



IFRS 15

Teach-in





Agenda for today

01 Introduction

02 IFRS 15 Impact on OE

03 IFRS 15 Impact on Services

04 Deeper dive into LTSAs

05 Balance sheet

06 Summary and
modelling
implications

07 Questions



01

Introduction



Overview:

IFRS 15 is simply an accounting change – **economic/business case unchanged**

1 OE

- Sell installed OE widebody engines below cost
- Sell business jet OE engines at a profit

2 Services

- Installed base and high LTSA* coverage drives engine flying hour based cash inflows
- Shop visits are an intermittent cost
- Additional regular costs are incurred on service provision

3 Key levers to the economic case

- Reduce cash deficits on OE
- Keep the fleet flying
- Reduce servicing cost and frequency
- Manage fixed costs

*Long term service agreement



Agenda

What we are going to cover

- It's all about Civil Aerospace
- OE is straightforward
- Services see the greatest change
- Regular vs intermittent costs
- Understand RRSP* dynamics
- Metrics we will provide to drive your models
- Considerations for modelling approach
 - need to disconnect cash flow from P&L modelling

*Risk and revenue sharing partner



IFRS 15 2017 analysis

Principal Group impact is at **Civil Aerospace**

Bigger profit adjustment than expected due to higher margin 'linked' Trent 700 sales

Group underlying	Current accounting 2017	Change	IFRS 15 2017
OE revenue (£m)	7,687	(928)	6,759
Service revenue (£m)	7,403	(480)	6,923
Total revenue (£m)	15,090	(1,408)	13,682
Operating profit/(loss) (£m)	1,175	(854)	321
Reserves (£bn)	6.2	(5.2)	1.0

Key drivers of difference
- £0.7bn of Widebody cash deficit

2017 IFRS 15 figures are preliminary and as processes and procedures are further embedded during 2018 it is possible that some changes may result



Major drivers IFRS 15

OE is greatly simplified and easy to model

Service has changed for **LTSA based activity**

Time and material service activity unchanged

OE revenue and margin P&L now recognises the loss or profit at the time of OE sale

- Unit volumes
- Sales prices
 - Concessions no longer spread across OE and service contract
- Unit costs
- In widebody, installed vs spare engine OE have different dynamics
- Business Aviation OE and Spare engines unchanged

Service revenue and margin Recognise revenue on long term service contracts as cost is incurred

- Two core types of service related costs
 - Intermittent / lumpy overhaul events
 - Regular, ongoing costs e.g. EHM, lease engine provision
- Overall LTSA margin % still key



02

IFRS 15 Impact on OE



IFRS 15 OE accounting is straightforward

Recognise a loss
when the cost
exceeds the price

Illustrative IFRS 15 OE calculation

Cash \$m

Gross revenue		100
Concession		(60)
Net revenue	1	40
Engine cost		(40)
RRSP (25%) share of net revenue	2	(10)
Cash margin	3	(10)

IFRS 15 income statement \$m

		Total
Net revenue	1	40
Cost of sales: engine cost		(40)
Cost of sales: RRSP	2	(10)
Margin	3	(10)

1 IFRS 15 revenue = net cash revenue (price after concession)

2 RRSP share of revenue is treated as part of the “cost of sale”

3 The cash deficit is recognised in the P&L when the OE sale occurs



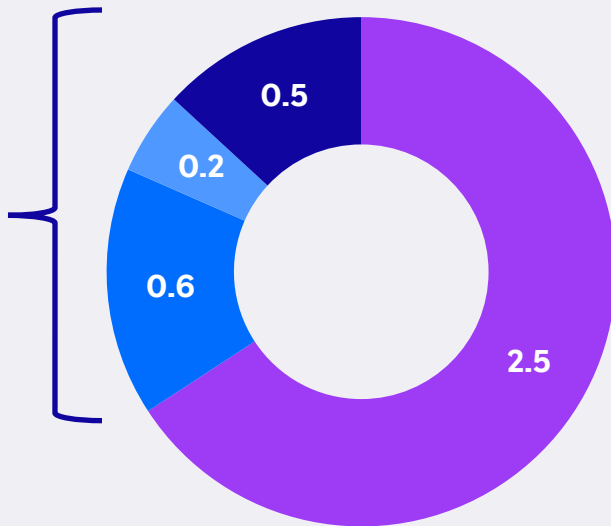
Civil Aerospace: Underlying OE revenue

£1.3bn

~£1.3bn of OE
revenue unaffected
by the transition -
positive cash margin

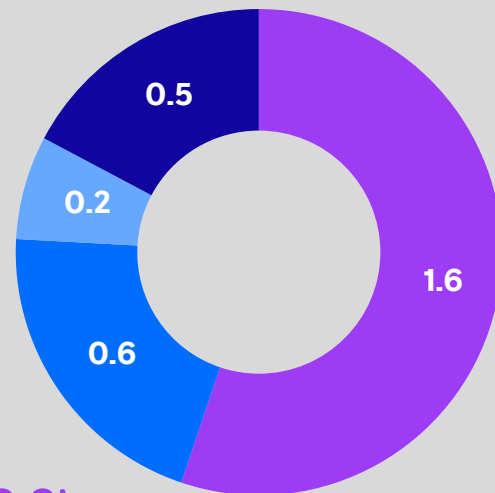
£0.9bn lower Large
engine installed OE
under IFRS 15

