INDEPENDENT AUDITOR'S REPORT

to the members of Rolls-Royce Holdings plc only

OPINIONS AND CONCLUSIONS ARISING FROM OUR AUDIT

1 OUR OPINION ON THE FINANCIAL STATEMENTS IS UNMODIFIED

We have audited the financial statements of Rolls-Royce Holdings plc for the year ended 31 December 2015 set out on pages 107 to 166.

In our opinion:

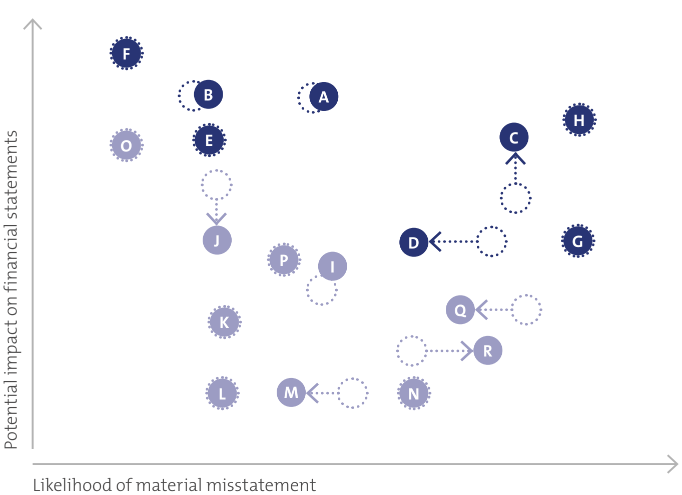
- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2015 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (Adopted IFRS);
- the parent company financial statements have been properly prepared in accordance with UK Accounting Standards, including FRS 101 *Reduced Disclosure Framework*; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

2 OUR ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT

When planning our audit, we made an assessment of the relative significance of the key risks of material misstatement to the Group financial statements initially without taking account of the effectiveness of controls implemented by the Group. This initial assessment is shown below in the output from our Dynamic Audit planning tool. As there has been no significant change in the Group's operations or in our assessment of materiality these key risks are the same as in the prior year, though there have been some changes in the significance to our audit of some of the risks.

Of the 18 key risks identified, we describe below (i) the eight risks of material misstatement that had the greatest effect on our audit (those in dark blue on the risk map – the descriptions of risks include an explanation for the changes in significance of these risks from last year), (ii) our key audit procedures to address those risks and (iii) our findings from those procedures in order that the Company's members as a body may better understand the process by which we arrived at our audit opinion. Our findings are the result of procedures undertaken in the context of and solely for the purpose of our statutory audit opinion on the financial statements as a whole and consequently are incidental to that opinion, and we do not express discrete opinions on separate elements of the financial statements.

Dynamic Audit planning tool



- **A** The pressure on and incentives for management to meet revised revenue and profit guidance
- **B** The basis of accounting for revenue and profit in the Civil Aerospace business
- **C** The measurement of revenue and profit in the Civil Aerospace business
- **D** Recoverability of intangible assets in the Civil Aerospace business
- **E** Liabilities arising from sales financing arrangements
- **F** Bribery and corruption
- **G** The presentation of 'underlying profit'
- **H** Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount
- **I** Measurement of revenue and profit on long term contracts outside the Civil Aerospace business (see page 115)
- **J** Determination of development costs to be capitalised (See page 115)
- **K** The basis of accounting for contractual aftermarket rights (see page 113)
- **L** Determination of the amortisation period of development costs and CARs (see page 119)
- **M** The basis of accounting for Risk and Revenue Sharing Arrangement (see page 114)
- **N** Estimating provisions for warranties and guarantees (see page 116)
- **O** Valuation of derivatives and hedge accounting (see page 118 and 119)
- **P** Measurement of post retirement benefits (see page 115)
- **Q** Accounting for uncertain tax positions and deferred tax assets (see page 116)
- **R** Valuation of goodwill (see page 115)

A The pressure on and incentives for management to meet revised revenue and profit guidance

Refer to pages 22 to 41 (Business review) and pages 93 to 94 (Audit Committee report – Financial reporting)

