SKARIE DAVID P
Form 4
February 07, 2012

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

OMB APPROVAL
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(Print or Type Responses)

1. Name and Address of Reporting Person *
SKARIE DAVID P

(Last) (First) (Middle)

C/O POST HOLDINGS, INC., 2503 S. HANLEY ROAD

(Street)

ST. LOUIS, MO 63144

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
Post Holdings, Inc. [POST]

3. Date of Earliest Transaction (Month/Day/Year)
02/03/2012

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director
_____ 10% Owner
_____ Officer (give title below)
_____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	02/03/2012		J (1)		27,365	A	$ 0	27,365	D	
Common Stock	02/03/2012		J (1)		655	A	$ 0	655	I	By 401(k) Plan

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Pric Deriva Securit (Instr.
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares	
Post Holdings, Inc. Stock Equivalents	(2)	02/03/2012		J(1)		65		(3)	(3)	Common Stock	65	$ 26

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
SKARIE DAVID P C/O POST HOLDINGS, INC. 2503 S. HANLEY ROAD ST. LOUIS, MO 63144	X			

Signatures

/s/ Diedre J. Gray, Attorney-in-Fact	02/07/2012
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Acquired in a pro rata distribution by Ralcorp Holdings, Inc.

(2) The value of these stock equivalents is distributed (on a one-for-one basis) in the form of cash upon retirement from the Board of Directors.

(3) The stock equivalents have no fixed exercisable or expiration dates.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
MERCURY SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(Unaudited)

	September 30, 2013	June 30, 2013
Assets		
Current assets:		
Cash and cash equivalents	$40,106	$39,126
Accounts receivable, net of allowance for doubtful accounts of $17 and $33 at September 30, 2013 and June 30, 2013, respectively	35,143	30,498
Unbilled receivables and costs in excess of billings	13,913	17,743
Inventory	35,179	37,432
Deferred income taxes	10,724	11,672
Prepaid income taxes	3,541	2,369
Prepaid expenses and other current assets	6,737	7,461
Total current assets	145,343	146,301
Restricted cash	546	546
Property and equipment, net	14,565	15,019
Goodwill	176,612	176,521
Intangible assets, net	32,758	34,866
Other non-current assets	1,061	1,178
Total assets	$370,885	$374,431
Liabilities and Shareholders’ Equity		
Current liabilities:		
Accounts payable	$7,522	$4,813
Accrued expenses	6,743	7,999
Accrued compensation	8,403	12,218
Deferred revenues and customer advances	4,749	5,788
Total current liabilities	27,417	30,818
Deferred gain on sale-leaseback	2,953	3,242
Deferred income taxes	7,238	7,721
Income taxes payable	2,880	2,880
Other non-current liabilities	1,179	1,269
Total liabilities	41,667	45,930
Commitments and contingencies (Note H)		
Shareholders’ equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, $0.01 par value; 85,000,000 shares authorized; 30,927,319 and 30,381,254 shares issued and outstanding at September 30, 2013 and June 30, 2013, respectively	309	304
Additional paid-in capital	234,620	231,711
Retained earnings	93,268	95,524
Accumulated other comprehensive income	1,021	962
Total shareholders’ equity	329,218	328,501

Total liabilities and shareholders’ equity	$370,885	$374,431

The accompanying notes are an integral part of the consolidated financial statements.

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Explanation of Responses:

MERCURY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,	
	2013	2012
Net revenues	$53,940	$49,428
Cost of revenues	31,355	29,038
Gross margin	22,585	20,390
Operating expenses:		
Selling, general and administrative	15,101	14,533
Research and development	9,344	10,039
Amortization of intangible assets	2,108	1,788
Restructuring and other charges	(15)	4,984
Acquisition costs and other related expenses	—	230
Total operating expenses	26,538	31,574
Loss from operations	(3,953)	(11,184)
Interest income	1	2
Interest expense	(15)	(8)
Other income, net	432	339
Loss before income taxes	(3,535)	(10,851)
Tax benefit	(1,279)	(3,651)
Net loss	$(2,256)	$(7,200)
Basic net loss per share:	$(0.07)	$(0.24)
Diluted net loss per share:	$(0.07)	$(0.24)
Weighted-average shares outstanding:		
Basic	30,653	29,883
Diluted	30,653	29,883
Comprehensive loss:		
Net loss	$(2,256)	$(7,200)
Foreign currency translation adjustments	59	12
Net unrealized gain on investments	—	21
Total comprehensive loss	$(2,197)	$(7,167)

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended September 30,	
	2013	2012
Cash flows from operating activities:		
Net loss	$(2,256)	$(7,200)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization expense	4,120	3,999
Stock-based compensation expense	3,035	2,345
Provision (benefit) for deferred income taxes	464	(3,507)
Excess tax benefit from stock-based compensation	—	(9)
Other non-cash items	(243)	(18)
Changes in operating assets and liabilities, net of effects of businesses acquired:		
Accounts receivable, unbilled receivable, and cost in excess of billings	(731)	1,758
Inventory	2,274	(2,488)
Prepaid income taxes	(1,172)	972
Prepaid expenses and other current assets	736	75
Other non-current assets	27	(31)
Accounts payable and accrued expenses	(2,750)	(5,820)
Deferred revenues and customer advances	(1,238)	(606)
Income taxes payable	—	10
Other non-current liabilities	(93)	571
Net cash provided by (used in) operating activities	2,173	(9,949)
Cash flows from investing activities:		
Acquisition of businesses, net of cash acquired	—	(67,721)
Purchases of property and equipment	(1,108)	(980)
Increase in other investing activities	—	(265)
Net cash used in investing activities	(1,108)	(68,966)
Cash flows from financing activities:		
Proceeds from employee stock plans	60	133
Excess tax benefits from stock-based compensation	—	9
Payments of acquired debt	—	(6,575)
Payments of capital lease obligations	(121)	(46)
Net cash used in financing activities	(61)	(6,479)
Effect of exchange rate changes on cash and cash equivalents	(24)	(2)
Net increase (decrease) in cash and cash equivalents	980	(85,396)
Cash and cash equivalents at beginning of period	39,126	115,964
Cash and cash equivalents at end of period	$40,106	$30,568
Cash paid (received) during the period for:		
Interest	$15	$8
Income taxes	$334	$(1,193)
Supplemental disclosures—non-cash activities:		
Issuance of restricted stock awards to employees	$7,728	$11,584
Capital lease	$494	$—
Share-based business combination consideration	$—	$513

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands except per share data)
(Unaudited)

A. Description of Business

Mercury Systems, Inc. (the “Company” or “Mercury”) provides commercially developed, open sensor and Big Data processing systems, software and services for critical commercial, defense and intelligence applications. The Company delivers innovative solutions, rapid time-to-value and world-class service and support to our defense prime contractor customers. The Company's products and solutions have been deployed in more than 300 programs with over 25 different defense prime contractors. Key programs include Aegis, Patriot, Surface Electronic Warfare Improvement Program ("SEWIP"), Predator and Reaper. The Company also delivers services and solutions in support of the intelligence community. Mercury Systems operates across a broad spectrum of defense and intelligence programs and the Company delivers its solutions and services via three business units: (i) Mercury Commercial Electronics ("MCE"); (ii) Mercury Defense Systems ("MDS") and; (iii) Mercury Intelligence Systems ("MIS").

MCE delivers innovative, commercially developed, open sensor and Big Data processing systems, software and services that include embedded multi-computing and embedded sensor processing. Mercury's products include, but are not limited to, embedded processing boards, digital receiver boards, and chassis-based systems using air, conduction, and proprietary cooling technologies. MCE has added capabilities around radio frequency ("RF") and microwave technologies, including tuners, converters, transceivers, switch filters, and power amplifiers and limiters, as well as emerging new manufacturing capabilities on a more scalable basis. MDS leverages commercially available technologies and solutions (or “building blocks”) from the Company's MCE business. MDS leverages this technology to develop integrated sensor processing subsystems and capabilities, for the C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance), electronic warfare ("EW"), electronic counter measures ("ECM"), signal intelligence ("SIGINT") and radar test and simulation markets. MIS delivers Big Data processing capabilities, software data processing solutions and predictive analytics capabilities to address intelligence community and Department of Defense ("DoD") mission needs. These three business units allow the Company to deliver capabilities that combine technology building blocks, deep domain expertise in the defense sector and critical solution areas, and specialized skills in serving the DoD and the intelligence community.

B. Summary of Significant Accounting Policies

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to the Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures, normally included in annual consolidated financial statements have been condensed or omitted pursuant to those rules and regulations; however, in the opinion of management the financial information reflects all adjustments, consisting of adjustments of a normal recurring nature, necessary for fair presentation. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the fiscal year ended June 30, 2013 which are contained in the Company’s Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”) on August 16, 2013. The results for the three months ended September 30, 2013 are not necessarily indicative of the results to be expected for the full fiscal year.

The Company is comprised of the following three operating segments: MCE, MDS and MIS. The Company reports MCE as a standalone reportable segment and has aggregated MDS and MIS to form the reportable segment Mercury Defense and Intelligence Systems (“MDIS”). The Company has presented prior period amounts to conform with the new reportable segments. None of these changes impact the Company’s previously reported consolidated financial results. See Note K of the Notes to Consolidated Financial Statements for further discussion.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated.

USE OF ESTIMATES

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

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REVENUE RECOGNITION

The Company relies upon FASB ASC 605, Revenue Recognition to account for its revenue transactions. Revenue from sales are recognized upon shipment provided that title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and customer acceptance criteria, if any, have been successfully demonstrated. Out-of-pocket expenses that are reimbursed by the customer are included in revenue and cost of revenue.

Certain contracts with customers require the Company to perform tests of its products prior to shipment to ensure their performance complies with the Company’s published product specifications and, on occasion, with additional customer-requested specifications. In these cases, the Company conducts such tests and, if they are completed successfully, includes a written confirmation with each order shipped. As a result, at the time of each product shipment, the Company believes that no further customer testing requirements exist and that there is no uncertainty of acceptance by its customer.

The Company uses FASB Accounting Standards Update (“ASU”) No. 2009-13 (“FASB ASU 2009-13”), Multiple-Deliverable Revenue Arrangements. FASB ASU 2009-13 establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence (“VSOE”) if available; (2) third-party evidence (“TPE”) if VSOE is not available; and (3) best estimated selling price (“BESP”), if neither VSOE nor TPE is available. Additionally, FASB ASU 2009-13 expands the disclosure requirements related to a vendor’s multiple-deliverable revenue arrangements.

The Company enters into multiple-deliverable arrangements that may include a combination of hardware components, related integration or other services. These arrangements generally do not include any performance-, cancellation-, termination- or refund-type provisions. Total revenue recognized under multiple-deliverable revenue arrangements was 27% and 30% of total revenues in the three months ended September 30, 2013 and 2012, respectively.

In accordance with the provisions of FASB ASU 2009-13, the Company allocates arrangement consideration to each deliverable in an arrangement based on its relative selling price. The Company generally expects that it will not be able to establish VSOE or TPE due to limited single element transactions and the nature of the markets in which the Company competes, and, as such, the Company typically determines its relative selling price using BESP.

The Company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact if the product or service were sold by the Company on a standalone basis. The Company’s determination of BESP involves the consideration of several factors based on the specific facts and circumstances of each arrangement. Specifically, the Company considers the cost to produce the deliverable, the anticipated margin on that deliverable, the selling price and profit margin for similar parts, the Company’s ongoing pricing strategy and policies (as evident from the price list established and updated by management on a regular basis), the value of any enhancements that have been built into the deliverable and the characteristics of the varying markets in which the deliverable is sold.