Current accounting
OE revenue: £3.8bn



- Large engine installed OE
- Business aviation OE
- V2500 OE
- Spare engines

IFRS 15
OE revenue: £2.9bn



£0.9bn

£0.7bn of Large engine cash
deficits

£0.2bn Large engine “linked”
profit

03

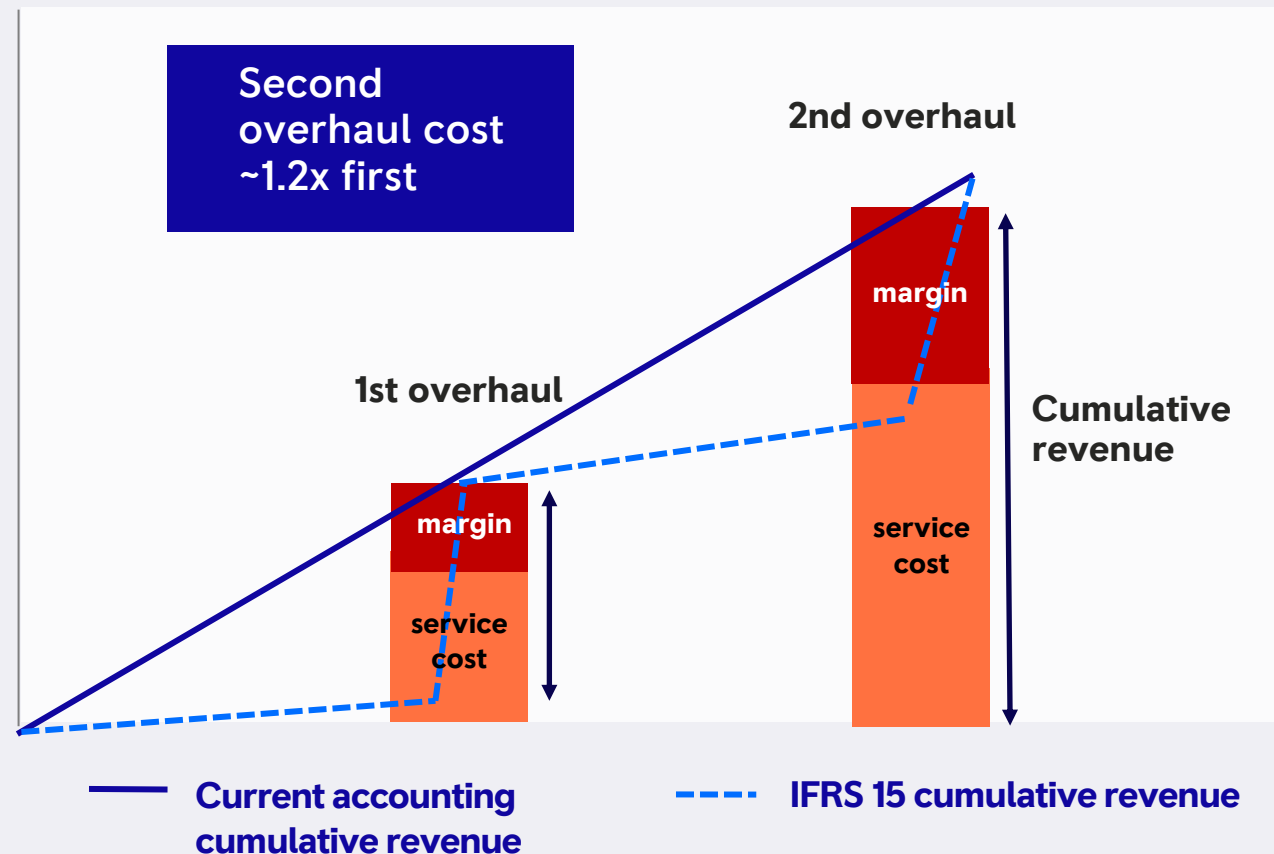
IFRS 15 Impact on Services



Simplified illustrative example

Current v IFRS 15 revenue from LTSAs

Revenue deferred under IFRS 15





Civil Aerospace:

Underlying service
revenue

LTSA vs T&M

~£1.3bn of other/T&M
revenue unaffected
by the transition

Around **90% of Trent
engine fleet covered
by LTSAs** and **>70%
of the business
aviation fleet**

Current accounting

Recognise LTSA revenue on a
flying hour basis

£bn	2017
Services revenue	4.2
LTSA: ~70% of revenues	2.9
<i>Other/T&M revenues</i>	<i>1.3</i>