The risk – The Group has published a number of revisions to its revenue and profit guidance during the last two years with a generally decreasing trend in profit and revenue and there have been significant associated decreases in the Group's share price. Clear instructions were given to the Executive Leadership Team and the senior finance executives on more than one occasion not to take any account of the pressure to meet forecasts in preparing the financial results and to manage and be alert to how this pressure might affect personnel across the wider Group. Nevertheless, the continuing heightened

INDEPENDENT AUDITOR'S REPORT CONTINUED

pressure on and incentives for management to meet the latest guidance increases the inherent risk of manipulation of the Group financial statements. The financial results are sensitive to significant estimates and judgements, particularly in respect of revenues and costs associated with long-term contracts, and there is a broad range of acceptable outcomes of these that could lead to different levels of profit and revenue being reported in the financial statements. Relatively small changes in the basis of those judgements and estimates could result in the Group meeting, exceeding or falling short of guidance.

The significance of the risk has increased marginally due to revisions to guidance issued during the year, continuing deterioration in the short-term business outlook and the incidence of individually significant items affecting profit.

Our response – We have: (i) extended our enquiries designed to assess whether judgements and estimates exhibited unconscious bias or whether management had taken systematic actions to manipulate the reported results; (ii) compared the results to forecasts and challenged variances at a much lower level than we would otherwise have done based on our understanding of factors affecting business performance with corroboration using external data where possible; and (iii) applied an increased level of scepticism throughout the audit by increasing the involvement of the senior audit team personnel, with particular focus on audit procedures designed to assess whether revenues and costs have been recognised in the correct accounting period, whether central adjustments were appropriate and whether the segmental analysis has been properly prepared.

In particular:

- when considering the risk relating to *The measurement of revenue and profit in the Civil Aerospace business* (C refer to page 169), we challenged the basis for changes in the estimated revenues and costs in long-term contracts, with a heightened awareness of the possibility of unconscious or systematic bias, particularly regarding the refinement in the basis of measurement of the risk contingency for forecasts of future revenue to be earned under long-term contracts which resulted in recognition of profit of £189m;
- when considering the risk relating to *Recoverability of intangible assets in the Civil Aerospace business* (D refer to page 170), we challenged with a heightened awareness of the possibility of unconscious or systematic bias the basis for changes in the estimated maintenance costs which led to the reversal of the impairment on certain Trent 1000 launch engine Contractual aftermarket rights ("CARs") assets and a related provision which resulted in recognition of profit of £65m and avoidance of impairments of £22m that otherwise would have been recorded;
- when considering the risk relating to *The basis of accounting for revenue and profit in the Civil Aerospace business* (B refer below), we challenged the basis on which management had accounted for a sale of engines and a long-term service agreement as a single arrangement which resulted in recognition of profit of £44m despite there being a significant period of time between concluding these agreements; and
- when considering the risk relating to *The presentation of underlying profit* (G refer to page 171) and the risk relating to *Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount* (H refer to page 172), we sought to identify items that affected profit (and/or the trend in profit) unevenly in frequency or amount (especially those where management had a greater degree of discretion over the timing or scale of transactions entered into) at a much lower level than we would otherwise have done and to assess the balance and transparency of disclosure of these items.

Our findings – Our testing did not identify any indication of manipulation of results *(2014 audit finding: one instance which was corrected by management)*. We found the degree of caution/optimism adopted in estimates to be slightly less cautious than in the previous year, but balanced overall. We found that there was ample unbiased disclosure of items affecting the trend in profit.

B The basis of accounting for revenue and profit in the Civil Aerospace business

Refer to page 113 and 114 (Key areas of judgement – Introduction, Contractual aftermarket rights, Linkage of original and long-term aftermarket contracts), pages 116 and 117 (Significant accounting policies – Revenue recognition) and pages 93 and 94 (Audit Committee report – Financial reporting)

The risk – The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the appropriate assessment of whether or not each long-term aftermarket contract for services is linked to or separate from the contract for sale of the related engines as this drives the accounting basis to be applied. As the commercial arrangements can be complex, significant judgement is applied in selecting the accounting basis in each case. The most significant risk is that the Group might inappropriately account for sales of engines and long-term service agreements as a single arrangement as this would usually lead to revenue and profit being recognised too early because the margin in the long-term service agreement is usually higher than the margin in the engine sale agreement.