The Company analyzes the selling prices used in its allocation of arrangement consideration at a minimum on an annual basis. Selling prices will be analyzed on a more frequent basis if a significant change in the Company’s business necessitates a more timely analysis or if the Company experiences significant variances in its selling prices.

Each deliverable within the Company’s multiple-deliverable revenue arrangements is accounted for as a separate unit of accounting under the guidance of FASB ASU 2009-13 if both of the following criteria are met: the delivered item or items have value to the customer on a standalone basis; and for an arrangement that includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. The Company's revenue arrangements generally do not include a general right of return relative to delivered products. The Company considers a deliverable to have standalone value if the item is sold separately by the Company or another vendor or if the item could be resold by the customer.

Deliverables not meeting the criteria for being a separate unit of accounting are combined with a deliverable that does meet that criterion. The appropriate allocation of arrangement consideration and recognition of revenue is then determined for the combined unit of accounting.

The Company also engages in long-term contracts for development, production and services activities which it accounts for consistent with FASB ASC 605-35, Accounting for Performance of Construction-Type and Certain

Production-Type Contracts, and other relevant revenue recognition accounting literature. The Company considers the nature of these contracts and the types of products and services provided when determining the proper accounting for a particular contract. Generally for fixed-price contracts, other than service-type contracts, revenue is recognized primarily under the percentage of completion method or, for certain short-term contracts, by the completed contract method. Revenue from service-type fixed-price contracts is recognized ratably over the contract period or by other appropriate input or output methods to measure service provided, and contract costs are expensed as incurred. The Company establishes billing terms at the time project deliverables and milestones

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are agreed. Revenues recognized in excess of the amounts invoiced to clients are classified as unbilled receivables. The risk to the Company on a fixed-price contract is that if estimates to complete the contract change from one period to the next, profit levels will vary from period to period. For time and materials contracts, revenue reflects the number of direct labor hours expended in the performance of a contract multiplied by the contract billing rate, as well as reimbursement of other billable direct costs. For all types of contracts, the Company recognizes anticipated contract losses as soon as they become known and estimable.

The use of contract accounting requires significant judgment relative to estimating total contract revenues and costs, including assumptions relative to the length of time to complete the contract, the nature and complexity of the work to be performed, anticipated increases in wages and prices for subcontractor services and materials, and the availability of subcontractor services and materials. The Company's estimates are based upon the professional knowledge and experience of its engineers, program managers and other personnel, who review each long-term contract monthly to assess the contract's schedule, performance, technical matters and estimated cost at completion. When adjustments in estimated contract costs are identified, such revisions may result in current period adjustments to earnings applicable to performance in prior periods.

Contract costs also may include estimated contract recoveries for matters such as contract changes and claims for unanticipated contract costs. The Company records revenue associated with these matters only when the amount of recovery can be estimated reliably and realization is probable. Assumed recoveries for claims included in contracts in process were not material for the three months ended September 30, 2013 and 2012.

The Company does not provide its customers with rights of product return, other than those related to warranty provisions that permit repair or replacement of defective goods. The Company accrues for anticipated warranty costs upon product shipment. Revenues from product royalties are recognized upon invoice by the Company. Additionally, all revenues are reported net of government assessed taxes (e.g. sales taxes or value-added taxes).

WEIGHTED-AVERAGE SHARES

Weighted-average shares were calculated as follows:

	Three Months Ended September 30,	
	2013	2012
Basic weighted-average shares outstanding	30,653	29,883
Effect of dilutive equity instruments	—	—
Diluted weighted-average shares outstanding	30,653	29,883

Equity instruments to purchase 4,178 and 4,402 shares of common stock were not included in the calculation of diluted net earnings per share for the three months ended September 30, 2013 and 2012, respectively, because the equity instruments were anti-dilutive.

C. Fair Value of Financial Instruments

The Company measures at fair value certain financial assets and liabilities, including cash equivalents and restricted cash. FASB ASC 820, Fair Value Measurement and Disclosures, specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs have created the following fair-value hierarchy:

Level 1—Quoted prices for identical instruments in active markets;

Level 2—Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3—Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The following table summarizes the Company's financial assets measured at fair value on a recurring basis at September 30, 2013:

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	Fair Value Measurements September 30, 2013	Level 1	Level 2	Level 3
Assets:				
U.S. Treasury bills and money market funds	$27,024	$27,024	$—	$—
Operating cash	13,082	13,082	—	—
Restricted cash	546	546	—	—
Total	$40,652	$40,652	$—	$—

The carrying values of cash and cash equivalents, including all U.S. Treasury bills and money market funds, accounts receivable and payable, and accrued liabilities approximate fair value due to the short-term maturities of these assets and liabilities.

D. Inventory

Inventory is stated at the lower of cost (first-in, first-out) or market value, and consists of materials, labor and overhead. On a quarterly basis, the Company uses consistent methodologies to evaluate inventory for net realizable value. The Company reduces the value of inventory for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order inventory in excess of estimated usage. The excess and obsolete inventory evaluation is based upon assumptions about future demand, history, product mix and possible alternative uses. Inventory was comprised of the following:

	September 30, 2013	June 30, 2013
Raw materials	$16,368	$17,512
Work in process	11,956	13,432
Finished goods	6,855	6,488
Total	$35,179	$37,432

There are no amounts in inventory relating to contracts having production cycles longer than one year.

E. Goodwill

The following table sets forth the changes in the carrying amount of goodwill for the three months ended September 30, 2013:

	MCE	MDS	MIS	Total
Balance at June 30, 2013	$133,783	$33,768	$8,970	$176,521
Goodwill adjustment for the Micronetics acquisition	91	—	—	91
Balance at September 30, 2013	$133,874	$33,768	$8,970	$176,612

In the three months ended September 30, 2013, there were no triggering events, as defined by FASB ASC 350, which required an interim goodwill impairment test. The Company performs its annual goodwill impairment test in the fourth quarter of each fiscal year. The goodwill adjustment for the Micronetics acquisition is the result of changes in fair value estimates derived from additional information gained during the measurement period which ended August 7, 2013.

The Company determines its reporting units in accordance with FASB ASC 350, by assessing whether discrete financial information is available and if management regularly reviews the operating results of that component. Following this assessment, the Company determined that its reporting units are the same as its operating segments, MCE, MDS and MIS.

F. Restructuring Plan

The following table presents the detail of activity for the Company’s restructuring plans:

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	Severance & Related	Facilities & Other	Total
Restructuring liability at June 30, 2013	$434	$286	$720
Cash paid	(305)	(218)	(523)
Reversals(*)	(15)	—	(15)
Restructuring liability at September 30, 2013	$114	$68	$182

(*) Reversals result from the finalization of severance agreements and unused outplacement services.

All of the restructuring charges are within the MCE reportable segment and classified as operating expenses in the consolidated statements of operations and comprehensive loss and any remaining obligations are expected to be paid within the next twelve months. The remaining restructuring liability is classified as accrued expenses in the consolidated balance sheets.

G. Income Taxes

The Company recorded a tax benefit of $1,279 and $3,651 on a loss before taxes of $3,535 and $10,851 for the three months ended September 30, 2013 and 2012, respectively. Income tax benefit for the three months ended September 30, 2013 differed from the federal statutory rate primarily due to the impact of federal research and development tax credits, Section 199 manufacturing deduction and stock compensation. Income tax benefit for the three months ended September 30, 2012 differed from the federal statutory rate primarily due to the impact of a Section 199 manufacturing deduction, state taxes and stock compensation.

No material changes in the Company’s unrecognized tax positions occurred during the three months ended September 30, 2013. The Company estimates that the unrecognized tax benefits could decrease by up to $684 within the next 12 months as a result of resolutions of tax positions and the expiration of applicable statutes of limitations.

H. Commitments and Contingencies

LEGAL CLAIMS

The Company is subject to litigation, claims, investigations and audits arising from time to time in the ordinary course of our business. Although legal proceedings are inherently unpredictable, the Company believes that it has valid defenses with respect to any matters currently pending against the Company and intends to defend itself vigorously. The outcome of these matters, individually and in the aggregate, is not expected to have a material impact on the Company’s cash flows, results of operations, or financial position.

INDEMNIFICATION OBLIGATIONS

The Company’s standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company’s products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments the Company could be required to make under these indemnification provisions is, in some instances, unlimited.

PURCHASE COMMITMENTS

As of September 30, 2013, the Company has entered into non-cancelable purchase commitments for certain inventory components and services used in its normal operations. The purchase commitments covered by these agreements are for less than one year and aggregate to $17,373.

I. Debt

Senior Unsecured Credit Facility

On October 12, 2012, the Company entered into a credit agreement (the “Credit Agreement”) with a syndicate of commercial banks, with KeyBank National Association acting as the administrative agent. The Credit Agreement provides for a $200,000 senior unsecured revolving line of credit (the “Revolver”). The Company can borrow up to $200,000 based on consolidated EBITDA for the four quarters ended September 30, 2013 and subject to compliance with the financial covenants discussed below. The Revolver is available for working capital, acquisitions, and general corporate purposes of the Company and its subsidiaries. The Revolver is available for borrowing during a five year period, with interest payable periodically during such period as provided in the Credit Agreement and principal due at

the maturity of the Revolver.

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The Credit Agreement has an accordion feature permitting the Company to request from the lenders an increase in the aggregate amount of the credit facility in the form of an incremental revolver or term loan in an amount not to exceed $50,000. Any such increase would require only the consent of the lenders increasing their respective commitments under the credit facility.

The interest rates applicable to borrowings under the Credit Agreement involve various rate options that are available to the Company. The rates are calculated using a combination of conventional base rate measures plus a margin over those rates. The base rates consist of LIBOR rates or prime rates. The actual rates will depend on the level of these underlying rates plus a margin based on the Company’s leverage at the time of borrowing.

Borrowings under the Credit Agreement are senior unsecured loans. Each of the Company’s domestic subsidiaries is a guarantor under the Credit Agreement.

The Credit Agreement provides for conventional affirmative and negative covenants, including a maximum leverage ratio of 3.50x and a minimum interest coverage ratio of 3.0x. Each of the two ratios referred to above is calculated based on consolidated EBITDA, as defined in the Credit Agreement, for each consecutive four fiscal quarter period, after giving pro forma effect for any acquisitions or dispositions. Acquisitions are permitted under the Credit Agreement without any dollar limitation so long as, among other requirements, no default or event of default exists or would result therefore; as of September 30, 2013, the Company is in compliance with a maximum leverage ratio of 3.25x and a minimum interest coverage ratio of 3.0x, in each case, after giving pro forma effect to the applicable acquisition. In addition, the Credit Agreement contains certain customary representations and warranties, and events of default.

As of September 30, 2013, there was $43,110 of borrowing capacity available. There were no borrowings outstanding on the Credit Agreement; however, there were outstanding letters of credit of $4,299. The Company was in compliance with all covenants and conditions under the Credit Agreement.

J. Stock-Based Compensation

STOCK OPTION PLANS

The number of shares authorized for issuance under the Company’s 2005 Stock Incentive Plan, as amended and restated (the “2005 Plan”), is 7,764 shares at September 30, 2013. The 2005 Plan will be increased by any future cancellations, forfeitures or terminations (other than by exercise) under the Company’s 1997 Stock Option Plan (the “1997 Plan”). The 2005 Plan provides for the grant of non-qualified and incentive stock options, restricted stock, stock appreciation rights and deferred stock awards to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the fair value of the Company’s common stock at the date of grant and the options generally have a term of seven years. There were 966 shares available for future grant under the 2005 Plan at September 30, 2013.