£0.5bn



IFRS 15

Recognise LTSA revenue on
a **cost incurred** basis

£bn	2017
Services revenue	3.7
LTSA: ~65% of revenues	2.4
<i>Other/T&M revenues</i>	<i>1.3</i>

IFRS 15 delays LTSA revenue recognition vs current accounting:

- young fleet of **large engines**: average age **< 7 years**
- **business jet engines** often on wing for many years prior to first overhaul



Civil Aerospace: Underlying service revenue

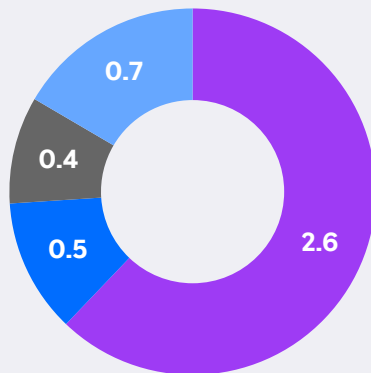
By category

**IFRS 15 Service
revenue £0.5m lower**

Principal changes:

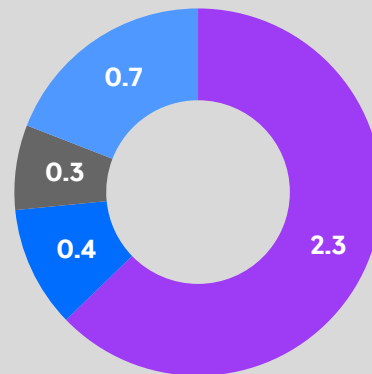
- Timing
- Concessions
- Contract accounting adjustments

Current accounting
Service revenue: £4.2bn



- Large engine
- Business aviation
- Regional
- V2500

IFRS 15
Service revenue: £3.7bn



£0.3bn



Timing – cost event vs EFH
No concession amortisation
Contract accounting adjustments