The significance of the risk has increased marginally during the year due to the identification of one instance where the Group had to apply significant judgement in concluding that it was appropriate to account for the sale of engines and the long-term service agreement as a single arrangement.

Our response – We re-evaluated the appropriateness of the accounting bases the Group applies in the Civil Aerospace business by reference to accounting standards and re-examining historical long-term aftermarket contracts. We considered whether the disclosure included in the financial statements enables shareholders to understand how the accounting policies represent the commercial substance of the Group's contracts with its customers. We made our own independent assessment, with reference to the relevant accounting standards, of the accounting basis that should be applied to each long-term aftermarket contract entered into during the year and compared this to the accounting basis applied by the Group.

Our findings – We found that the Group has developed a framework for selecting the accounting bases which is consistent with a balanced interpretation of accounting standards *(2014 audit finding: balanced)* and has applied this consistently. We found that the disclosure was ample.

For the agreements entered into during this year, it was generally clear which accounting basis should apply. We identified one instance where the Group had to apply significant judgement in concluding that it was appropriate to account for the sale of engines and the long-term service agreement as a single arrangement, resulting in the recognition of incremental profit of £44m. In this case there was a longer than usual period between conclusion of the engine sale contract and conclusion of the long-term service agreement. We found sufficient evidence that the key commercial terms included in the long-term service agreement had been established at the time the engine sale contract had been concluded and that the intention of both parties had always been to enter into a long-term service agreement on those terms. Consequently, we found the judgements made in the application of the Group's accounting bases to these particular contracts to be balanced.

C The measurement of revenue and profit in the Civil Aerospace business

Refer to page 114 (Key areas of judgement – Measurement of performance on long-term aftermarket contracts), pages 116 and 117 (Significant accounting policies – Revenue recognition and TotalCare arrangements) and pages 93 and 94 (Audit Committee report – Financial reporting)

The risk – The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the assessment of the percentage of completion of long-term aftermarket contracts and the forecast cost profile of each arrangement. As long-term aftermarket contracts can extend over significant periods and the profitability of these arrangements typically assumes significant life-cycle cost improvement over the term of the contracts, the estimated outturn requires significant judgement to be applied in estimating future engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred. The nature of these estimates means that their continual refinement can have an impact on the profits of the Civil Aerospace business that can be significant in an individual financial year. The assessment of the estimated outturn for each arrangement involves detailed calculations using large and complex databases with a significant level of manual intervention.

In 2012, the Group made changes to the way it takes account of risk in making these estimates and agreed with the Audit Committee that it would carry out a comprehensive review of how well the revised basis reflected actual experience after three years. In 2015, the Group has refined the basis of taking account of risk in its estimates of future revenue resulting in an increase in estimated future revenue of approximately 2% which had a one-off profit benefit of £189m.

This refinement in basis together with changes in customer flying patterns on some of the older engine programmes resulted in the significance of the risk increasing marginally in the year.

Our response – We tested the controls designed and applied by the Group to provide assurance that the estimates used in assessing revenue and cost profiles are appropriate and that the resulting estimated cumulative profit on these contracts is accurately reflected in the financial statements; these controls operated over both the inputs and the outputs of the calculations. We challenged the appropriateness of these estimates for each programme and assessed whether or not the estimates showed any evidence of systematic or unconscious management bias in the context of the heightened pressure on and incentives for management to meet the latest guidance discussed above. Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions within programmes.

In particular with regard to the refined approach to revenue forecasting risk, we assessed the extent to which the new basis better incorporates business risks affecting the Group's customers based on recently emerging trends being experienced by the Group and our own experience.

In terms of future cost estimates, we undertook detailed assessments of the achievability of the Group's plans to reduce life-cycle costs and an analysis of the impact of these plans on forecast cost profiles taking account of contingencies and analysis of the impact of known technical issues on cost forecasts. Our analysis considered each significant airframe that is powered by the Group's engines and was based on our own experience supplemented by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuation specialist was objective and suitably qualified.

We also checked the mathematical accuracy of the revenue and profit for each arrangement and considered the implications of identified errors and changes in estimates.

