make what are commonly regarded as donations to any political party. However, the Act defines political donations very broadly and so it is possible that normal business activities, such as sponsorship, subscriptions, payment of expenses, paid leave for employees fulfilling certain public duties and support for bodies representing the business community in policy review or reform, which might not be thought of as political expenditure in the usual sense, could be captured. Activities of this nature would not be thought of as political donations in the ordinary sense of those words. The resolution to be proposed at the AGM, authorising political donations and expenditure, is to ensure that the Group does not commit any technical breach of the Act.

During the year, expenses incurred by Rolls-Royce North America, Inc. in providing administrative support for the Rolls-Royce North America political action committee (PAC) was US\$111,961 (2017: US\$118,104). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act.

The PAC is independent of the Group and independent of any political party. The PAC funds are contributed voluntarily by employees and the Group cannot affect how they are applied, although under US law, the business expenses are paid by the employee's company. Such contributions do not count towards the limits for political donations and expenditure for which shareholder approval will be sought at this year's AGM to renew the authority given at the 2018 AGM.

Greenhouse gas emissions

In 2018, our total greenhouse gas (GHG) emissions were 596 kilotonnes carbon dioxide equivalent (ktCO₂e). This represents a decrease of 5% compared with 627 ktCO₂e in 2017.

We have revised our total GHG emissions for 2017 to reflect the actual figures for the full year, rather than estimated figures prepared in line with our basis of reporting. This has had a material impact on previously reported figures. The figures for 2016, 2017 and 2018 include emissions associated with ITP Aero. Emissions associated with L'Orange have been removed from these figures but do not have a material impact.

We have included the reporting of fugitive emissions of hydrofluorocarbons (HFCs), associated with air conditioning equipment, into our GHG emissions figures from 2016. Figures from 2014 and 2015 exclude emissions from these sources. These include emissions from our facilities in the UK, US, Canada and France only. We do not anticipate that emissions from other facilities will have a material impact.

Total GHG emissions (ktCO ₂ e)	2014	2015 [☒]	2016 [☒]	2017 [☒]	2018 [☒]
Direct emissions (Scope 1)	456	374	368	331	305
Indirect emissions (Scope 2)	396	375	336	296	291
Total emissions (Scope 1 + Scope 2)	852	749	704	627	596
Intensity ratio (total emissions normalised by revenue) (ktCO₂e/£m)	0.062	0.055	0.047	0.043	0.038

[☒] We engaged Bureau Veritas to undertake a limited assurance engagement, reporting to Rolls-Royce Holdings plc, using the assurance standards ISAE 3000 and ISAE 3410 over the energy, GHG, TRI rate and STEM data that has been highlighted with [☒] and as set out on pages 43 to 47 and in the table above. The sustainability assurance statement is included on page 197.

With the exceptions noted above, we have reported on all of the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013. These sources fall within our Consolidated Financial Statements. We do not have responsibility for any emission sources that are not included in our Consolidated Financial Statements.

We have used the GHG Protocol Corporate Accounting and Reporting Standard (revised edition) as of 31 December 2014, data gathered to fulfil our requirements under the Carbon Reduction Commitment (CRC) Energy Efficiency scheme and emission factors from the UK Government's GHG Conversion Factors for Company Reporting 2018.

Further details on our methodology for reporting and the criteria used can be found within our basis of reporting, available to download at www.rolls-royce.com/sustainability.

Branches

Rolls-Royce is a global company and our activities and interests are operated through subsidiaries, branches of subsidiaries, joint ventures and associates which are subject to the laws and regulations of many different jurisdictions. Our subsidiaries, joint ventures and associates are listed on pages 178 to 185.

Financial instruments

Details of the Group's financial instruments are set out in note 17 to the Consolidated Financial Statements.

Related party transactions

Related party transactions are set out in note 24 to the Consolidated Financial Statements.

Information required by UK Listing Rule (LR) 9.8.4

There are no disclosures to be made under LR 9.8.4.

Management report

The Strategic Report and the Directors' Report together are the management report for the purposes of Rule 4.1.8R of the DTR.

Disclosure of information to auditors

Each of the persons who is a Director at the date of approval of this report confirms that so far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware. The Director has taken all steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given, and should be interpreted, in accordance with the provisions of section 418 of the Act.

SHAREHOLDER INFORMATION

Financial calendar 2019-2020



Managing your shareholding

Your shareholding is managed by Computershare Investor Services PLC (the Registrar). When making contact with the Registrar please quote your Shareholder Reference Number (SRN). This is a 10-digit number prefixed with the letter 'C' that can be found on the right-hand side of your share certificate or in any other shareholder correspondence.

You can manage your shareholding at www.investorcentre.co.uk, speak to the Registrar on +44 (0)370 703 0162 (8.30am to 5.30pm Monday to Friday) or you can write to the Registrar at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8AE.