£0.1bn



Timing – cost event vs EFH
Contract accounting adjustments

£0.1bn



Timing – cost event vs EFH
Contract accounting adjustments

04

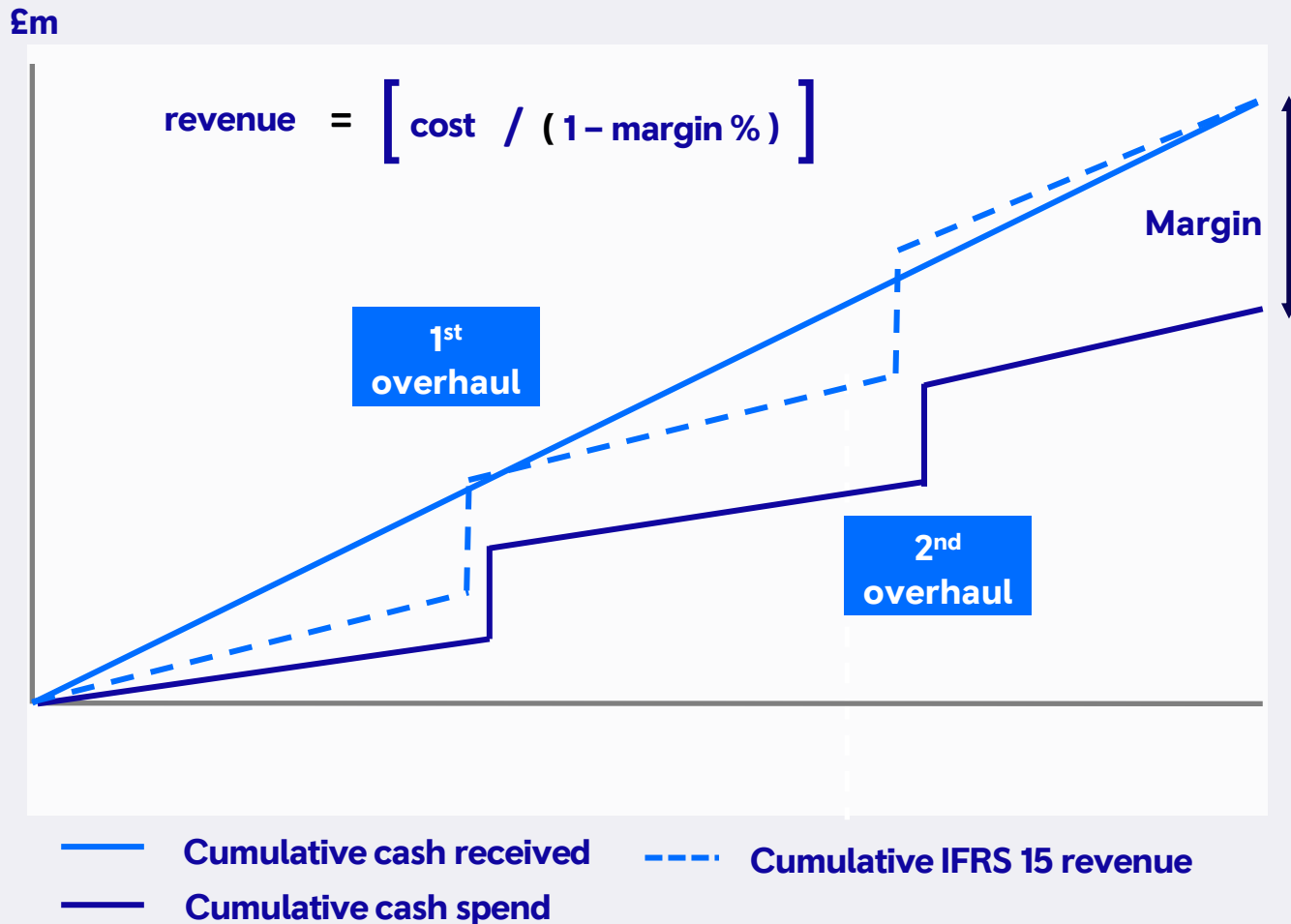
Deeper dive into LTSA's



IFRS 15 LTSA accounting

Combination of
regular and
intermittent costs

**Refurbishment
overhauls** drive
significant
proportion of
individual contract
cost





LTSA accounting IFRS 15

Low revenues
recognised in early
stages of service
agreements under
IFRS 15

**Overhauls drive
significant revenue
recognition**

Simplified LTSA accounting example – no RRSP

Cash

	Year										
\$m	1	2	3	4	5	6	7	8	9	10	Total
Net revenue	100	100	100	100	100	100	100	100	100	100	1000
Overhaul cost	-	-	-	(200)	-	-	-	(200)	-	-	(400)
Other costs	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
Total costs	(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
Cash margin	90	90	90	(110)	90	90	90	(110)	90	90	500
Cash margin %											50%

**Annual cash
revenues** (constant
EFH)

Cost peaks driven
by overhauls

Regular lower level
of other contract
cost

IFRS 15

Overhaul 1

	Year										
\$m	1	2	3	4	5	6	7	8	9	10	Total
Net revenue	20	20	20	420	20	20	20	420	20	20	1000
Cost of sales	(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
Margin	10	10	10	210	10	10	10	210	10	10	500
Margin (%)	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Completion (%)	2%	2%	2%	42%	2%	2%	2%	42%	2%	2%	100%

Revenue is
recognised on cost

Cost recognised as
incurred.

Margin recognised
when cost activity
occurs.

NB: In practice, costs will be spread more evenly as not all the engines in a fleet will be overhauled in the same period. Refurbishment overhauls generally take place every 5-7 years. Shorter periods have been used above to simplify the calculations.