Our findings – Control weaknesses identified in earlier periods have been partially remediated. The scope and depth of our detailed testing and analysis was expanded to take account of the remaining weaknesses. We found no evidence that the refinement to the basis for incorporating revenue risk was motivated by the positive impact it has had on profit in the current year. Overall, our assessment is that the refined basis for incorporating revenue risk is an improvement and the assumptions and resulting estimates (including appropriate contingencies) resulted in balanced *(2014 audit finding: mildly cautious)* profit recognition. We found the disclosure of the impact of the refined basis for incorporating revenue risk to be ample.

INDEPENDENT AUDITOR'S REPORT CONTINUED

D Recoverability of intangible assets (certification costs and participation fees, development expenditure and contractual aftermarket rights) in the Civil Aerospace business

Refer to page 115 (Key sources of estimation uncertainty – Forecasts and discount rates), pages 119 and 120 (Significant accounting policies – Certification costs and participation fees, Research and development, Contractual aftermarket rights and Impairment of non-current assets), pages 132 and 133 (Note 9 to the financial statements – Intangible assets) and pages 93 and 94 (Audit Committee report – Financial reporting)

The risk – The recovery of these assets depends on a combination of achieving sufficiently profitable business in the future as well as the ability of customers to pay amounts due under contracts often over a long period of time. Assets relating to a particular engine programme are more prone to the risk of impairment in the early years of a programme as the engine's market position is established. In addition, the pricing of business with launch customers makes assets relating to these engines more prone to the risk of impairment.

In 2015, the Group reduced its estimate of the future maintenance costs on certain Trent 1000 launch engines which in previous periods had been at a level requiring the impairment of the related CARs assets and the recording of a related provision. This resulted in the reversal of previously recognised impairments and the related provision with a profit of £65m being recognised *(2014: impairment charge of £19m)* and the capitalisation of £22m that would otherwise have been impaired.

The significance of the risk has decreased somewhat during the year due to better information on the performance of the Trent 1000 engine following the first shop visits and confirmation of the Emirates order for Trent 900 engines (the Trent 900 programme assets had been identified as being at higher risk of impairment in the prior year).

Our response – We tested the controls designed and applied by the Group to provide assurance that the assumptions used in preparing the impairment calculations are regularly updated, that changes are monitored, scrutinised and approved by appropriate personnel and that the final assumptions used in impairment testing have been appropriately approved. We challenged the appropriateness of the key assumptions in the impairment test (including market size, market share, pricing, engine and aftermarket unit costs, individual programme assumptions, price and cost escalation, discount rate and exchange rates). Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, our understanding of the commercial prospects of key engine programmes, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes and customers and comparison of assumptions with publicly available data where this was available. We tested the mathematical accuracy of the impairment calculations. We considered whether the disclosures in note 9 to the financial statements describe the inherent degree of subjectivity in the estimates and the potential impact on future periods of revisions to these estimates.

In particular, with regard to the reversal of impairments on certain Trent 1000 launch engine CARs and a related provision, we challenged the key assumptions underlying the forecast future cash flows to be derived from the engines including: the period and mode of operation of the engines, the time and materials maintenance revenue (which the Group has guaranteed will not exceed a specified maximum amount) and the cost of required maintenance activity. Our assessment was that the amount of profit to be recognised depended critically on the Group engineering department's judgement as to the impact on estimated future maintenance costs of the wear and tear on the engines based on their first few years of operation (evidenced by the first strip down and detailed off-wing investigations of engines in the second half of 2015). Given the specialist knowledge necessary to make these judgements appropriately, we assessed the capabilities and objectivity of the employees making the judgement and the members of management reviewing and approving the judgements. Finally to supplement this and to ensure that the matter had received appropriate attention from the Board, we sought and received written representations from the Directors that, based on their enquiries, they consider that the engineering judgement is appropriate and that, based on that consideration, the recognition of the profit of £65m is appropriate.

Our findings – Our testing did not identify weaknesses in the design and operation of controls that would have required us to expand the nature or scope of our planned detailed test work. We found that the assumptions and resulting estimates were balanced *(2014 audit finding: balanced)* and that the disclosures were proportionate *(2014 audit finding: proportionate)*. We found no errors in calculations *(2014 audit finding: none)*.