If you hold your shares in a share dealing account (sometimes referred to as a nominee account) then you must contact your account provider with any questions about your shareholding.

Payments to shareholders

The Company makes payments to shareholders by issuing redeemable C Shares of 0.1p each. You can redeem C Shares for cash and either take the cash or reinvest the cash to purchase additional ordinary shares providing you complete a payment instruction form, which is available from the Registrar. Once you have submitted your payment instruction form, you will receive cash or additional ordinary shares each time the Company issues C Shares. If you choose to receive cash we strongly recommend that you include your bank details on the payment instruction form and have payments credited directly to your bank account. This removes the risk of a cheque going astray and means that cleared payments will be credited to your bank account on the payment date.

Share dealing

The Registrar offers shareholders an internet dealing service at www.computershare.co.uk and a telephone dealing service (+44 (0)370 703 0084). Real-time dealing is available during market hours, 8.00am to 4.30pm, Monday to Friday excluding bank holidays. Orders can still be placed outside of market hours. The fee for internet dealing is 1% of the transaction value subject to a minimum fee of £30. The fee for telephone dealing is 1% of the transaction value plus £35. Stamp duty of 0.5% is payable on all purchases. This service is only available to shareholders resident in certain jurisdictions. Before you can trade you must register to use the service. Other share dealing facilities are available but you should always use a firm regulated by the FCA (see www.fca.org.uk/register).

Your share certificate

Your share certificate is an important document. If you sell or transfer your shares you must make sure that you have a valid share certificate in the name of Rolls-Royce Holdings plc. If you place an instruction to sell your shares and cannot provide a valid share certificate, the transaction cannot be completed and you may be liable for any costs incurred by the broker. If you are unable to find your share certificate please inform the Registrar immediately.

American Depositary Receipts (ADR)

ADR holders should contact the depositary, JP Morgan, by calling +1 (800) 990 1135 (toll free within the US) or +1 (651) 453 2128 (outside the US) or emailing adr@jpmorgan.com.

Warning to shareholders – investment scams

We are aware that some of our shareholders have received unsolicited telephone calls or correspondence, offering to buy or sell their shares at very favourable terms. The callers can be very persuasive and extremely persistent and often have professional websites and telephone numbers to support their activities. These callers will sometimes imply a connection to Rolls-Royce and provide incorrect or misleading information. This type of call should be treated as an investment scam – the safest thing to do is hang up.

You should always check that any firm contacting you about potential investment opportunities is properly authorised by the FCA. If you deal with an unauthorised firm you will not be eligible for compensation under the Financial Services Compensation Scheme. You can find out more about protecting yourself from investment scams by visiting the FCA's website at www.fca.org.uk/consumers, or by calling the FCA's consumer helpline on 0800 111 6768 (overseas callers dial +44 20 7066 1000). If you have already paid money to share fraudsters contact Action Fraud immediately on 0300 123 2040, whose website is www.actionfraud.police.uk.

Remember: if it sounds too good to be true it probably is.

Visit Rolls-Royce online

Visit www.rolls-royce.com to find out more about the latest financial results, the share price, payments to shareholders, the financial calendar and shareholder services.



Keeping up to date

You can sign up to receive the latest news updates to your phone or email address by visiting www.rolls-royce.com and registering for our alert service.

Dividends paid on C Shares held

C Share calculation period	C Share dividend rate (%)	Record date for C Share dividend	Payment date
1 July 2018 – 31 December 2018	0.30	16 November 2018	3 January 2019
1 January 2018 – 30 June 2018	0.22	4 June 2018	3 July 2018

Previous C Share issues

Issue date	Apportionment values				CGT apportionment					
	No. of C Shares issued per ordinary share	Record date for entitlement to C Shares	Latest date for receipt of payment instruction forms by Registrar	Price of ordinary shares on first day of trading (p)	Value of C Share issues per ordinary shares (p)	Ordinary shares (%)	C Shares (%)	Date of redemption of C Shares	CRIP purchase date	CRIP purchase price (p)
3 January 2019	46	26 October 2018	3 December 2018	788.20	4.6	99.42	0.58	7 January 2019	8 January 2019	846.0466
2 July 2018	71	27 April 2018	1 June 2018	975.00	7.1	99.28	0.72	5 July 2018	5 July 2018	983.6912

For information on earlier C Share issues, please refer to www.rolls-royce.com.