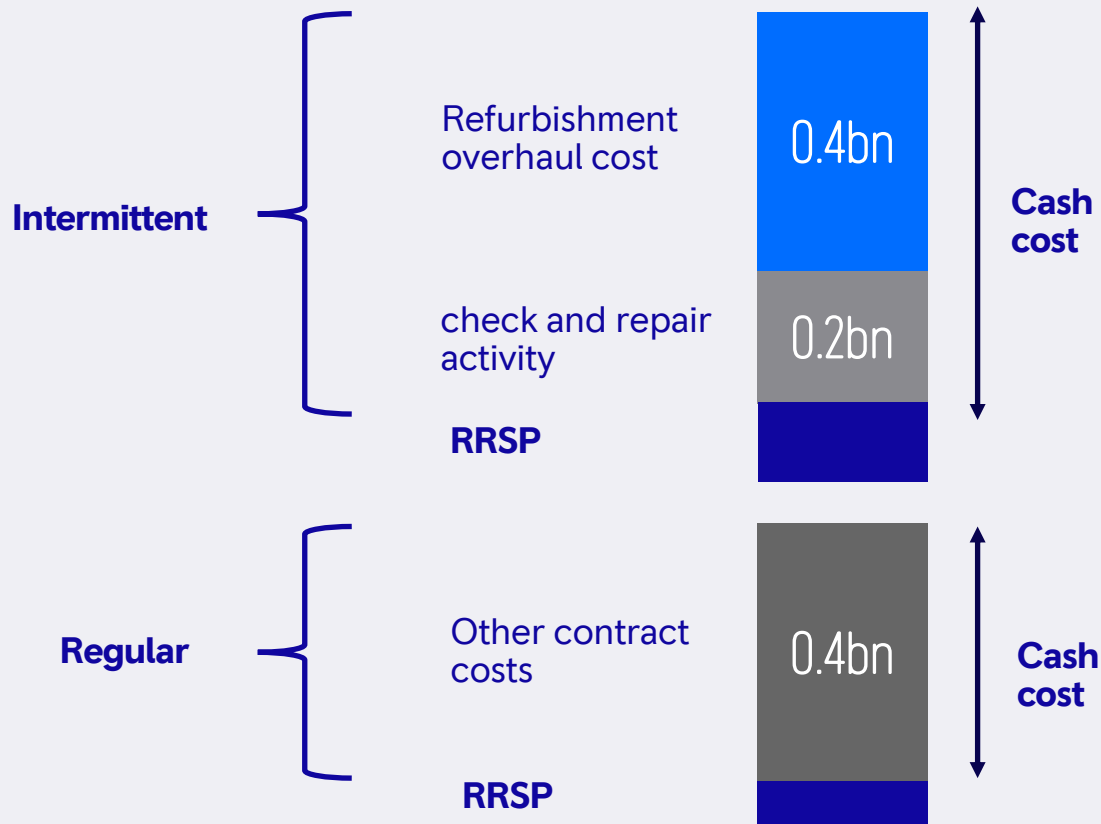


Large engine LTSA cost drivers

Combination of regular and intermittent cost

Pro rata RRSP cost across regular and intermittent

2017 Large engine LTSA cost: ~£1.1bn





Large engine LTSA cost drivers

Intermittent costs

Refurbishment overhauls generally **every 5-7 years**

Majority of the **£170m Trent 1000 and 900 in-service costs** within LTSA check and repair activity

2017 Large engine LTSA cost



service cost variability:

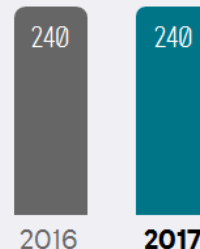
- engine type
- fleet operation
- 1st v 2nd overhaul

Major Engine refurbishment overhauls – LTSA

Flat number of overhauls despite growing fleet

c.350 check & repair overhauls

Large engines





Large engine LTSA cost drivers

Other contract
costs

2017 Large engine LTSA cost: ~£1.1bn

Other contract costs includes spare engines, transportation, tooling, engine health monitoring and on-wing support

These costs are incurred on an ongoing basis across the LTSA engine portfolio





LTSA accounting (RRSP) STEP ONE IFRS 15

Recognise RRSP net revenue/cost share within cost of sales

“pro rata” across other costs

\$m	Cash	Year	1	2	3	4	5	6	7	8	9	10	Total
Net revenue			100	100	100	100	100	100	100	100	100	100	1000
RRSP share of revenue			(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(200)
RR retained revenue			80	80	80	80	80	80	80	80	80	80	800
Overhaul cost			-	-	-	(200)	-	-	-	(200)	-	-	(400)
Other costs			(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
Total costs			(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
% cost complete			2%	4%	6%	48%	50%	52%	54%	96%	98%	100%	
RRSP share of cost			2	2	2	42	2	2	2	42	2	2	100
Net RRSP share			(18)	(18)	(18)	22	(18)	(18)	(18)	22	(18)	(18)	(100)
Cost incl. RRSP			(28)	(28)	(28)	(188)	(28)	(28)	(28)	(188)	(28)	(28)	(600)
Cash margin			72	72	72	(88)	72	72	72	(88)	72	72	400
Cash margin %													40%

20% RRSP partner receives a share of RR revenues.....

.....and contributes 20% of the costs

‘Total cost’ includes net RRSP share

IFRS 15

\$m	Year	1	2	3	4	5	6	7	8	9	10	Total
Net revenue												
Overhaul cost					(200)	-	-	-	(200)	-	-	(400)
Other costs					(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
Total costs					(10)	(10)	(10)	(210)	(10)	(10)	(10)	(500)
RRSP share					(2)	(2)	(2)	(42)	(2)	(2)	(2)	(100)
Total “cost” incl. RRSP					(12)	(12)	(12)	(252)	(12)	(12)	(12)	(600)
Margin												
Margin %												
Completion %												

1 Calculate total “cost” excluding RRSP

2 In the P&L recognise the net payments made to RRSPs in line with other contract cost activity



LTSA accounting (RRSP) STEP TWO IFRS 15

As revenue is recognised on cost, including pro rata RRSP, **overhauls are major drivers of revenue recognition**

\$m	Cash	Year	1	2	3	4	5	6	7	8	9	10	Total
Net revenue			100	100	100	100	100	100	100	100	100	100	1000
RRSP share of revenue			(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(200)
RR retained revenue			80	80	80	80	80	80	80	80	80	80	800
Overhaul cost			-	-	-	(200)	-	-	-	(200)	-	-	(400)
Other costs			(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
Total costs			(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
% cost complete			2%	2%	2%	42%	2%	2%	2%	42%	2%	2%	100%
RRSP share of cost			2	2	2	42	2	2	2	42	2	2	100
Net RRSP share			(18)	(18)	(18)	22	(18)	(18)	(18)	22	(18)	(18)	(100)
Cost incl. RRSP			(28)	(28)	(28)	(188)	(28)	(28)	(28)	(188)	(28)	(28)	(600)
Cash margin			72	72	72	(88)	72	72	72	(88)	72	72	400
Cash margin %													40%

20% RRSP partner receives a share of RR revenues.....