The number of shares authorized for issuance under the 1997 Plan was 8,650 shares, of which 100 shares could be issued pursuant to restricted stock grants. The 1997 Plan provided for the grant of non-qualified and incentive stock options and restricted stock to employees and non-employees. All stock options were granted with an exercise price of not less than 100% of the fair value of the Company’s common stock at the date of grant. The options typically vested over periods up to four years and have a maximum term of 10 years. Following shareholder approval of the 2005 Plan on November 14, 2005, the Company’s Board of Directors determined that no further grants of stock options or other awards would be made under the 1997 Plan, and the 1997 Plan subsequently expired in June 2007. The foregoing does not affect any outstanding awards under the 1997 Plan, which remains in full force and effect in accordance with their terms.

EMPLOYEE STOCK PURCHASE PLAN

The number of shares authorized for issuance under the Company’s 1997 Employee Stock Purchase Plan, as amended and restated (“ESPP”), is 1,400 shares. Under the ESPP, rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at either the beginning or the end of each six-month offering period. The ESPP permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee’s compensation as defined in the ESPP. There were no shares issued under the ESPP during the three months ended September 30, 2013 and 2012. Shares available for future purchase under the ESPP totaled 256 at September 30, 2013.

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STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company’s stock option plans since June 30, 2013:

	Options Outstanding		
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)
Outstanding at June 30, 2013	2,070	$ 13.44	2.60
Granted	—	—	
Exercised	(10)	5.82	
Cancelled	(191)	20.77	
Outstanding at September 30, 2013	1,869	$ 12.73	2.58

The following table summarizes the status of the Company’s non-vested restricted stock awards since June 30, 2013:

	Non-vested Restricted Stock Awards	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at June 30, 2013	2,007	$ 10.82
Granted	838	9.22
Vested	(536)	10.54
Forfeited	—	—
Outstanding at September 30, 2013	2,309	$ 10.31

STOCK-BASED COMPENSATION EXPENSE

The Company recognized the full expense of its share-based payment plans in the consolidated statements of operations for the three months ended September 30, 2013 and 2012 in accordance with FASB ASC 718 and did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. Under the fair value recognition provisions of FASB ASC 718, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period. The following table presents share-based compensation expenses included in the Company’s consolidated statements of operations:

	Three Months Ended September 30,	
	2013	2012
Cost of revenues	$236	$131
Selling, general and administrative	2,332	1,903
Research and development	467	311
Share-based compensation expense before tax	3,035	2,345
Income taxes	(1,090)	(853)
Net compensation expense	$1,945	$1,492

K. Operating Segment, Geographic Information and Significant Customers

Operating segments are defined as components of an enterprise evaluated regularly by the Company’s chief operating decision maker (“CODM”) in deciding how to allocate resources and assess performance. The Company is presently organized in three operating segments. The following operating segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company’s management structure:

- Mercury Commercial Electronics (“MCE”): this operating segment delivers innovative, commercially developed, open sensor and Big Data processing systems, software and services for critical commercial, defense and intelligence applications. MCE delivers solutions that are secure and based upon open architectures and widely adopted industry standards. MCE's products include, but are not limited to, embedded processing

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Explanation of Responses:

boards, digital receiver boards, chassis-based systems using air, conduction, and proprietary cooling technologies and RF and microwave technologies, including tuners, converters, transceivers, switch filters, and power amplifiers and limiters. MCE delivers rapid time-to-value and world-class service and support to our commercial and defense prime contractor customers.

- Mercury Defense Systems (“MDS”): this operating segment delivers innovative, open sensor processing solutions to key defense prime contractors leveraging commercially available technologies and solutions from our MCE business. MDS leverages this technology to develop integrated sensor processing subsystems, often including classified application-specific software and intellectual property (“IP”) for the C4ISR (command, control, communications, computers, intelligence, surveillance and reconnaissance), EW, and ECM markets. MDS's products include, but are not limited to, Digital Radio Frequency Memory ("DRFM") jammers and radar environment simulators.
- Mercury Intelligence Systems (“MIS”): this operating segment delivers technologically advanced hardware and software data processing solutions and predictive analytics capabilities to address the intelligence community and Department of Defense mission needs.

The Company’s operating segments were evaluated in accordance with FASB ASC 280- “Segment Reporting” in order to determine which operating segments qualified as reportable segments. The Company considered qualitative factors, including the economic characteristics of each operating segment to determine if any of its three operating segments qualified for aggregation into fewer reportable segments.

The Company’s evaluation of the economic characteristics of its operating segments included comparisons of revenues and applicable growth rates, gross margins, operating margins, future projections, and additional non-GAAP financial measurements which indicate that MDS and MIS have similar economic characteristics. The Company also evaluated the following qualitative factors in accordance with FASB ASC 280 paragraph 10-50-11: the nature of products and services, the corresponding production processes, the types of customers, distribution methods for products and services and the nature of the corresponding regulatory environment associated with its operating segments. The Company determined each of these factors are similar for both the MDS and MIS operating segments and supports the aggregation of MDS and MIS into one reportable segment, Mercury Defense and Intelligence Systems (“MDIS”).

The Company analyzed quantitative thresholds of each reportable segment including but not limited to reported revenues, including sales to external customers and intersegment sales or transfers, reported profits or losses, and total assets of each operating segment. The Company determined that both MCE and MDIS met the quantitative thresholds for reporting.

During fiscal 2013, the Company redefined its operating and reportable segments. The Company reclassified the segment data for the prior periods presented below to conform to the current year’s presentation.

The accounting policies of the reportable segments are the same as those described in “Note B: Summary of Significant Accounting Policies.” The profitability measure employed by the Company and its CODM as the basis for allocating resources to segments and assessing segment performance is adjusted EBITDA. The Company believes the adjusted EBITDA financial measure assists in providing an enhanced understanding of its underlying operational measures to manage its business, to evaluate its performance compared to prior periods and the marketplace, and to establish operational goals.

Adjusted EBITDA is defined as net income (loss) before interest income and expense, income taxes, depreciation, amortization of acquired intangible assets, restructuring, impairment of long-lived assets, acquisition costs and other related expenses, fair value adjustments from purchase accounting and stock-based compensation costs. Prior year's amounts have been presented to reflect the current profitability measures for comparative purposes. Additionally, asset information by reportable segment is not reported because the Company and its CODM utilize consolidated asset information when making business decisions. The following is a summary of the performance of the Company's operations by reportable segment:

	MCE	MDIS	Eliminations	Total
THREE MONTHS ENDED SEPTEMBER 30, 2013				
Net revenues to unaffiliated customers	$43,488	$11,130	$(678)	$53,940
Intersegment revenues	1,114	—	(1,114)	—
Net revenues	$44,602	$11,130	$(1,792)	$53,940
Adjusted EBITDA	$2,343	$1,358	$(82)	$3,619
THREE MONTHS ENDED SEPTEMBER 30, 2012				
Net revenues to unaffiliated customers	$31,897	$15,827	$1,704	$49,428
Intersegment revenues	4,908	8	(4,916)	—
Net revenues	$36,805	$15,835	$(3,212)	$49,428
Adjusted EBITDA	$(2,209)	$3,223	$624	$1,638

The following table reconciles the Company's net loss, the most directly comparable GAAP financial measure, to its adjusted EBITDA:

	Three Months Ended September 30,	
	2013	2012
Net loss	$(2,256)	$(7,200)
Interest expense, net	14	6
Tax benefit	(1,279)	(3,651)
Depreciation	2,012	2,211
Amortization of intangible assets	2,108	1,788
Restructuring and other charges	(15)	4,984
Acquisition costs and other related expenses	—	230
Fair value adjustments from purchase accounting	—	925
Stock-based compensation expense	3,035	2,345
Adjusted EBITDA	$3,619	$1,638

The geographic distribution of the Company's revenues is summarized as follows:

	US	Europe	Asia Pacific	Eliminations	Total
THREE MONTHS ENDED SEPTEMBER 30, 2013					
Net revenues to unaffiliated customers	$52,670	$508	$762	$—	$53,940
Inter-geographic revenues	819	157	140	(1,116)	—
Net revenues	$53,489	$665	$902	$(1,116)	$53,940
THREE MONTHS ENDED SEPTEMBER 30, 2012					
Net revenues to unaffiliated customers	$47,635	$345	$1,448	$—	$49,428
Inter-geographic revenues	1,177	49	26	(1,252)	—
Net revenues	$48,812	$394	$1,474	$(1,252)	$49,428

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Foreign revenue is based on the country in which the Company’s legal subsidiary is domiciled.

The geographic distribution of the Company’s long-lived assets is summarized as follows:

	U.S.	Europe	Asia Pacific	Eliminations	Total
September 30, 2013	$14,528	$37	$—	$—	$14,565
June 30, 2013	$14,986	$33	$—	$—	$15,019

Identifiable long-lived assets exclude goodwill and intangible assets.

Customers comprising 10% or more of the Company’s revenues for the periods shown below are as follows:

	Three Months Ended September 30,			
	2013		2012	
Northrop Grumman Corporation	15	%	12	%
Raytheon Company	13	%	12	%
Lockheed Martin Corporation	11	%	*	
BAE Systems PLC	10	%	*	
Sierra Nevada Corporation	*		14	%
	49	%	38	%

*Indicates that the amount is less than 10% of the Company’s revenues for the respective period.

While the Company typically has customers from which it derives 10% or more of its revenue, the sales to each of these customers are spread across multiple programs and platforms. For the three months ended September 30, 2013, no single program comprised 10% or more of the Company's revenue. For the three months ended September 30, 2012, the Gorgon Stare program individually comprised 14% of the Company's revenues.

L. Subsequent Events

The Company has evaluated subsequent events from the date of the consolidated balance sheet through the date the consolidated financial statements were issued.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

From time to time, information provided, statements made by our employees or information included in our filings with the Securities and Exchange Commission may contain statements that are not historical facts but that are "forward-looking statements," which involve risks and uncertainties. The words "may," "will," "would," "should," "could," "p "expect," "believe," "anticipate," "continue," "estimate," "project," "intend," "likely," "forecast," "probable," and similar expr intended to identify forward-looking statements regarding events, conditions and financial trends that may affect our future plans of operations, business strategy, results of operations and financial position. These forward-looking statements, which include those related to our strategic plans, business outlook, and future business and financial performance, involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Such risks and uncertainties include, but are not limited to, continued funding of defense programs and the timing and amounts of such funding, including the potential for a continuing resolution for the defense budget and the potential for continued defense budget sequestration, general economic and business conditions, including unforeseen economic weakness in our markets, effects of continued geo-political unrest and regional conflicts, competition, changes in technology and methods of marketing, delays in completing various engineering and manufacturing programs, changes in customer order patterns, changes in product mix, continued success in technological advances and delivering technological innovations, changes in the U.S. Government's interpretation of federal procurement rules and regulations, market acceptance of our products, shortages in components, production delays due to performance quality issues with outsourced components, inability to fully realize the expected benefits from acquisitions and restructurings or delays in realizing such benefits, challenges in integrating acquired businesses and achieving anticipated synergies, changes to export regulations, increases in tax rates, changes to generally accepted accounting principles, difficulties in retaining key employees and customers, unanticipated costs under fixed-price service and system integration engagements, and various other factors beyond our control. These risks and uncertainties also include such additional risk factors as set forth under Part I-Item 1A (Risk Factors) in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2013. We caution readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

OVERVIEW

Mercury Systems, Inc. (the "Company" or "Mercury") provides commercially developed, open sensor and Big Data processing systems, software and services for critical commercial, defense and intelligence applications. We deliver innovative solutions, rapid time-to-value and world-class service and support to our defense prime contractor customers. Our products and solutions have been deployed in more than 300 programs with over 25 different defense prime contractors. Key programs include Aegis, Patriot, Surface Electronic Warfare Improvement Program ("SEWIP"), Predator and Reaper. We also deliver services and solutions in support of the intelligence community.