With regard to the reversal of impairments on certain Trent 1000 launch engine CARs and a related provision, we found no evidence that this was motivated by the positive impact it has had on profit in the current year. We found that the change in estimate from the prior periods was based on improved information becoming available in 2015 as the engine programme moved out of its earliest stages which has reduced estimation uncertainty, that there was no indication of bias and that the estimate of forecast future cash flows to be derived from the engines was balanced and supported the accounting treatments adopted by the Group. We found the disclosure of the impact to be ample.

E Liabilities arising from sales financing arrangements

Refer to page 115 (Key areas of judgement – Customer financing contingent liabilities), page 121 (Significant accounting policies – Sales financing support), page 148 (Note 18 to the financial statements – Provisions for liabilities and charges) and pages 93 and 94 (Audit Committee report – Financial reporting)

The risk – The Group has contingent liabilities in respect of financing and asset value support provided to customers. This support typically takes the form of a guarantee with respect to the value of an aircraft at a future date, a commitment to buy used aircraft or a guarantee of a customer's future payments under an aircraft financing arrangement. The Group also provides standby finance lines to certain customers that can be accessed if they fail to arrange alternative financing at the time they take delivery of engines. Judgement is required to assess the likelihood of these liabilities crystallising, in order to assess whether a provision should be recognised and, if so, the amount of that provision. The total potential liability is significant and can be affected by the assessment of the residual value of the aircraft and the creditworthiness of the customers.

The significance of the risk has not changed during the year.

Our response – We analysed the terms of guarantees on aircraft delivered during the year in detail and obtained aircraft values from and held discussions with aircraft valuation specialists engaged by the Group. We assessed whether the valuer was objective and suitably qualified, had been appropriately instructed and had been provided with complete, accurate data on which to base its evaluation. For all contracts on delivered aircraft, we assessed the commercial factors relevant to the likelihood of the guarantees being called, including the credit ratings and recent financial performance of the relevant customers and their fleet plans, and critically assessed the Group's estimate of the required provisions for those liabilities. We considered movements in aircraft values and potential changes in the assessed probability of a liability crystallising since the previous year end and considered whether the evidence supported the Group's assessment as to whether or not a liability needs to be recognised and the amount of the liability recognised or contingent liability disclosed. We considered whether the related disclosure in note 18 to the financial statements appropriately explains the potential liability in excess of the amount provided for in the financial statements for delivered aircraft and highlights the significant but unquantifiable contingent liability in respect of aircraft which will be delivered in the future.

Our findings – We found that the level of exposure from asset value support had reduced during the year and that the assumptions and estimates were balanced *(2014 audit finding: balanced)* and that the disclosures were proportionate *(2014 audit finding: proportionate).*

F Bribery and corruption

Refer to page 155 (Note 23 to the financial statements – Contingent liabilities) and pages 93 and 94 (Audit Committee report – Financial reporting)

The risk – A large part of the Group's business is characterised by competition for individually significant contracts with customers, which are often directly or indirectly associated with governments, and the award of individually significant contracts to suppliers. The procurement processes associated with these activities are highly susceptible to the risk of corruption. In addition the Group operates in a number of territories where the use of commercial intermediaries is either required by the government or is normal practice. In December 2013, the Group announced that it had been informed by the Serious Fraud Office in the UK that it had commenced a formal investigation into bribery and corruption in overseas markets. The Group is cooperating with the Serious Fraud Office and other agencies, including the US Department of Justice. Breaches of laws and regulations in this area can lead to fines, penalties, criminal prosecution, commercial litigation and restrictions on future business.

The significance of the risk has not changed during the year.

Our response – We evaluated and tested the Group's policies, procedures and controls over the selection and renewal of intermediaries, contracting arrangements, ongoing management, payments and responses to suspected breaches of policy. We sought to identify and tested payments made to intermediaries during the year, made enquiries of appropriate personnel and evaluated the tone set by the Board and the Executive Leadership Team and the Group's approach to managing this risk. Having enquired of management, the Audit Committee and the Board as to whether the Group is in compliance with laws and regulations relating to bribery and corruption, we made written enquiries of and met with the Group's legal advisers to cross check the results of those enquiries with third parties and maintained a high level of vigilance to possible indications of significant non-compliance with laws and regulations relating to bribery and corruption whilst carrying out our other audit procedures. We discussed the areas of potential or suspected breaches of law, including the ongoing investigations, with the Audit Committee and the Board as well as the Group's legal advisers and assessed related documentation. We assessed whether the disclosure in note 23 to the financial statements of the Group's exposure to the financial effects of potential or suspected breaches of law or regulation complies with accounting standards and in particular whether it is the case that the investigations remain at too early a stage to assess the consequences (if any), including in particular the size of any possible fines.

