



14 April 2005

## ROLLS-ROYCE GROUP plc

### PREPARATIONS COMPLETED FOR ADOPTION OF IFRS

Rolls-Royce, the world-leading power systems company for aerospace, marine and energy markets, today announced the completion of preparations to adopt International Financial Reporting Standards (IFRS).

Commenting on the Group's adoption of the new accounting rules, Andrew Shilston, Finance Director, said:

*"Rolls-Royce has followed a consistent and successful strategy for many years. Our business model has proved robust and we are focused on the creation of long-term value for our shareholders, customers and employees."*

*"The adoption of IFRS will have some impact on the presentation of our accounts but will not change our business model, our strategy, our risk management processes or our cash flows."*

#### Highlights

- Reported earnings per share for 2004 up by 29%, as compared with the figure announced in February (and underlying eps up by 7%)
- No change to the Group's guidance on trading performance for 2005. Under IFRS, however, underlying profits for 2005 are expected to be significantly ahead of current market expectations, which are based on UK Generally Accepted Accounting Principles
- No effect on the Group's trading cash flows
- No effect on the Group's management of its businesses
- "Underlying profits" to be retained as key measure of operating performance, with some redefinition

A full overview of the impact of IFRS is set out on pages 1 to 16 of the Transition document, together with a set of restated 2004 financial statements for comparative purposes (pages 17 to 23). Six appendices to the (unaudited) financial statements describe the Group's summarised accounting policies under IFRS (appendix 1) and provide a numerical breakdown of the restatements for 2004 (appendices 2 to 6).

To date, Rolls-Royce has prepared its accounts in compliance with UK Generally Accepted Accounting Principles ("UK GAAP"). EU regulations require Rolls-Royce to adopt IFRS in its financial statements from 2005. A study was begun by the Group in 2002, in conjunction with our auditors KPMG Audit plc, to review what changes would be required in order to move from UK GAAP to IFRS. Restatements of our 2004 results are unaudited, but our auditors have agreed the principles that have now been adopted by the Group.

There are five principal areas in which the implementation of the new accounting rules will result in important changes to the financial statements as compared with past practice.

As a consequence of these changes, and other less significant adjustments noted in the attached document, future financial statements will not be readily comparable with past statements. Setting the restated 2004 Results\* against those announced in February 2005, the net differences can be summarised as follows:

- **2004 profit and loss account under IFRS vs. UK GAAP**
- Increase of £58 million profit before tax (from £306 million to £364 million)
- Increase of 29 per cent in reported earnings per share (from 12.07pence to 15.56 pence)
  
- **2004 profit and loss account under IFRS vs. UK GAAP - underlying \*\***
- Increase of £19 million profit before tax (from £345 million to £364 million)
- Increase of 7 per cent in underlying earnings per share (from 14.50 pence to 15.56 pence)
  
- **2004 year end balance sheet under IFRS vs. UK GAAP**
- Reduction of £861 million net assets (from £2,307m to £1,446m)
- Increase of £69 million net debt (from £80m to £149m)

\* excluding the impact of IAS 39 *Financial Instruments*, which has been adopted with effect from 1.1.05 (see page 2, "*Basis of preparation*" in the Transition document)

\*\*before non-trading items (see page 4 in the Transition document)

The five principal areas are affected as follows:

## **1. Research and Development costs**

*UK GAAP:* Research and development costs were in general expensed through the profit and loss account as and when they were incurred.

*IFRS (as required by IAS 38):* A portion of development costs, as defined by specified criteria, must be capitalised as intangible assets. Broadly, these criteria will apply where the relevant spending can be reliably identified with development rather than research and is likely to generate future earnings – conditions that will generally be met, on a typical new engine programme, at around the date of engine certification. Spending will then be capitalised from the date of capitalisation – to be determined in practice by two internal review boards, covering commercial and technical issues – until the respective engine's entry into service. (Spending prior to the threshold date will continue to be expensed as incurred.) The resulting asset will be amortised on a straight-line basis over 15 years. It will also be re-assessed each year (in an "impairment test") to ensure that the recorded value is supported by the estimated value of the respective future earnings.

*Financial impact:* An additional (post-tax) net asset of £108 million will appear on the restated ("R") 2004 year-end balance sheet. Research and development costs expensed through the 2004 (R) profit and loss account will increase by £6 million, because the amount required to be amortised will exceed by £6 million the amount that was previously expensed and will now be removed from the profit and loss account by being capitalised for the year.

## **2. Sales of original equipment**

*UK GAAP:* Where no linked aftermarket contract existed at the time of the original equipment (OE) sale, all costs of OE sold were expensed through the profit and loss account as incurred.

*IFRS (as required by IAS 38):* Where no linked aftermarket contract exists but the Group has contractually agreed to supply aftermarket parts and services to the purchaser of a new engine, and has a reasonable degree of control over the aftermarket, any production costs in excess of the engine's cash selling price will be treated as an investment made with a view to the future value of the engine's aftermarket. IFRS requires this investment, as an intangible asset, to be capitalised (subject, as in (1) above, to the amount being reliably quantifiable and expected to generate future earnings). The asset will be amortised on a straight-line basis over a maximum of ten years (subject, as in (1) above, to an impairment test to ensure that the recorded value is supported by the estimated value of the respective future earnings).