Mercury operates across a broad spectrum of defense and intelligence programs and we deliver our solutions and services via three business units: (i) Mercury Commercial Electronics ("MCE"); (ii) Mercury Defense Systems ("MDS") and; (iii) Mercury Intelligence Systems ("MIS").

As of September 30, 2013, we had 752 employees. Our revenue, net loss and adjusted EBITDA for the three month period ended September 30, 2013 were $53.9 million, $(2.3) million, and $3.6 million, respectively. See the Non-GAAP Financial Measures section for a reconciliation of our net loss to adjusted EBITDA.

Our operations are organized in the following two reportable segments: (i) Mercury Commercial Electronics ("MCE") and (ii) Mercury Defense and Intelligence Systems ("MDIS"). We combined the MDS and MIS businesses as they both entail similar products and services and have a similar customer base. See below for a description of our two reportable segments:

Mercury Commercial Electronics, or MCE, delivers innovative, commercially developed, open sensor and Big Data processing systems for critical commercial, defense and intelligence applications. We deliver solutions that are secure and based upon open architectures and widely adopted industry standards. MCE's products include, but are not limited

to, embedded processing boards, digital receiver boards, chassis-based systems using air, conduction, and proprietary cooling technologies and RF and microwave technologies, including tuners, converters, transceivers, switch filters, and power amplifiers and limiters. We deliver rapid time-to-value and world-class service and support to prime defense contractors and commercial customers. MCE provides solutions to prime contractor customers on a variety of programs. MCE also provides technology building blocks to Mercury Defense Systems on key classified and unclassified programs. MCE has a legacy of embedded multi-computing and embedded sensor processing expertise. More recently, MCE has added substantial capabilities around radio frequency ("RF") and microwave technologies as well as emerging new manufacturing capabilities to bring design, production and test capabilities of our RF and microwave solutions to market on a more scalable basis.
For the three months ended September 30, 2013, MCE accounted for 79% of our total net revenues.

Mercury Defense and Intelligence Systems, or MDIS, leverages the technology building blocks developed within MCE for key solutions required by our prime contractor customers. This segment represents an aggregation of Mercury Defense Systems ("MDS") and Mercury Intelligence Systems ("MIS"). Technology building blocks from MCE are deployed as part of solutions that fall into the areas of electronic warfare ("EW"), electronic counter measures ("ECM"), signals intelligence ("SIGINT"), electro optical/infrared, and radar test and simulation. Most of this work is done with Defense Contract Audit Agency (“DCAA”) oversight on behalf of one or more of our prime contractor customers and U.S. Department of Defense agencies. MDIS's products include, but are not limited to, Digital Radio Frequency Memory ("DRFM") jammers and radar environment simulators. MDIS also provides analyst and systems engineering support, also under DCAA oversight, to the intelligence community. This professional services work falls into the critical areas of Big Data processing, predictive analytics and multi-intelligence analysis. For the three months ended September 30, 2013, MDIS accounted for 21% of our total net revenues.

Since we are an OEM supplier to our commercial markets and conduct much of our business with our defense customers via commercial items, requests by customers are a primary driver of revenue fluctuations from quarter to quarter. Customers specify delivery date requirements that coincide with their need for our products. Because these customers may use our products in connection with a variety of defense programs or other projects of different sizes and durations, a customer’s orders for one quarter generally do not indicate a trend for future orders by that customer. Additionally, order patterns do not necessarily correlate amongst customers and, therefore, we generally cannot identify sequential quarterly trends, even within our business units.

RESULTS OF OPERATIONS:

Three months ended September 30, 2013 compared to the three months ended September 30, 2012

The following tables set forth, for the three months periods indicated, financial data from the consolidated statements of operations:

(In thousands)	September 30, 2013	As a % of Total Net Revenue	September 30, 2012	As a % of Total Net Revenue
Net revenues	$53,940	100.0 %	$49,428	100.0 %
Cost of revenues	31,355	58.1	29,038	58.7
Gross margin	22,585	41.9	20,390	41.3
Operating expenses:				
Selling, general and administrative	15,101	28.0	14,533	29.4
Research and development	9,344	17.3	10,039	20.3
Amortization of intangible assets	2,108	3.9	1,788	3.6
Restructuring and other charges	(15)	—	4,984	10.1
Acquisition costs and other related expenses	—	—	230	0.5
Total operating expenses	26,538	49.2	31,574	63.9
Loss from operations	(3,953)	(7.3)	(11,184)	(22.6)
Other income, net	418	0.8	333	0.6
Loss before income taxes	(3,535)	(6.5)	(10,851)	(22.0)
Tax benefit	(1,279)	(2.4)	(3,651)	(7.4)
Net loss	$(2,256)	(4.1)%	$(7,200)	(14.6)%

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REVENUES

(In thousands)	September 30, 2013	September 30, 2012	$ Change	% Change
MCE	$43,488	$31,897	$11,591	36 %
MDIS	11,130	15,827	(4,697)	(30)%
Eliminations	(678)	1,704	(2,382)	(140)%
Total revenues	$53,940	$49,428	$4,512	9 %

Total revenues increased $4.5 million, or 9%, to $53.9 million during the three months ended September 30, 2013 as compared to the comparable period in fiscal 2013. This increase was driven by higher commercial sales of $2.6 million, coupled with a $1.9 million increase in defense sales. The increase in total revenues is primarily attributed to increases in the SEWIP and B-1 Bomber programs, as well as increased revenues from international customers, including foreign military sales through our prime customers and direct sales to non-U.S. based customers. International sales increased from $10.2 million in the three months ended September 30, 2012 to $15.4 million for the three months ended September 30, 2013. Key programs driving the increase in international revenues were Patriot, F-16, F-15 and higher shipments to a telecommunications customer for product that was designated as end of life.

Net MCE revenues increased $11.6 million, or 36%, during the three months ended September 30, 2013 as compared to the same period in the prior fiscal year. This increase was primarily driven by higher defense sales of $8.9 million related to increases from the Patriot, SEWIP, F-16, F-15 and B-1 Bomber programs, partially offset by lower Joint Strike Fighter revenues, and a $2.6 million increase in commercial sales as the result of higher shipments to a telecommunications customer for product that was designated as end of life.

Net MDIS revenues decreased $4.7 million, or 30%, during the three months ended September 30, 2013 as compared to the same period in the previous fiscal year. This decrease was primarily driven by lower revenues from the Gorgon Stare program, as well as lower DRFM jammer and MIS revenues due to customer funding delays.

Eliminations revenue is attributable to development programs where the revenue is recognized in each segment under contract accounting, and reflects the reconciliation to our consolidated results.

GROSS MARGIN

Gross margin was 41.9% for the three months ended September 30, 2013, an increase of 60 basis points from the 41.3% gross margin achieved during the same period in fiscal 2013. The higher gross margin between years was due to a more favorable product mix and lower inventory provision. In addition, for the three months ended September 30, 2012 there was a $0.8 million non-recurring charge for a fair value adjustment from purchase accounting resulting from the Micronetics acquisition.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased $0.6 million, or 4%, to $15.1 million during the three months ended September 30, 2013, compared to $14.5 million during the comparable period in fiscal 2013. The increase was primarily due to an increase in employee stock compensation expense. Selling, general and administrative expenses decreased as a percentage of revenues to 28.0% during the three months ended September 30, 2013 from 29.4% during the same period in fiscal 2013 due to higher revenues in the first quarter of fiscal 2014 as compared to the comparable period in fiscal 2013.

RESEARCH AND DEVELOPMENT

Research and development expenses decreased $0.7 million, or 7%, to $9.3 million during the three months ended September 30, 2013, compared to $10.0 million during the comparable period in fiscal 2013. The decrease was primarily due to savings related to restructuring actions initiated in fiscal 2013 that were partially offset by lower resource allocations to customer funded projects.

AMORTIZATION OF INTANGIBLE ASSETS

Amortization of acquired intangible assets increased $0.3 million, to $2.1 million for the three months ended September 30, 2013 as compared to $1.8 million during the comparable period in fiscal 2013, primarily due to amortization of intangible assets from the Micronetics acquisition which was completed midway through the first

quarter of fiscal 2013.

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RESTRUCTURING EXPENSE

We implemented restructuring plans in the first and fourth quarters of fiscal 2013. These plans consisted of involuntary separation costs related to a reduction in force and facility charges for our Hudson, NH, Huntsville, AL, and Ewing, NJ sites. The plans were implemented to cope with reduced defense revenues and the near term uncertainties in the defense industry driven by the potential for sequestration. The $5.0 million of restructuring expense recorded during the three months ended September 30, 2012 related to the elimination of 142 positions largely from our engineering, administrative and manufacturing functions.

OTHER INCOME, NET

Other income, net increased to $0.4 million during the three months ended September 30, 2013, as compared to $0.3 million for the same period in fiscal 2013. Other income, net consists of $0.3 million in amortization of the gain on the sale leaseback of our corporate headquarters located in Chelmsford, Massachusetts and foreign currency exchange gains and losses. Interest income and interest expense were de minimis.

INCOME TAXES

We recorded an income tax benefit of $1.3 million during the three months ended September 30, 2013 as compared to a $3.7 million income tax benefit for the comparable period in the prior fiscal year. Our income tax benefit for the three months ended September 30, 2013 differed from the federal statutory tax rate of 35% primarily due to the impact of federal research and development tax credits, Section 199 manufacturing deduction and stock compensation. Our effective tax rate during the comparable period in fiscal 2013 also differed from the federal statutory rate primarily due to the impact of the Section 199 manufacturing deduction, state taxes and stock compensation.

As of September 30, 2013, we had approximately $3.5 million in net deferred tax assets. Each quarter, we determine the probability of the realization of deferred tax assets, using significant judgments and estimates with respect to, among other things, historical operating results, expectations of future earnings and tax planning strategies. If we determine in the future that there is not sufficient positive evidence to support the valuation of these assets we may be required to further adjust the valuation allowance to reduce our deferred tax assets.

SEGMENT OPERATING RESULTS

We use adjusted EBITDA as the profitability measure for our segment reporting. Adjusted EBITDA for MCE increased $4.5 million during the three months ended September 30, 2013 to $2.3 million as compared to $(2.2) million for the comparable period in fiscal 2013. The increase in adjusted EBITDA is primarily driven by higher revenues of $11.6 million primarily from the Patriot, SEWIP, and B-1 Bomber programs, coupled with higher gross margins.

Adjusted EBITDA for MDIS decreased $1.8 million during the three months ended September 30, 2013 to $1.4 million as compared to $3.2 million for the comparable period in fiscal 2013. The decrease in adjusted EBITDA was primarily due to lower revenues from the Gorgon Stare and DRFM jammer programs and corresponding gross margin due to customer funding delays.