.....and contributes 20% of the costs

'Total cost' includes net RRSP share

IFRS 15

\$m	Year	1	2	3	4	5	6	7	8	9	10	Total
Net revenue		20	20	20	420	20	20	20	420	20	20	1000
Overhaul cost		-	-	-	(200)	-	-	-	(200)	-	-	(400)
Other costs		(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
Total costs		(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
RRSP cost of sale		(2)	(2)	(2)	(42)	(2)	(2)	(2)	(42)	(2)	(2)	(100)
Total cost of sale		(12)	(12)	(12)	(252)	(12)	(12)	(12)	(252)	(12)	(12)	(600)
Margin		8	8	8	168	8	8	8	168	8	8	400
Margin %		40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%
% of total cost of sale		2%	2%	2%	42%	2%	2%	2%	42%	2%	2%	

3

Apply contract margin to total "cost" including RRSP pro rata to calculate revenue

Revenue = total "cost" / (1 - 40%)

(600)/60% = 1000



Risk & Revenue Sharing Partners (RRSPs)

RRSP participation on newer engine programmes is **higher** than for more mature programmes

RRSP in-service fleet coverage will increase in future

Programmes	RRSP %	in-service engines in 2017	in-service engine % in 2017	in-service engine % in 2020
<i>RB211, Trent 700 and Trent 800</i>	<i><10%</i>	<i>3,015</i>	<i>68%</i>	
<i>Trent 500 and Trent 900</i>	<i>15-20%</i>	<i>640</i>	<i>15%</i>	
<i>Trent 1000, Trent 7000 and Trent XWB-84 and Trent XWB-97</i>	<i>25-30%</i>	<i>754</i>	<i>17%</i>	



Contract accounting

“catch up adjustments”

Adjustments will remain a feature under IFRS 15

Impact will change because timing of revenue recognition changes

Current accounting

LTSA Main principles:

- EFH drives revenue recognition
- Margin based on overall contract margin % x revenue
- cost of sales is balancing figure

LTSA “catch up” adjustments affect cost of sales and profit

“Linked” adjustments affect revenue and profit

IFRS 15

LTSA Main principles:

- Cost event drives revenue recognition
- Revenue calculated from cost using overall contract margin %

LTSA “catch up” adjustments affect revenue and profit

05

Balance sheet



Estimated Civil Aerospace Balance Sheet impact

Most significant impact is the **net contract balance**

Reflects

- Reversal of linked profit
- EFH to cost event based revenue recognition

£bn	Current accounting	IFRS 15	Delta
Contractual Aftermarket Rights	0.8	-	(0.8)
Participation Fees – Intangible Asset	0.4	-	(0.4)
Participation Fees – Contract Asset	-	0.4	0.4
Net Contract Debtor/(Creditor)	2.5	(2.7)	(5.2)
Other	(0.6)	(0.3)	0.3
Risk and revenue sharing partner participation fees	(0.3)	(0.8)	(0.5)
Total reserves impacted (pre-tax)	2.8	(3.4)	(6.2)
Tax			1.1
Total reserves impact (post tax)			(5.1)

Change in accounting of **cash contributions** received **from RRSPs** at the start of a programme