*Financial impact:* An adjustment to net assets of £87 million, after tax, will be reported on the 2004 (R) balance sheet. This represents the cumulative deficits, net of past amortisation, incurred on engines sold by the Group since 1998. Operating costs recorded in the 2004 (R) profit and loss account will

increase by £10 million, this being the amount by which the required amortisation for the year exceeds the engine-sale deficits incurred in 2004 that were previously charged to the profit and loss account but will now be capitalised, after off-setting existing provisions.

### **3. Financial risk and revenue-sharing partners**

*UK GAAP:* Receipts from financial risk and revenue-sharing partners (“RRSPs”) were recorded within the profit and loss account as ‘other operating income’. Payments to partners, which arose from sales of the respective programmes, were charged through the profit and loss account and included within ‘cost of sales’.

*IFRS (as required by IAS 32/39):* Investments that are made by financial RRSPs (i.e. as opposed to investments made by industrial partners and any repayable UK government launch investment) are regarded under IFRS as financial instruments. Thus receipts from financial RRSPs will no longer be treated as operating income. Instead, they will give rise to a balance sheet liability – which will be set up to reflect the present value of expected future payments to these partners. Thereafter, this creditor item will be adjusted to take account of (a) actual payments made; and (b) any change in the present value of future payments, as a consequence of the imputed finance costs and any altered revenue expectations. The net adjustment to the balance sheet item will be recorded in the profit and loss account within ‘net finance costs’.

*Financial impact:* A liability of £325 million, after tax, will be reported on the opening balance sheet for 2005, representing the present value of expected future payments to financial RRSPs under existing agreements. No restatement of 2004 results is required for the introduction of this new policy.

### **4. Treatment of hedging for foreign exchange**

*UK GAAP:* Financial derivatives, employed to hedge future transactions, particularly in respect of foreign exchange, were “hedge” accounted. That is to say, profit was recorded at the achieved exchange rate, blending together any transactions executed at spot rates and the settlement of maturing forward contracts held in the hedge book. Unrealised losses and gains on the on-going contracts within the hedge book were disclosed within the notes to the accounts.

*IFRS (as required by IAS 32/39):* The Group will continue to utilise forward exchange contracts, in the “portfolio” approach that is well suited to its needs. It will no longer apply “hedge” accounting, however, which under IFRS would require the Group to make significant changes to the way in which it operates its hedging policies. Therefore, operating profits will be reported without the benefit of any off-set from financial derivatives, as though translated at spot rates only. At the same time, the aggregate value of all the Group’s outstanding derivatives will be shown as one asset on the balance sheet, which will be “marked-to-market” each year, to reflect its fair value. In the profit and loss account, net finance costs will record the net gain or loss on

both realised derivative transactions *and* unrealised, marked-to-market adjustments. In order to retain a fundamental feature of its past reporting, the Group will exclude the unrealised gains/losses in its calculation of “underlying profits”, which will continue to reflect the settlement of foreign exchange cover and other benefits, as in the past.

*Financial impact:* A “hedging reserve” of £719 million, net of tax, will be established on the opening balance sheet for 2005, to reflect an unrealised foreign exchange gain resulting from the marked-to-market valuation of the Group’s derivatives hedge book at that date. This will be released through turnover over a four-year period. Future changes in marked-to-market valuations will be passed through the profit and loss account in the year they arise. No restatement of 2004 results is required for the introduction of this new policy.

## **5. Pensions and other post-retirement benefits**

*UK GAAP:* Pension-funding requirements were determined by triennial actuarial reviews. Pension costs were charged to the profit and loss account as operating costs in accordance with UK GAAP (ie SSAP 24). Any deficits in the pension schemes’ assets as compared with their future liabilities were recorded in the notes to the accounts.

*IFRS (as required by IAS19, but closely in line with disclosures already made in Notes to the Accounts under FRS17):* Any deficit will be recorded as a liability on the balance sheet. Changes in the value of the deficit will be taken through the Statement of Recognised Income and Expenses, which has no impact on the calculation of earnings per share. A separate annual charge will be made to the profit and loss account, which will comprise a service cost and a finance cost – though these will be separated, with the service charge going through operating costs and the finance charge through net finance costs. Generally, as for other companies that have a large deficit, the total pension fund charge to the profit and loss account will under IFRS be lower than under UK GAAP. The change in the accounting treatment of the Group’s pension arrangements will have no impact on their funding.

*Financial impact:* An additional liability of £1,076m, after tax, will be reported on the 2004 (R) balance sheet, with a corresponding reduction to Group reserves. The charge to the profit and loss account for 2004 (R) will fall by £41m, before tax.

Finally, four important points should be noted about the impact on the Group of switching to accounts compiled under IFRS:

- (i) it will have no effect on the Group's trading cash flows;
- (ii) it will have no impact on how the Group's businesses are managed;
- (iii) it is expected that the Group's reported profits for 2005 on an underlying basis will be significantly ahead of current market expectations, which are based on UK GAAP;
- (iv) it is expected that reported profits will in future be significantly more volatile, principally as a result of the requirement to mark-to-market the value of financial instruments.

The policies now being adopted by Rolls-Royce are in line with the IFRS expected to be adopted by the EU formally as of December 31, 2005. These standards still remain subject to further change, which may lead to further refinement of the policies implemented by Rolls-Royce.

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