See Note K to our consolidated financial statements included in this report for more information regarding our operating segments.

LIQUIDITY AND CAPITAL RESOURCES

Our primary source of liquidity comes from existing cash and cash generated from operations. Our near-term fixed commitments for cash expenditures consist primarily of payments under operating leases and inventory purchase commitments with our contract manufacturers. We do not currently have any material commitments for capital expenditures.

Based on our current plans and business conditions, we believe that existing cash, cash equivalents, available line of credit, cash generated from operations, and financing capabilities will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months.

Senior Unsecured Credit Facility

On October 12, 2012, we entered into a credit agreement (the “Credit Agreement”) with a syndicate of commercial banks, with KeyBank National Association acting as the administrative agent. The Credit Agreement provides for a $200.0 million senior unsecured revolving line of credit (the “Revolver”). We can borrow up to $200.0 million based on consolidated EBITDA for the four quarters ended September 30, 2013 and subject to compliance with the financial

covenants discussed below. The Revolver is available for working capital, acquisitions, and general corporate purposes of the Company and its subsidiaries. The Revolver is available for borrowing during a five year period, with interest payable periodically during such period as provided in the Credit Agreement and principal due at the maturity of the Revolver.

The Credit Agreement has an accordion feature permitting us to request from the lenders an increase in the aggregate amount of the credit facility in the form of an incremental revolver or term loan in an amount not to exceed $50.0 million. Any such increase would require only the consent of the lenders increasing their respective commitments under the credit facility.

The interest rates applicable to borrowings under the Credit Agreement involve various rate options that are available to us. The rates are calculated using a combination of conventional base rate measures plus a margin over those rates. The base rates consist of LIBOR rates or prime rates. The actual rates will depend on the level of these underlying rates plus a margin based on our leverage at the time of borrowing.

Borrowings under the Credit Agreement are senior unsecured loans. Each of our domestic subsidiaries is a guarantor under the Credit Agreement.

The Credit Agreement provides for conventional affirmative and negative covenants, including a maximum leverage ratio of 3.50x and a minimum interest coverage ratio of 3.0x. Each of the two ratios referred to above is calculated based on consolidated EBITDA, as defined in the Credit Agreement, on a consolidated basis for each consecutive four fiscal quarter period, after giving pro forma effect for any acquisitions or dispositions. Acquisitions are permitted under the Credit Agreement without any dollar limitation so long as, among other requirements, no default or event of default exists or would result therefore; at September 30, 2013, we are in compliance with a maximum leverage ratio of 3.25x and a minimum interest coverage ratio of 3.0x. In addition, the Credit Agreement contains certain customary representations and warranties, and events of default.

As of September 30, 2013, there was $43.1 million of borrowing capacity available. There were no borrowings outstanding on the Credit Agreement; however, there were outstanding letters of credit of $4.3 million. We were in compliance with all covenants and conditions under the Credit Agreement.

Shelf Registration Statement

On August 2, 2011, we filed a shelf registration statement on Form S-3 with the SEC. The shelf registration statement, which has been declared effective by the SEC, registered up to $500 million of debt securities, preferred stock, common stock, warrants and units. We intend to use the proceeds from a financing using the shelf registration statement for general corporate purposes, which may include the following:

- the acquisition of other companies or businesses;
- the repayment and refinancing of debt;
- capital expenditures;
- working capital; and
- other purposes as described in the prospectus supplement.

CASH FLOWS

	As of and for the period ended September 30,	
(In thousands)	2013	2012
Net cash provided by (used in) operating activities	$2,173	$(9,949)
Net cash used in investing activities	$(1,108)	$(68,966)
Net cash used in financing activities	$(61)	$(6,479)
Net increase (decrease) in cash and cash equivalents	$980	$(85,396)
Cash and cash equivalents at end of period	$40,106	$30,568

Our cash and cash equivalents increased by $1.0 million from June 30, 2013 to September 30, 2013, primarily as a result of $2.2 million in cash generated from operating activities, partially offset by $1.1 million in purchases of property and equipment.

Operating Activities

During the three months ended September 30, 2013, we generated $2.2 million in cash from operating activities compared to $9.9 million in cash used for operating activities during the same period in fiscal 2013. The $12.1 million increase in cash generated by operating activities was primarily a result of a smaller comparable net loss of $4.9 million, $4.8 million in lower inventory purchases, and a $3.1 million decrease in cash used for payables and accrued

expenses. These increases in cash generated from operations were partially offset by $2.5 million in higher accounts receivable. Our ability to generate cash from

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operations in future periods will depend in large part on profitability, the rate and timing of collections of accounts receivable, our inventory turns and our ability to manage other areas of working capital.

Investing Activities

During the three months ended September 30, 2013, we used cash of $1.1 million in investing activities compared to $69.0 million used by investing activities during the same period in fiscal 2013. The $67.9 million decrease in cash used in investing activities was driven by $67.7 million of cash spent on the Micronetics acquisition during the three months ended September 30, 2012.

Financing Activities

During the three months ended September 30, 2013, we used $0.1 million for financing activities compared to $6.5 million used for financing activities during the same period in fiscal 2013. The $6.4 million change in cash from financing activities was primarily due to a $6.6 million payment to settle debt acquired as part of the Micronetics acquisition during the three months ended September 30, 2012.

COMMITMENTS AND CONTRACTUAL OBLIGATIONS

The following is a schedule of our commitments and contractual obligations outstanding at September 30, 2013:

(In thousands)	Total	Less Than 1 Year	2-3 Years	4-5 Years	More Than 5 Years
Purchase obligations	$17,373	$17,373	$—	$—	$—
Operating leases	24,652	4,892	8,745	4,641	6,374
Capital lease obligations and other	633	419	209	5	—
	$42,658	$22,684	$8,954	$4,646	$6,374

We have a liability at September 30, 2013 of $2.9 million for uncertain tax positions, not included in the table above, that has been taken or is expected to be taken in various income tax returns. We expect to make a payment of $0.7 million in the next twelve months as a result of resolutions of certain tax positions.

Purchase obligations represent open non-cancelable purchase commitments for certain inventory components and services used in normal operations. The purchase commitments covered by these agreements are for less than one year and aggregated approximately $17.4 million at September 30, 2013.

Our standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with certain intellectual property infringement claims by any third party with respect to our products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments we could be required to make under these indemnification provisions is, in some instances, unlimited.

OFF -BALANCE SHEET ARRANGEMENTS

Other than our lease commitments incurred in the normal course of business and certain indemnification provisions, we do not have any off- balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not consolidated in the financial statements. Additionally, we do not have an interest in, or relationships with, any special purpose entities.

NON-GAAP FINANCIAL MEASURES

In our periodic communications, we discuss two important measures that are not calculated according to U.S. generally accepted accounting principles (“GAAP”), adjusted EBITDA and free cash flow.

Adjusted EBITDA, the profitability measure for our segment reporting, is defined as net income (loss) before interest income and expense, income taxes, depreciation, amortization of acquired intangible assets, restructuring, impairment of long-lived assets, acquisition costs and other related expenses, fair value adjustments from purchase accounting and stock-based compensation costs. We use adjusted EBITDA as an important indicator of the operating performance of our business. We use adjusted EBITDA in internal forecasts and models when establishing internal operating budgets, supplementing the financial results and forecasts reported to our board of directors, determining a component of bonus compensation for executive officers

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and other key employees based on operating performance and evaluating short-term and long-term operating trends in our operations. We believe the adjusted EBITDA financial measure assists in providing a more complete understanding of our underlying operational measures to manage our business, to evaluate our performance compared to prior periods and the marketplace, and to establish operational goals. We believe that these non-GAAP financial adjustments are useful to investors because they allow investors to evaluate the effectiveness of the methodology and information used by management in our financial and operational decision-making.

Adjusted EBITDA is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. This non-GAAP financial measure may not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenses similar to the adjusted EBITDA financial adjustments described above, and investors should not infer from our presentation of this non-GAAP financial measure that these costs are unusual, infrequent or non-recurring.

The following table reconciles our net loss, the most directly comparable GAAP financial measure, to our adjusted EBITDA:

	Three Months Ended September 30,	
(In thousands)	2013	2012
Net loss	$(2,256)	$(7,200)
Interest expense, net	14	6
Tax benefit	(1,279)	(3,651)
Depreciation	2,012	2,211
Amortization of intangible assets	2,108	1,788
Restructuring and other charges	(15)	4,984
Acquisition costs and other related expenses	—	230
Fair value adjustments from purchase accounting	—	925
Stock-based compensation cost	3,035	2,345
Adjusted EBITDA	$3,619	$1,638

Free cash flow, a non-GAAP measure for reporting cash flow, is defined as cash provided by operating activities less capital expenditures for property and equipment. We believe free cash flow provides investors with an important perspective on cash available for investments and acquisitions after making capital investments required to support ongoing business operations and long-term value creation. We believe that trends in our free cash flow are valuable indicators of our operating performance and liquidity.

Free cash flow is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with GAAP. This non-GAAP financial measure may not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenditures similar to the free cash flow adjustment described above, and investors should not infer from our presentation of this non-GAAP financial measure that these expenditures reflect all of our obligations which require cash.

The following table reconciles cash provided by operating activities, the most directly comparable GAAP financial measure, to free cash flow:

	Three Months Ended September 30,	
(In thousands)	2013	2012
Cash provided by (used in) operating activities	$2,173	$(9,949)
Capital expenditures	(1,108)	(980)
Free cash flow	$1,065	$(10,929)

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, an amendment of the FASB Accounting Standards Codification. The ASU requires an unrecognized tax benefit to be presented as a decrease in a deferred tax asset when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist and

certain criteria are met. The

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ASU is effective prospectively for annual reporting periods beginning after December 15, 2013. This guidance is not expected to have a material impact to our consolidated financial statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes in our exposure to market risk from June 30, 2013 to September 30, 2013.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

We conducted an evaluation under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively), regarding the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2013. We continue to review our disclosure controls and procedures and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our Company's business. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

(b) Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13c-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to litigation, claims, investigations and audits arising from time to time in the ordinary course of our business. Although legal proceedings are inherently unpredictable, we believe that we have valid defenses with respect to those matters currently pending against us and intend to defend our self vigorously. The outcome of these matters, individually and in the aggregate, is not expected to have a material impact on our cash flows, results of operations, or financial position.

ITEM 1A. RISK FACTORS

You should carefully review and consider the information regarding certain factors that could materially affect our business, financial condition or future results set forth under Item 1A (Risk Factors) in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013. There have been no material changes from the factors disclosed in our 2013 Annual Report on Form 10-K filed on August 16, 2013, although we may disclose changes to such factors or disclose additional factors from time to time in our future filings with the Securities and Exchange Commission.

ITEM 6. EXHIBITS

The following Exhibits are filed or furnished, as applicable, herewith:

31.1	Certification of the Company’s Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Company’s Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1+	Certification of the Company’s Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from the Company’s Quarterly Report on the Form 10-Q for the quarter ended September 30, 2013 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Cash Flows; and (iv) notes to the Consolidated Financial Statements

+ Furnished herewith. This certificate shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, nor shall it be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

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MERCURY SYSTEMS, INC.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Chelmsford, Massachusetts, on November 7, 2013.

MERCURY SYSTEMS, INC.