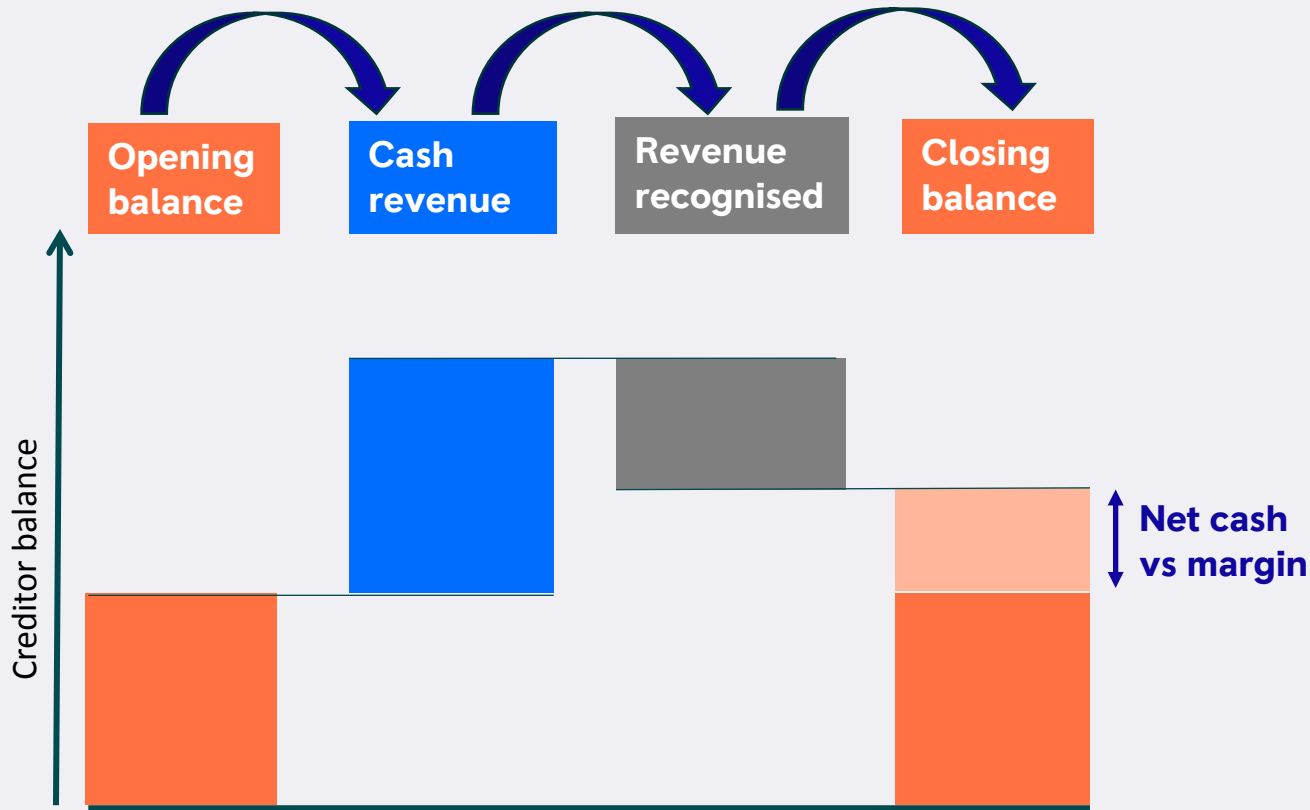
- **IFRS 15**: recognised as reduction to cost of sales
- Current accounting: recognised as reduction to R&D charge



Net contract balance

Cash received in advance of margin

Expect **continued growth in creditor for a number of years** – EFH cash revenues will be greater than IFRS 15 cost-event driven revenue



Contract creditor represents future revenues –
not Rolls-Royce overdue debt!



LTSA accounting IFRS 15

Cash received ahead of margin is reflected on the balance sheet as a creditor

Simplified LTSA accounting example – no RRSP

Cash

	Year										
\$m	1	2	3	4	5	6	7	8	9	10	Total
Net revenue	100	100	100	100	100	100	100	100	100	100	1000
Overhaul cost	-	-	-	(200)	-	-	-	(200)	-	-	(400)
Other costs	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
Total costs	(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
Cash margin	90	90	90	(110)	90	90	90	(110)	90	90	500
Cash margin %											50%

In year 1
cash margin is 90

IFRS 15

Overhaul 1

	Year										
\$m	1	2	3	4	5	6	7	8	9	10	Total
Net revenue	20	20	20	420	20	20	20	420	20	20	1000
Cost of sales	(10)	(10)	(10)	(210)	(10)	(10)	(10)	(210)	(10)	(10)	(500)
Margin	10	10	10	210	10	10	10	210	10	10	500
Margin (%)	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Completion (%)	2%	2%	2%	42%	2%	2%	2%	42%	2%	2%	100%
Contract balance	(80)	(160)	(240)	80	0	(80)	(160)	160	80	0	

p&l margin only 10

...so 80 of cash received ahead of p&l margin goes onto the balance sheet as a contract balance creditor

NB: In practice, costs will be spread more evenly as not all the engines in a fleet will be overhauled in the same period. Refurbishment overhauls generally take place every 5-7 years. Shorter periods have been used above to simplify the calculations.

06

Summary and modelling implications



Conclusions



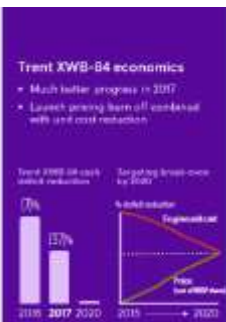
Major Engine refurbishment overhauls – LTSA

Flat number of overhauls despite growing fleet
c.350 check & repair overhauls



Installed engine economics

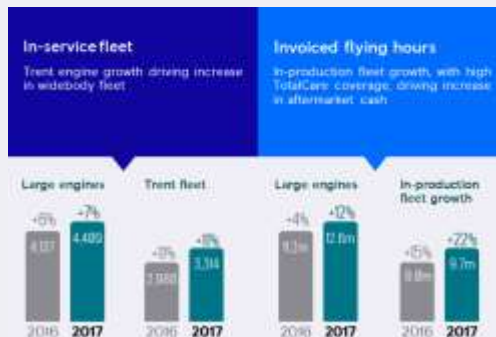
Overall average installed engine cash deficit remained flat at \$1.6m
Good progress on Trent XWB-84



Metrics we will provide

- OE volumes
- Average OE cash deficit
- LTSA shop visits
- Installed fleet
- Invoiced flying hours