Our findings – We found that disclosure to be proportionate *(2014 audit finding: proportionate).*

Presentation and explanation of results

Refer to pages 22 to 41 (Business review), pages 42 to 47 (Financial review), pages 122 to 126 (Note 2 to the financial statements – Segmental analysis) and pages 93 and 94 (Audit Committee report – Financial reporting)

G The presentation of 'underlying profit'

The risk – In addition to its Adopted IFRS financial statements, the Group presents an alternative income statement on an 'underlying' basis. The directors believe the 'underlying' income statement reflects better the Group's trading performance during the year. The basis of adjusting between the Adopted IFRS and 'underlying' income statements and a full reconciliation between them is set out in note 2 to the financial statements on pages 124 and 125.

A significant recurring adjustment between the Adopted IFRS income statement and the 'underlying' income statement relates to the foreign exchange rates used to translate foreign currency transactions. The Group uses forward foreign exchange contracts to manage the cash flow exposures of forecast transactions denominated in foreign currencies but does not generally apply hedge accounting in its Adopted IFRS income statement. The 'underlying' income statement translates these amounts at the achieved foreign exchange rate on forward foreign exchange contracts settled in the period, retranslates assets and liabilities at exchange rates forecast to be achieved from future settlement of such contracts and excludes unrealised gains and losses on such contracts which are included in the Adopted IFRS income statement. The Group has discretion over which forward foreign exchange contracts are settled in each financial year, which could impact the achieved rate both for the period and in the future.

In addition, adjustments are made to exclude one-off past-service costs on post-retirement schemes, restructuring activities that significantly change the shape of the Group's operations and the effect of acquisition accounting (including any subsequent impairments of goodwill or other intangible assets) and a number of other items.

Alternative performance measures can provide shareholders with appropriate additional information if properly used and presented. In such cases, measures such as these can assist shareholders in gaining a more detailed and hence better understanding of a company's financial performance and strategy. However, when improperly used and presented, these kinds of measures

INDEPENDENT AUDITOR'S REPORT CONTINUED

might prevent the Annual Report being fair, balanced and understandable by hiding the real financial position and results or by making the profitability of the reporting entity seem more attractive.

The significance of the risk has not changed during the year.

Our response – We assessed the appropriateness of the basis for the adjustments between the Adopted IFRS income statement and the 'underlying' income statement and the consistency of application of this basis and we recalculated the adjustments with a particular focus on the impact of the foreign exchange rates used to translate foreign currency amounts in the 'underlying' income statement. We assessed whether or not the selection of forward foreign exchange contracts settled in the year showed any evidence of management bias. We also assessed: (i) the extent to which the prominence given to the 'underlying' financial information and related commentary in the Annual Report compared to the Adopted IFRS financial information and related commentary could be misleading; (ii) whether the Adopted IFRS and 'underlying' financial information are reconciled with sufficient prominence given to that reconciliation; (iii) whether the basis of the 'underlying' financial information is clearly and accurately described and consistently applied; and (iv) whether the 'underlying' financial information is not otherwise misleading in the form and context in which it appears in the Annual Report.

Our findings – We found no concerns regarding the basis of the 'underlying' financial information or its calculation and no indication of management bias in the settlement of forward foreign exchange contracts. We consider that there is proportionate disclosure of the nature and amounts of the adjustments to allow shareholders to understand the implications of the two bases on the financial measures being presented *(2014 audit finding: proportionate)*. We found the overall presentation of the 'underlying' financial information to be balanced *(2014 audit finding: balanced)*.

H Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount

The risk – The Group's profits are significantly impacted by items such as cumulative adjustments to profit recognised on long-term contracts, impairments (and reversals of impairments) of goodwill, CARs and other intangible assets, sale and leasebacks of spare engines to joint ventures, research and development charges, reorganisation costs and foreign exchange translation which can be uneven in frequency and/or amount. If significant either to the profit for the year or to the trend in profit, appropriate disclosure of the effect of these items is necessary in the Annual Report and financial statements to provide the information necessary to enable shareholders to assess the Group's performance.

The significance of the risk has not changed during the year.

Our response – We undertook detailed analysis of business performance at Group and sector level that sought to identify items that affect profit (and the trend in profit) which are uneven in frequency or amount at a much lower level than we would otherwise have done and to assess the transparency of disclosure of these items. We focused on the enhanced financial disclosures included in note 2 to the financial statements and the Business and Financial reviews.

Our findings – We identified a number of significant items that had affected profit for the year or the prior year that required appropriate disclosure in the Annual Report to enable shareholders to assess the Group's performance. The key items are:

1) the £1,315m unrealised fair value losses *(2014: £1,156m)* on derivative contracts;
2) the £189m profit *(2014: nil)* arising from refinement in the basis of measurement of the risk contingency for forecasts of future revenue to be earned under long-term contracts;
3) the £140m profit *(2014: £60m profit)* arising from the impact of improvements in lifecycle costs on long-term contracts;
4) the £107m loss *(2014: £90m profit)* arising from other estimate changes on long-term contracts;
5) the £65m profit *(2014: £19m charge)* (and capitalisation of £22m that otherwise would have been impaired) arising from the reversal of the impairment on certain Trent 1000 launch engine CARs and the related provision;
6) the £818m *(2014: £793m)* of research and development charges;
7) the £88m, net of a release of prior year provisions of £30m, *(2014: £188m)* of restructuring charges;
8) the £71m *(2014: £54m)* profit arising from sales of spare engines to joint ventures;
9) the £75m *(2014: £1m)* impairments of goodwill;
10) the £142m profit for the year from discontinued operations in 2014; and
11) the £64m tax charge arising from derecognition of advance corporation tax in 2014.

We found that the Group had improved the disclosure of its results and the transparency of its commentary on profit trends and that ample disclosure of these items had been provided in the Annual Report and financial statements taken as a whole *(2014 audit finding: proportionate)*.

In reaching our audit opinion on the financial statements we took into account the findings that we describe above and those for other, lower risk areas including those included in the output from our Dynamic Audit planning tool set out above. Overall the findings from across the whole audit are that the financial statements have been prepared on the basis of appropriate accounting policies, reflect balanced estimates compared to the mildly cautious estimates made last year resulting in slightly favourable current year profit recognition, and provide proportionate disclosure. Having assessed these findings and evaluated uncorrected misstatements in the context of materiality and considered the qualitative aspects of the financial statements as a whole, we have not modified our opinion on the financial statements.

3 OUR APPLICATION OF MATERIALITY AND AN OVERVIEW OF THE SCOPE OF OUR AUDIT

Our measure of materiality for the Group financial statements as a whole has reduced in line with the reduction in the Group's profit. This was set at £66m *(2014: £70m)* and was, as last year, determined with reference to a benchmark of Group profit before taxation, normalised to exclude the volatility in reported profit due to gains and losses on revaluation of foreign currency and other derivative financial instruments which could otherwise result in an inappropriate materiality level being determined. This materiality measure represents 4.5% *(2014: 4.6%)* of this benchmark and 41.3% *(2014: 34.3%)* of total reported profit before tax. We carry out audit procedures to assess the accuracy of the gains and losses on these derivative financial instruments (which this year amounted to a £1.3bn *(2014: £1.1bn)* loss) as part of our audit of the Group's treasury operations.

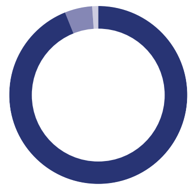
We report to the Audit Committee: (i) all material corrected identified misstatements; (ii) uncorrected identified misstatements exceeding £3m *(2014: £4m)* for income statement items; and (iii) other identified misstatements that warrant reporting on qualitative grounds.