By: /S/ KEVIN M. BISSON
Kevin M. Bisson
Senior Vice President,
Chief Financial Officer, and Treasurer

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Loan impairment (releases)/losses

RBS excluding RCR/Non-Core

150

3,766

53

(193)

1,924

RCR

(1,320)

n/a

(691)

(610)

n/a

Non-Core

n/a

4,646

n/a

n/a

3,207

Customer loan impairment (releases)/charge

Explanation of Responses:

as a % of gross loans and advances

RBS non-statutory (1)

(0.3%)

2.0%

(0.6%)

(0.8%)

4.9%

RBS statutory basis

(0.4%)

2.2%

(0.8%)

(0.9%)

5.5%

RBS excluding RCR/Non-Core (1)

-

1.0%

Explanation of Responses:

0.1%

(0.2%)

2.0%

RCR (1)

(6.0%)

n/a

(12.6%)

(9.5%)

n/a

Non-Core (1)

n/a

12.8%

n/a

n/a

35.3%

For the note to this table refer to the following page.

Explanation of Responses:

Analysis of results

	31 December 2014	30 September 2014	31 December 2013
Loan impairment provisions			
- RBS	**£18.0bn**	£20.0bn	£25.2bn
- RBS excluding RCR/Non-Core	**£7.1bn**	£7.4bn	£11.4bn
- RCR	**£10.9bn**	£12.6bn	n/a
- Non-Core	**n/a**	n/a	£13.8bn
Risk elements in lending			
- RBS	**£28.2bn**	£30.5bn	£39.4bn
- RBS excluding RCR/Non-Core	**£12.8bn**	£13.1bn	£20.4bn
- RCR	**£15.4bn**	£17.4bn	n/a
- Non-Core	**n/a**	n/a	£19.0bn
Provisions as a % of REIL			
- RBS	**64%**	66%	64%
- RBS excluding RCR/Non-Core	**55%**	57%	56%
- RCR	**71%**	72%	n/a
- Non-Core	**n/a**	n/a	73%
REIL as a % of gross customer loans			
- RBS	**6.8%**	7.4%	9.4%
- RBS excluding RCR/Non-Core	**3.3%**	3.4%	5.3%
- RCR	**70.3%**	67.6%	n/a
- Non-Core	**n/a**	n/a	51.8%

Note:

(1) Excludes reverse repurchase agreements and includes disposals groups.

Key points

2014 compared with 2013

Net impairment releases of £1,352 were recorded in 2014 compared with a net impairment charge of £8,120 million which included £4,490 million provisions related to the creation of RCR. Releases were recorded principally in RCR (£1,306 million) and in Ulster Bank (£365 million), which benefited from favourable economic and market conditions, supported by rising Irish property values and

proactive debt management. Excluding these releases, the underlying charge was low at just over £500 million.
On a non-statutory basis net impairment releases of £1,155 million were recorded in 2014 compared with a net impairment charge of £8,432 million in the prior year.

Q4 2014 compared with Q3 2014

Net impairment releases totalled £670 million, down £177 million, again principally in RCR and Ulster Bank. Underlying bad debt flows remained low. On a non-statutory basis net impairment releases totalled £623 million, down £178 million.

Q4 2014 compared with Q4 2013

Net impairment releases totalled £670 million compared with a net impairment charged of £5,030 million in Q4 2013, which included £4,290 million related to the creation of RCR and £82 million in relation to Citizens (Q4 2013 - £82 million).
On a non-statutory basis net impairment releases totalled £623 million compared with a net impairment charge of £5,112 million in Q4 2013.

Analysis of results

Capital and leverage ratios							
	End-point CRR basis (1)				PRA transitional basis (1)		
	31 December 2014	30 September 2014	31 December 2013 (2)		**31 December 2014**	30 September 2014	31 December 2013 (2)
Risk asset ratios	**%**	%	%		**%**	%	%
CET1	**11.2**	10.8	8.6		**11.1**	10.8	8.6
Tier 1	**11.2**	10.8	8.6		**13.2**	12.7	10.3
Total	**13.7**	13.1	10.6		**17.1**	16.3	13.6
Capital	**£bn**	£bn	£bn		**£bn**	£bn	£bn
Tangible equity	**44.4**	44.3	41.1		**44.4**	44.1	41.1
Expected loss less impairment provisions	**(1.5)**	(1.6)	(1.7)		**(1.5)**	(1.6)	(1.7)
Prudential valuation adjustment (PVA)	**(0.4)**	(0.4)	(0.8)		**(0.4)**	(0.4)	(0.8)
Deferred tax assets	**(1.2)**	(1.6)	(2.3)		**(1.2)**	(1.6)	(2.3)
Own credit adjustments	**0.5**	0.6	0.6		**0.5**	0.6	0.6
Pension fund assets	**(0.2)**	(0.2)	(0.2)		**(0.2)**	(0.2)	(0.2)
Other deductions	**(1.7)**	0.1	0.1		**(2.0)**	0.2	0.1
Total deductions	**(4.5)**	(3.1)	(4.3)		**(4.8)**	(3.0)	(4.3)
CET1 capital	**39.9**	41.2	36.8		**39.6**	41.1	36.8
AT1 capital	**-**	-	-		**7.5**	7.5	7.5
Tier 1 capital	**39.9**	41.2	36.8		**47.1**	48.6	44.3
Tier 2 capital	**8.7**	8.8	8.7		**13.6**	13.6	13.9
Total regulatory capital	**48.6**	50.0	45.5		**60.7**	62.2	58.2
Risk-weighted assets	**£bn**	£bn	£bn		**£bn**	£bn	£bn
Credit risk							
- non-counterparty	**264.7**	277.0	317.9		**264.7**	277.0	317.9
- counterparty	**30.4**	38.2	39.1		**30.4**	38.2	39.1
Market risk	**24.0**	29.7	30.3		**24.0**	29.7	30.3
Operational risk	**36.8**	36.8	41.8		**36.8**	36.8	41.8

Total RWAs	**355.9**	381.7	429.1		**355.9**	381.7	429.1
Leverage (3)	**£bn**	£bn	£bn				
Derivatives	**354.0**	314.0	288.0				
Loans and advances	**419.6**	422.1	418.4				
Reverse repos	**64.7**	75.5	76.4				
Other assets	**212.5**	234.5	245.1				
Total assets	**1,050.8**	1,046.1	1,027.9				
Derivatives							
- netting	**(330.9)**	(254.5)	(227.3)				
- potential future exposures	**98.8**	106.2	128.0				
Securities financing transactions gross up	**25.0**	72.9	59.8				
Weighted undrawn commitments	**96.4**	98.7	100.2				
Regulatory deductions and other							
adjustments	**(0.6)**	(1.4)	(6.6)				
Leverage exposure	**939.5**	1,068.0	1,082.0				
Leverage ratio %	**4.2**	3.9	3.4				

Notes:

(1) Capital Requirements Regulation (CRR) as implemented by the Prudential Regulation Authority in the UK, with effect from 1 January 2014. All regulatory adjustments and deductions to CET1 have been applied in full for the end-point CRR basis with the exception of unrealised gains on AFS securities which has been included from 2015 for the PRA transitional basis.
(2) Estimated.
(3) Based on end-point CRR Tier 1 capital and revised 2014 Basel III leverage ratio framework.

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Analysis of results

Key points

31 December 2014 compared with 30 September 2014

The end-point CRR CET1 ratio improved to 11.2% from 10.8%, driven by continuing risk and balance sheet reduction in CIB and the success of RCR's capital release strategy.

RWAs decreased by £25.8 billion in the quarter to £355.9 billion. The reductions were achieved principally in CIB (down £16.1 billion), RCR (down £8.6 billion) and UK PBB (down £1.9 billion). These were partially offset by a £4.0 billion increase in CFG which was partly due to the strengthening of the US dollar.

31 December 2014 compared with 31 December 2013

The end-point CRR CET1 ratio improved to 11.2% from 8.6%, driven by continuing reduction in RWAs coupled with retained earnings after adjusting for CFG loss provision attributed to intangible assets and a deferred tax write down.

RWAs decreased by £73.2 billion in the year to £355.9 billion. The decrease was principally in CIB (down £40.0 billion), RCR (down £24.7 billion), UK PBB (down £6.9 billion) and Ulster Bank (down £4.4 billion) and included risk and business reductions and improvements in credit metrics. These were partially offset by an increase in CFG (up £7.8 billion) which was partly due to the strengthening of the US dollar.

The leverage ratio improved by 80 basis points to 4.2% reflecting both increased CET1 capital and reduced leverage exposure driven by lower funded assets and higher derivatives netting.

Full implementation of the 2014 Basel III leverage ratio framework, particularly on securities financing transactions, also contributed to the leverage exposure reduction.

Refer to Appendix 1 for further details on capital and leverage.

Current period segment performance

The tables on pages 30 and 31 summarise the results and key metrics for each operating segment and franchise for the year and quarter ended 31 December 2014. Comparative period data are detailed in Appendix 3. The following tables reconcile the non-statutory basis results (a non-GAAP financial measure) to the statutory basis.

	Year ended 31 December 2014										
	PBB			CPB			CIB				Non
		Ulster		Commercial	Private			Central			statutory
	UK PBB	Bank	Total	Banking	Banking	Total		items (1)	CFG	RCR	Tota
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£n
Income statement											
Net interest income	4,683	636	5,319	2,041	691	2,732	817	440	2,013	(47)	11,274
Non-interest income	1,354	194	1,548	1,169	391	1,560	3,132	(477)	1,068	92	6,923
Total income	6,037	830	6,867	3,210	1,082	4,292	3,949	(37)	3,081	45	18,197
Direct expenses											
- staff costs	(892)	(247)	(1,139)	(508)	(317)	(825)	(729)	(2,516)	(1,030)	(167)	(6,406
- other costs **	(380)	(74)	(454)	(249)	(72)	(321)	(400)	(3,742)	(990)	(85)	(5,992
Indirect expenses	(2,027)	(265)	(2,292)	(882)	(439)	(1,321)	(2,432)	6,149	-	(104)	-
Restructuring costs											
- direct	(10)	8	(2)	(40)	(8)	(48)	(93)	(1,011)	(103)	-	(1,257
- indirect	(92)	(30)	(122)	(53)	(10)	(63)	(202)	394	-	(7)	-
Litigation and conduct costs	(918)	19	(899)	(112)	(90)	(202)	(994)	(99)	-	-	(2,194
Operating expenses	(4,319)	(589)	(4,908)	(1,844)	(936)	(2,780)	(4,850)	(825)	(2,123)	(363)	(15,849
Profit/(loss) before impairment losses	1,718	241	1,959	1,366	146	1,512	(901)	(862)	958	(318)	2,348
	(268)	365	97	(76)	4	(72)	9	12	(197)	1,306	1,155

Impairment (losses)/releases											
Operating profit/(loss)	**1,450**	**606**	**2,056**	**1,290**	**150**	**1,440**	**(892)**	**(850)**	**761**	**988**	**3,503**
Additional information											
Return on equity (3)	**19.4%**	**16.1%**	**17.5%**	**12.6%**	**7.8%**	**11.9%**	**(4.2%)**	**nm**	**6.6%**	**nm**	**(8.0%**
Cost:income ratio	**72%**	**71%**	**71%**	**57%**	**87%**	**65%**	**123%**	**nm**	**69%**	**nm**	**87%**
Funded assets (£bn)	**134.3**	**27.5**	**161.8**	**89.4**	**20.4**	**109.8**	**241.1**	**84.7**	**84.5**	**14.9**	**696.8**
Total assets (£bn)	**134.3**	**27.6**	**161.9**	**89.4**	**20.5**	**109.9**	**577.2**	**87.9**	**84.9**	**29.0**	**1,050.8**
Risk-weighted assets (£bn)	**42.8**	**23.8**	**66.6**	**64.0**	**11.5**	**75.5**	**107.1**	**16.3**	**68.4**	**22.0**	**355.9**
Employee numbers (FTEs - thousands)	**24.8**	**4.4**	**29.2**	**6.2**	**3.4**	**9.6**	**3.7**	**48.1**	**17.4**	**0.7**	**108.7**
nm = not meaningful											

*Operating profit/(loss) for the segments is presented before certain reconciling items, namely own credit adjustments, gain on redemption of own debt, write down of goodwill, strategic disposals, and RFS Holdings minority interest and includes the results of Citizens ('non-statutory'). The following adjustments are reallocations within segment operating profit/(loss): restructuring costs and litigation and conduct costs. These excluded or reallocated costs for the period presented reflect the following; net interest income - loss of £3 million on RFS Holdings minority interest; non-interest income - gain of £20 million on redemption of own debt, £18 million loss on RFS Holdings minority interest, loss on own credit adjustment of £146 million and gain on strategic disposal of £191 million; staff costs - reallocation of £409 million from restructuring costs; and other costs – reallocation of £601 million from restructuring costs, reallocation of £247 million from write off of intangible assets, reallocation of £130 million from write down of goodwill, reallocation of £3 million from RFS holdings MI and £2,194 million from litigation and conduct costs.