- Reminder: IFRS 15 changes LTSA revenue; T&M still the same
- Contract accounting adjustments remain a fact of life
- LTC balance is growth indicator of future revenue (and doesn't mean building overdue debt!)
- Not just about the lumpy costs





Modelling

Need to **maintain separate driver based cash** and **p&l** models

RR will provide certain metrics & direction to help both elements

Other metrics will reflect your assumptions

Cash

- OE/ spares volumes
- Average OE cash deficits
- Invoiced flying hours
- In-service fleet
- No. of LTSA engine overhauls

- EFH revenue
- EFH yield

P&L

- OE/ spares volumes
- Average OE cash deficits
- No. of LTSA engine overhauls

- EFH revenue
- LTSA margin %
- Recurring costs



IFRS 15 no change to cash

The first year of
adoption – still learning

No change
to in-year
cash

No change to
total profit or
cash over the
life of a long
term contract

Significantly
improves
transparency
on Civil
Aerospace OE
– much closer
to cash

Continue long-
term contract
accounting –
accounting
adjustments
remain a
feature



Civil Aftermarket: greater forecasting challenge

- first year of adoption
- in-service vs regular overhauls
- impact of overhaul deferrals



07

Questions

08

Appendices

Detailed adjustments



Estimated IFRS 15 changes - 2017 Civil Aerospace OE

No change to cash flows from any of the revenue and profit changes

Underlying Revenue

No profit on linked OE sale
£(194)m

Total OE deficit £(704)m includes:
No capitalisation of linked engine cash deficit
£(418)m
No CARs on unlinked contracts
£(286)m

Treatment of guarantees and penalties
£(13)m

Treatment of participation fees
£(22)m

Other timing differences
£20m

£(913)m

Underlying Profit

No profit on linked OE sales
£(194)m

Total OE deficit £(704)m includes:
No capitalisation of linked engine cash deficit
£(418)m
No CARs on unlinked contracts
£(286)m

Treatment of guarantees and penalties
£5m

No amortisation of CARs
£57m

RRSP participation fees
£23m

Other timing differences
£(14)

£(827)m

Note: All adjustments shown pre-tax effects

These estimated figures are preliminary and, as processes and procedures are further embedded during 2018, it is possible that some changes to the impact may result



Estimated IFRS 15 changes – 2017 Civil Aerospace Services

No change to cash flows from any of the revenue and profit changes

Underlying Revenue

No amortisation of prior years concession deferral
£353m

Contract accounting adjustments difference
£(341)m

Large engine cost incurred vs engine flying hour impact
£(344)m

CorporateCare® and regional cost incurred vs engine flying hour impact
£(165)m

£(497)m

Underlying Profit

No amortisation of prior years concession deferral
£353m

Contract accounting adjustments difference
£(131)m

Large engine cost incurred vs engine flying hour impact
£(127)m

CorporateCare® and regional cost incurred vs engine flying hour impact
£(118)m

£(23)m

Note: All adjustments shown pre-tax effects

These estimated figures are preliminary and, as processes and procedures are further embedded during 2018, it is possible that some changes to the impact may result



Other parts of the group

£(34)m LTSA margin impact offset by £30m favourable timing benefit from spares distribution contract in **Defence Aerospace** - LTSA margin impact expected to recur in the short term; timing benefit from the spares distribution contract is not

The overall net impact across the rest of the group is insignificant.

£m	Current accounting	IFRS 15	Change
Revenue			
Civil	8,023	6,613	(1,410)
Defence	2,275	2,282	7
Power Systems	2,923	2,919	(4)
Marine	1,077	1,075	(2)
Nuclear	818	818	-
Other	(26)	(25)	1
Total revenue	15,090	13,682	(1,408)
Operating profit			
Civil	520	(330)	(850)
Defence	374	370	(4)
Power Systems	330	331	1
Marine	(25)	(26)	(1)
Nuclear	38	38	-
Other	(62)	(62)	-
Total operating profit	1,175	321	(854)



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Safe harbour statement

This announcement contains certain forward-looking statements. These forward-looking statements can be identified by the fact that they do not relate only to historical or current facts. In particular, all statements that express forecasts, expectations and projections with respect to future matters, including trends in results of operations, margins, growth rates, overall market trends, the impact of interest or exchange rates, the availability of financing to the Company, anticipated cost savings or synergies and the completion of the Company's strategic transactions, are forward-looking statements. By their nature, these statements and forecasts involve risk and uncertainty because they relate to events and depend on circumstances that may or may not occur in the future. There are a number of factors that could cause actual results or developments to differ materially from those expressed or implied by these forward-looking statements and forecasts. The forward-looking statements reflect the knowledge and information available at the date of preparation of this announcement, and will not be updated during the year. Nothing in this announcement should be construed as a profit forecast. All figures are on an underlying basis unless otherwise stated - see note 2 of the 2017 full year results statement for the definition.