Analysis of ordinary shareholders at 31 December 2018

Type of holder	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	170,690	97.65	87,362,888	4.61
Institutional and other investors	4,112	2.35	1,808,347,563	95.39
Total	174,802	100.00	1,895,710,451	100.00
Size of holding (number of ordinary shares)				
1 – 150	56,186	32.14	5,128,416	0.27
151 – 500	84,667	48.44	22,851,592	1.21
501 – 10,000	32,298	18.48	49,522,520	2.61
10,001 – 100,000	1,143	0.65	31,244,558	1.65
100,001 – 1,000,000	334	0.19	113,567,593	5.99
1,000,001 and over	174	0.10	1,673,395,772	88.27
Total	174,802	100.00	1,895,710,451	100.00

GLOSSARY

ABC	anti-bribery and corruption
ACARE	Advisory Council for Aviation Research and Innovation in Europe
AGM	Annual General Meeting
AMRCs	Advanced Manufacturing Research Centres
AOG	aircraft on ground
Articles	Articles of Association of Rolls-Royce Holdings plc
ASC	Authorised Service Centres
bps	basis points
Brexit	UK exit from the European Union
C Shares	non-cumulative redeemable preference shares
C&A	commercial and administrative
CARs	contractual aftermarket rights
CEO	chief executive officer
CFO	chief financial officer
CGT	capital gains tax
Our Code	Global Code of Conduct
revised Code	UK Corporate Governance Code 2018
the Code	UK Corporate Governance Code 2016
Company	Rolls-Royce Holdings plc
CPS	cash flow per share
CRIP	C Share reinvestment plan
CROIC	cash return on invested capital
DJSI	Dow Jones Sustainability Index
DoJ	US Department of Justice
DPAs	deferred prosecution agreements
DTR	the FCA's Disclosure Guidance and Transparency Rules
EASA	European Aviation Safety Agency
ELG	Enterprise Leadership Group
EPS	earnings per share
ERG	employee resource group
ESG	environment, social and governance
EU	European Union
EUR	euro
EVTOL	electric vertical take-off and landing
FCA	Financial Conduct Authority
FCF	free cash flow
FRC	Financial Reporting Council
FTE	full time equivalent
FX	foreign exchange
GBP	Great British pound or pound sterling
GHG	greenhouse gas
Group	Rolls-Royce Holdings plc and its subsidiaries
HSE	health, safety and environment
IAE	International Aero Engines AG

Trade marks

The following trade marks which appear throughout this Annual Report are trade marks registered and owned by companies within the Rolls-Royce Group:

BR710®	Pearl®
CorporateCare®	Pioneering the power that matters™
Flex®	RB211®
Gnome®	Reman®
LiftSystem™	TotalCare®
MTU®	Trent®
MTU PowerPacks®	UltraFan®

Photograph credits

The F-35B Lightning II aircraft image shown on page 35 is reproduced courtesy of Lockheed Martin.

The Dreadnought submarine image shown on page 37 is reproduced courtesy of BAE Systems.

IASB	International Accounting Standards Board
IFRS	International financial reporting standards
ITP Aero	Industria de Turbo Propulsores S.A.
KPIs	key performance indicators
ktCO ₂ e	kilotonnes carbon dioxide equivalent
kW	kilowatts
LGBT+	lesbian, gay, bisexual and transgender
LIBOR	London inter-bank offered rate
LTI	long-term incentive plan
LTPR	long-term planning exchange rate
LTSA	long-term service agreement
MOU	memorandum of understanding
MPF	Ministério Público Federal, Brazil
MRO	maintenance repair and overhaul
MW	megawatts
NCI	non-controlling interest
NO _x	nitrogen oxide
OCI	other comprehensive income
OE	original equipment
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
P&L	profit and loss
PBT	profit before tax
PPE	property, plant and equipment
PSMS	product safety management system
PSP	performance share plan
R&D	research and development
R&T	research and technology
REACH	registration, evaluation, authorisation and restriction of chemicals
Registrar	Computershare Investor Services PLC
RRSAs	risk and revenue sharing arrangements
SENER	SENER Grupo de Ingeniería, S.A.
SFO	UK Serious Fraud Office
SMR	small modular reactors
SSA	Special Security Agreement
STEM	science, technology, engineering and mathematics
TCFD	Taskforce on Climate-related Financial Disclosures
Trent 1000	Thrust, Efficiency and New technology
TEN	
TRI	total reportable injuries
TSR	total shareholder return
USD/US\$	United States dollar
UTCs	University Technology Centres

Credits

Designed and produced by **CONRAN DESIGN GROUP**

Printed on Innovation Premium which is an FSC® certified paper. The pulps used are Totally Chlorine Free (TCF), and the manufacturing mill has ISO 14001 environmental management certification. The mill's energy is produced from 100% biomass fuels sourced from local forestry and no fossil fuels are used. The carbon emissions have been measured and offset using the World Land Trust's Carbon Balanced scheme.

Printed in the UK by **pureprint** using their environmental printing technology, using vegetable inks throughout. **pureprint** is a CarbonNeutral® company. Both the paper manufacturing mill and the printer are registered to the Environmental Management System ISO 14001 and are Forest Stewardship Council® (FSC®) chain-of-custody certified.