** Other costs include the following: premises and equipment of £2,081 million, other administrative expenses of £4,568 million and depreciation and amortisation of £930 million and write down of goodwill and intangible assets of £523 million.

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Current period segment performance

	Quarter ended 31 December 2014											
	PBB			CPB			CIB				Non-	
		Ulster		Commercial	Private			Central			statutory	R
	UK PBB	Bank	Total	Banking	Banking	Total		items (1)	CFG	RCR	Total	C
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Income statement												
Net interest income	**1,209**	**150**	**1,359**	**521**	**175**	**696**	**222**	**128**	**533**	**(23)**	**2,915**	
Non-interest income	**323**	**54**	**377**	**310**	**92**	**402**	**469**	**(374)**	**233**	**(162)**	**945**	
Total income	**1,532**	**204**	**1,736**	**831**	**267**	**1,098**	**691**	**(246)**	**766**	**(185)**	**3,860**	
Direct expenses												
- staff costs	**(220)**	**(65)**	**(285)**	**(118)**	**(78)**	**(196)**	**(63)**	**(607)**	**(263)**	**(41)**	**(1,455)**	
- other costs **	**(82)**	**(19)**	**(101)**	**(73)**	**(21)**	**(94)**	**(100)**	**(1,094)**	**(258)**	**(29)**	**(1,676)**	**(1**
Indirect expenses	**(564)**	**(78)**	**(642)**	**(284)**	**(129)**	**(413)**	**(659)**	**1,739**	**-**	**(25)**	**-**	
Restructuring costs												
- direct	**(2)**	**-**	**(2)**	**-**	**(6)**	**(6)**	**(49)**	**(485)**	**(21)**	**-**	**(563)**	
- indirect	**(16)**	**4**	**(12)**	**(13)**	**(2)**	**(15)**	**(39)**	**69**	**-**	**(3)**	**-**	
Litigation and conduct costs	**(650)**	**19**	**(631)**	**(62)**	**(90)**	**(152)**	**(382)**	**1**	**-**	**-**	**(1,164)**	**1**
Operating expenses	**(1,534)**	**(139)**	**(1,673)**	**(550)**	**(326)**	**(876)**	**(1,292)**	**(377)**	**(542)**	**(98)**	**(4,858)**	
Profit/(loss) before impairment losses	**(2)**	**65**	**63**	**281**	**(59)**	**222**	**(601)**	**(623)**	**224**	**(283)**	**(998)**	
Impairment (losses)/releases	**(41)**	**104**	**63**	**(33)**	**-**	**(33)**	**(42)**	**1**	**(47)**	**681**	**623**	
	(43)	**169**	**126**	**248**	**(59)**	**189**	**(643)**	**(622)**	**177**	**398**	**(375)**	

Operating profit/(loss)													
Additional information													
Return on equity (3)	**(2.5%)**	**20.1%**	**4.7%**		**9.6%**	**(12.5%)**	**6.2%**		**(13.6%)**	**nm**	**5.7%**	**nm**	**(49.6%)**
Cost:income ratio	**100%**	**68%**	**96%**		**66%**	**122%**	**80%**		**187%**	**nm**	**71%**	**nm**	**126%**
Funded assets (£bn)	**134.3**	**27.5**	**161.8**		**89.4**	**20.4**	**109.8**		**241.1**	**84.7**	**84.5**	**14.9**	**696.8**
Total assets (£bn)	**134.3**	**27.6**	**161.9**		**89.4**	**20.5**	**109.9**		**577.2**	**87.9**	**84.9**	**29.0**	**1,050.8**
Risk-weighted assets (£bn)	**42.8**	**23.8**	**66.6**		**64.0**	**11.5**	**75.5**		**107.1**	**16.3**	**68.4**	**22.0**	**355.9**
Employee numbers (FTEs - thousands)	**24.8**	**4.4**	**29.2**		**6.2**	**3.4**	**9.6**		**3.7**	**48.1**	**17.4**	**0.7**	**108.7**

For the notes to this table refer to Appendix 3.

*Operating profit/(loss) for the segments is presented before certain reconciling items, namely own credit adjustments, gain on redemption of own debt, write down of goodwill, strategic disposals, and RFS Holdings minority interest and includes the results of Citizens ('non-statutory'). The following adjustments are reallocations within segment operating profit/(loss): restructuring costs and litigation and conduct costs. These excluded or reallocated costs for the period presented reflect the following; non-interest income - £13 million gain on RFS Holdings minority interest and loss on own credit adjustment of £144 million; staff costs - reallocation of £134 million from restructuring costs; and other costs – reallocation of £182 million from restructuring costs, reallocation of £247 million from write off of intangible assets, reallocation of £2 million from RFS holdings MI and £1,164 million from litigation and conduct costs.

** Other costs include the following: premises and equipment of £480 million, other administrative expenses of £1,999 million and depreciation and amortisation of £203 million and write down of goodwill and intangible assets of £311 million.

Explanation of Responses:

UK Personal & Business Banking

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m
Income statement						
Net interest income	**4,683**	4,490		**1,209**	1,198	1,149
Net fees and commissions	**1,287**	1,309		**315**	335	341
Other non-interest income	**67**	14		**8**	10	4
Non-interest income	**1,354**	1,323		**323**	345	345
Total income	**6,037**	5,813		**1,532**	1,543	1,494
Direct expenses						
- staff costs	**(892)**	(928)		**(220)**	(223)	(230)
- other costs	**(380)**	(524)		**(82)**	(78)	(203)
Indirect expenses	**(2,027)**	(1,954)		**(564)**	(481)	(519)
Restructuring costs						
- direct	**(10)**	(118)		**(2)**	(2)	(27)
- indirect	**(92)**	(109)		**(16)**	(63)	(41)
Litigation and conduct costs	**(918)**	(860)		**(650)**	(118)	(450)
Operating expenses	**(4,319)**	(4,493)		**(1,534)**	(965)	(1,470)
Profit before impairment losses	**1,718**	1,320		**(2)**	578	24
Impairment losses	**(268)**	(501)		**(41)**	(79)	(107)
Operating profit/(loss)	**1,450**	819		**(43)**	499	(83)

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m
Analysis of income by product						

Personal advances	**920**	923		**222**	231	247
Personal deposits	**706**	468		**210**	194	116
Mortgages	**2,600**	2,605		**656**	657	665
Cards	**730**	838		**169**	187	206
Business banking	**1,021**	973		**270**	261	247
Other	**60**	6		**5**	13	13
Total income	**6,037**	5,813		**1,532**	1,543	1,494
Analysis of impairments by sector						
Personal advances	**161**	179		**36**	46	61
Mortgages	**(26)**	31		**(23)**	(8)	(13)
Business banking	**53**	177		**3**	20	34
Cards	**80**	114		**25**	21	25
Total impairment losses (1)	**268**	501		**41**	79	107
Loan impairment charge as % of gross						
customer loans and advances (excluding						
reverse repurchase agreements) by sector						
Personal advances	**2.2%**	2.2%		**1.9%**	2.5%	3.0%
Mortgages	**-**	-		**(0.1%)**	-	(0.1%)
Business banking	**0.4%**	1.2%		**0.1%**	0.5%	0.9%
Cards	**1.6%**	2.0%		**2.0%**	1.6%	1.7%
Total	**0.2%**	0.4%		**0.1%**	0.2%	0.3%

Note:

(1) Includes £2 million in Q4 2013 pertaining to the creation of RCR and related strategy.

UK Personal & Business Banking

Key metrics					
	Year ended		Quarter ended		
	31 December 2014	31 December 2013	**31 December 2014**	30 September 2014	31 December 2013
Performance ratios					
Return on equity (1)	**19.4%**	9.8%	**(2.5%)**	26.9%	(4.0%)
Net interest margin	**3.68%**	3.56%	**3.74%**	3.72%	3.62%
Cost:income ratio	**72%**	77%	**100%**	63%	98%

Notes:

(1) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

(2) From Q1 2015 business segment return on equity will be calculated based on operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 13% of the monthly average RWAes). At 31 December 2014 the RWAes on this basis were £46.6 billion and the return on equity 16%.

	31 December 2014	30 September 2014		31 December 2013	
	£bn	£bn	Change	£bn	Change
Capital and balance sheet					
Loans and advances to customers (gross)					
- personal advances	**7.4**	7.3	1%	8.1	(9%)
- mortgages	**103.2**	102.7	-	99.3	4%
- business	**14.3**	14.6	(2%)	14.6	(2%)
- cards	**4.9**	5.1	(4%)	5.8	(16%)
Total loans and advances to customers (gross)	**129.8**	129.7	-	127.8	2%
Loan impairment provisions	**(2.6)**	(2.7)	(4%)	(3.0)	(13%)
Net loans and advances to customers	**127.2**	127.0	-	124.8	2%

Funded assets	**134.3**	134.2	-		132.2	2%
Total assets	**134.3**	134.2	-		132.2	2%
Risk elements in lending	**3.8**	4.1	(7%)		4.7	(19%)
Provision coverage (1)	**69%**	67%	200bp		63%	600bp
Customer deposits						
- personal current accounts	**35.9**	34.9	3%		32.5	10%
- personal savings	**81.0**	79.9	1%		82.3	(2%)
- business/commercial	**31.8**	31.2	2%		30.1	6%
Total customer deposits	**148.7**	146.0	2%		144.9	3%
Assets under management (excluding deposits)	**4.9**	5.0	(2%)		5.8	(16%)
Loan:deposit ratio (excluding repos)	**86%**	87%	(1%)		86%	-
Risk-weighted assets (2)						
- Credit risk (non-counterparty)	**33.4**	35.3	(5%)		41.4	(19%)
- Operational risk	**9.4**	9.4	-		9.8	(4%)
Total risk-weighted assets	**42.8**	44.7	(4%)		51.2	(16%)

Notes:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

(2) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. RWAs on the end-point CRR basis as at 1 January 2014 were £49.7 billion.