We subjected 31 *(2014: 33)* of the Group's reporting components to audits for group reporting purposes and 11 *(2014: 14)* to specified risk-focused audit procedures. The latter were not individually financially significant enough to require an audit for group reporting purposes, but did present specific individual risks that needed to be addressed. This work also provided further audit coverage. For the remaining components, the Group audit team performed analysis at an aggregated group level to re-examine our assessment that there were no significant risks of material misstatement within these components. The reduction in reporting components subject to audit primarily resulted from the disposal of the Energy business in late 2014.

The Group operates shared service centres for the bulk processing of financial transactions in Derby (UK) and Indianapolis (US), the outputs of which are included in the financial information of the reporting components they service and therefore they are not separate reporting components. Each of the service centres is subject to specified risk-focused audit procedures, predominantly the testing of transaction processing and review controls. Additional audit procedures are performed at certain reporting components to address the audit risks not covered by the work performed over the shared service centres.

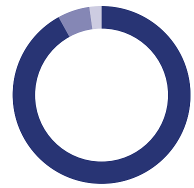
SUMMARY AUDIT SCOPE

Revenue



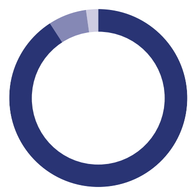
- 94% (2014: 90%)
- 5% (2014: 7%)
- 1% (2014: 3%)

Underlying profit before tax



- 92% (2014: 91%)
- 6% (2014: 9%)
- 2% (2014: 0%)

Total assets



- 91% (2014: 83%)
- 7% (2014: 12%)
- 2% (2014: 5%)

- Audits for group reporting purposes
- Specified risk-focused audit procedures
- Group-level procedures only

The Group audit team instructed component auditors, and the auditors of the shared service centres, as to the significant areas to be covered, including the relevant risks detailed above, and the information to be reported back. The Group audit team approved the component materialities, which ranged from £0.2m to £52m *(2014: £0.3m to £60m)*, having regard to the mix of size and risk profile of the Group across the components. The work on 21 of the 42 *(2014: 29 of 47)* components was performed by component auditors and the rest by the Group audit team. The Group audit team visited 31 *(2014: 25)* component locations in the UK, the US, Germany, China and Scandinavia, the purpose of which included an assessment of the audit risk and strategy. Telephone conference meetings were also held with these component auditors and with those of the higher risk components that were not physically visited. At these visits and meetings, the findings reported to the Group audit team were discussed in more detail, and any further work required by the Group audit team was then performed by the component auditor.

INDEPENDENT AUDITOR'S REPORT CONTINUED

4 OUR OPINION ON OTHER MATTERS PRESCRIBED BY THE COMPANIES ACT 2006 IS UNMODIFIED

In our opinion:

- the part of the directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the strategic report and directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the strategic report and the directors' report:

- we have not identified material misstatements in those reports; and
- in our opinion, those reports have been prepared in accordance with the Companies Act 2006.

5 WE HAVE NOTHING TO REPORT ON THE DISCLOSURES OF PRINCIPAL RISKS

Based on the knowledge we acquired during our audit, we have nothing material to add or draw attention to in relation to:

- the directors' viability statement on page 57, concerning the principal risks, their management, and, based on that, the Directors' assessment and expectations of the Group's continuing in operation over the five years to 31 December 2020; or
- the disclosures on page 57 and in note 1 of the financial statements concerning the use of the going concern basis of accounting.

6 WE HAVE NOTHING TO REPORT IN RESPECT OF THE MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

Under ISA (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the Annual Report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading. In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the Annual Report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's performance, business model and strategy; or
- the Audit Committee report does not appropriately address matters communicated by us to the Audit Committee.

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

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

Under the Listing Rules we are required to review:

- the directors' statements, set out on page 57, in relation to going concern and longer term viability; and
- the part of the corporate governance report on page 67 relating to the Company's compliance with the eleven provisions of the 2014 UK Corporate Governance Code specified for our review.

We have nothing to report in respect of the above responsibilities.

Scope of report and responsibilities
As explained more fully in the directors' responsibilities statement set out on page 105, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2014b, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

JIMMY DABOO (SENIOR STATUTORY AUDITOR)
for and on behalf of KPMG LLP, Statutory Auditor

Chartered Accountants
15 Canada Square
London E14 5GL
11 February 2016