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UK Personal & Business Banking

Key points

The strategic goal of UK PBB is to become the number one personal and business bank for customer service, trust and advocacy in the UK. Throughout 2014, the business has made steady progress in making banking fairer and simpler for its customers through a number of fair banking initiatives and technology investments. Progress made in 2014 by UK PBB included:

Helping customers with their needs:

As the UK's biggest lender for SMEs, UK PBB continued to offer support to small business customers. Following storms and floods in February 2014, the business introduced a £250 million interest free loan fund for small business to help them get themselves back on their feet. An additional £1 billion Small Business Fund was launched to support small businesses with fee free, fixed rate loans.

UK PBB has been able to help more customers in 2014. With additional mortgage advisors recruited (up 18% from 630 to 744), gross mortgage lending increased by 37% year on year. The business's commitment to helping its customers get on and move up the property ladder has been a success and it has now helped almost 15,000 customers buy their first or next home with the government-backed Help to Buy schemes since their launch in May 2013.

There are now more ways to bank with UK PBB than ever. With services being extended to the Post Office network, customers now have over 13,000 branches and post offices across the UK where they can carry out their every day banking.

Simpler and fairer products supported by the launch of the 'Goodbye-Hello' campaign:

The business committed to responsible and fair lending by removing 0% teaser deals from its offering and introducing the new Clear Rate and cash-back credit cards in 2014.

Business banking arrangement fees and surprise overdraft fees have been replaced with fixed rates on new business loans and text alerts when customers are overdrawn to keep them on track.

Service charges have been reviewed and made simpler and fairer for customers. The business re-introduced access to the LINK ATM network for all basic account customers, reduced its daily overdraft fees for all customers, placed a 60 day cap on overdraft charges and improved credit card late fee terms.

RBS became the first of the main high street banks to ensure all of its savers get the same or better deals as new customers. Those deals are available regardless of how customers choose to bank (e.g. branch, telephony or digital). With just five personal savings products now on sale the range is the simplest on the high street both for

customers and for front line staff. Teaser savings rates have been removed and the business is committed to helping customers save for the long term rather than luring them in for the short term.

Investments in Technology

UK PBB continued with its commitment to invest in technology to make things better for the customer. As its award winning mobile banking application celebrated 5 years, the business received another gold award for the “Pay your Contacts” service, which was named “Best new service of the year” in July at the ‘Best in Biz’ International awards. UK PBB now has over 6.9 million online and mobile banking users, with the mobile app being used more than 23 million times every week.
Further improvements have been made to the mobile banking application and personal customers are now able to use the new industry-wide Pay-m application that allows customers to receive payments from customers of other participating banks just by providing their mobile number. Customers will no longer have to divulge their sort code and account number to receive payment. Pay-m has already enrolled over 1.8 million customers in the service since its launch at the end of April 2014. WiFi in branches has also been a great success with customers already using the free service over 1 million times since it started in May.

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UK Personal & Business Banking

Key points (continued)

2014 compared with 2013

UK PBB recorded an operating profit of £1,450 million (2013 - £819 million), up £631 million, Operating profit excluding restructuring costs of £102 million (2013 - £227 million) and litigation and conduct costs of £918 million (2013 - £860 million) totalled £2,470 million compared with £1,906 million in the prior year. This reflected higher income, up 4% to £6,037 million and lower expenses after excluding restructuring of £102 million (2013 - £227 million) and litigation of £918 million (2013 - £860 million), down 3% to £3,299 million, together with substantially lower impairments, down £233 million to £268 million.

Net interest income increased by £193 million or 4% with strong improvements in deposit margins and volume growth. This was partly offset by lower asset margins linked to the continued change in the mix of the loan book towards secured lending and lower mortgage margins.

Non-interest income increased by £31 million or 2%, largely reflecting the transfer of the commercial cards business to UK PBB from CPB in August 2014.

Operating expenses decreased by £174 million or 4%, reflecting lower restructuring costs of £102 million (2013 - £227 million) and litigation and conduct costs of £918 million (2013 - £860 million). Operating expenses excluding these items, declined by £107 million or 3% supported by a 7% reduction in headcount and lower Financial Services Compensation Scheme (FSCS) accruals.. Litigation and conduct costs included additional provisions for Payment Protection Insurance redress (£650 million) and other conduct provisions in respect of legacy investment products and packaged account sales.

The net impairment charge was down by 47% to £268 million driven by a further decrease in new default charges together with releases of provisions and recoveries on previously written off debt.

Mortgage balances increased by £3.9 billion or 4%, to £103.2 billion driven by strong performance as advisor capacity increased. Gross new mortgage business increased by 37% to £19.7 billion, representing a market share of 10% with our stock share of 8% continuing to grow.

RWAs to decline of 16% to £42.8 billion with improved credit quality and lower unsecured balances.

Q4 2014 compared with Q3 2014

Operating loss totalled £43 million compared with an operating profit of £499 million, primarily as a result of additional conduct costs that included provisions for PPI redress (£400 million) and other conduct provisions in respect of legacy packaged account sales and investment products (£250

million). Operating profit excluding restructuring costs of £18 million (2013 - £65 million) and litigation and conduct costs of £650 million (2013 - £118 million) decreased by £57 million or 8% to £625 million, reflecting the annual charge for bank levy (£38 million) and write-offs of intangible assets (£41 million). This was partly offset by lower impairments down £38 million to £41 million.

Net interest income increased by £11 million or 1% to £1,209 million supported by improved net interest margin and continued deposit growth.

Non-interest income fell by £22 million or 6% with lower cards transaction net income reflecting increased loyalty scheme costs. Q3 included profit recognised from the sale of NatWest Stockbrokers (£7 million).

The impairment charge declined by £38 million to £41 million primarily driven by increased portfolio provision releases. Underlying defaults also continued to trend lower.

RWAs continued to decrease, down £1.9 billion reflecting improved credit quality together with lower unsecured balances.

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UK Personal & Business Banking

Key points (continued)

Q4 2014 compared with Q4 2013

Operating loss improved by £40 million to £43 million despite higher conduct charges, with net interest income up 5%, costs down and impairments substantially lower.

Net interest income grew by £60 million or 5% attributable to improvements in deposit income driven by margin and volume improvements. This was partly offset by a decline in asset margins from lower mortgage and loan pricing in line with the market and increased roll-off of higher margin loans.

Non-interest income fell by £22 million or 6% to £323 million as a result of a change in the daily overdraft fee tariff in Q4 2014, the re-opening of access to the LINK ATM network for all customers, lower packaged account fees and lower transactional income from cards.

Operating expenses excluding restructuring of £18 million (Q4 2013 - £68 million) and litigation and conduct costs of £650 million (Q4 2013 - £450 million) were down 9% to £866 million, largely reflecting lower provision for FSCS accruals and conduct provisions combined with lower staff costs as customer transactions migrate to lower cost channels.

Net impairment charges declined £66 million to £41 million, reflecting continued positive default trends. Portfolio provision releases also supported a lower charge in Q4 2014.

Ulster Bank

	Year ended		Quarter ended		
	31 December	31 December	**31 December**	30 September	31 December
	2014	2013	**2014**	2014	2013
	£m	£m	**£m**	£m	£m
Income statement					
Net interest income	**636**	619	**150**	163	164
Net fees and commissions	**139**	141	**38**	35	37
Other non-interest income	**55**	99	**16**	16	1
Non-interest income	**194**	240	**54**	51	38
Total income	**830**	859	**204**	214	202
Direct expenses					
- staff costs	**(247)**	(239)	**(65)**	(57)	(51)
- other costs	**(74)**	(63)	**(19)**	(20)	(21)
Indirect expenses	**(265)**	(263)	**(78)**	(61)	(75)
Restructuring costs					
- direct	**8**	(27)	**-**	-	(9)
- indirect	**(30)**	(12)	**4**	(12)	(3)
Litigation and conduct costs	**19**	(90)	**19**	-	(65)
Operating expenses	**(589)**	(694)	**(139)**	(150)	(224)
Profit/(loss) before impairment losses	**241**	165	**65**	64	(22)
Impairment releases/(losses)	**365**	(1,774)	**104**	318	(1,067)
Operating profit/(loss)	**606**	(1,609)	**169**	382	(1,089)

	Year ended		Quarter ended		
	31 December	31 December	**31 December**	30 September	31 December
	2014	2013	**2014**	2014	2013
	£m	£m	**£m**	£m	£m
Analysis of income by business					

Corporate	**268**	315		**69**	65	69
Retail	**401**	408		**100**	111	98
Other	**161**	136		**35**	38	35
Total income	**830**	859		**204**	214	202
Analysis of impairments by sector						
Mortgages	**(172)**	235		**(39)**	(168)	24
Commercial real estate						
- investment	**(16)**	593		**(7)**	(18)	392
- development	**(11)**	153		**4**	(9)	115
Other corporate	**(186)**	771		**(64)**	(130)	534
Other lending	**20**	22		**2**	7	2
Total impairment (releases)/losses (1)	**(365)**	1,774		**(104)**	(318)	1,067
Loan impairment charge as % of gross						
customer loans and advances (excluding						
reverse repurchase agreements) by sector						
Mortgages	**(1.0%)**	1.2%		**(0.9%)**	(3.8%)	0.5%
Commercial real estate						
- investment	**(1.6%)**	17.4%		**(2.8%)**	(7.2%)	46.1%
- development	**(3.7%)**	21.9%		**5.3%**	(9.0%)	65.7%
Other corporate	**(3.8%)**	10.9%		**(5.2%)**	(10.4%)	30.1%
Other lending	**2.0%**	1.8%		**0.8%**	3.1%	0.7%
Total	**(1.5%)**	5.6%		**(1.7%)**	(5.1%)	13.6%

Note:

(1) Includes £892 million in Q4 2013 pertaining to the creation of RCR and related strategy.

Ulster Bank

Key metrics					
	Year ended		Quarter ended		
	31 December 2014	31 December 2013	**31 December 2014**	30 September 2014	31 December 2013
Performance ratios					
Return on equity (1)	**16.1%**	(33.2%)	**20.1%**	42.2%	(97.8%)
Net interest margin	**2.27%**	1.88%	**2.14%**	2.32%	2.04%
Cost:income ratio	**71%**	81%	**68%**	70%	111%

Notes:

(1) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

(2) From Q1 2015 business segment return on equity will be calculated based on operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 13% of the monthly average RWAes). At 31 December 2014 the RWAes on this basis were £22.3 billion and the return on equity 17.2%.

Ulster Bank

	31 December 2014 £bn	30 September 2014 £bn	Change		31 December 2013 £bn	Change
Capital and balance sheet						
Loans and advances to customers (gross)						
Mortgages	**17.5**	17.6	(1%)		19.0	(8%)
Commercial real estate						
- investment	**1.0**	1.0	-		3.4	(71%)
- development	**0.3**	0.4	(25%)		0.7	(57%)
Other corporate	**4.9**	5.0	(2%)		7.1	(31%)
Other lending	**1.0**	0.9	11%		1.2	(17%)
Total loans and advances to customers (gross)	**24.7**	24.9	(1%)		31.4	(21%)
Loan impairment provisions						
- mortgages	**(1.4)**	(1.4)	-		(1.7)	(18%)
- commercial real estate						
- investment	**(0.2)**	(0.2)	-		(1.2)	(83%)
- development	**(0.2)**	(0.2)	-		(0.3)	(33%)
- other corporate	**(0.8)**	(0.9)	(11%)		(2.0)	(60%)
- other lending	**(0.1)**	(0.2)	(50%)		(0.2)	(50%)
Total loan impairment provisions	**(2.7)**	(2.9)	(7%)		(5.4)	(50%)
Net loans and advances to customers (1)	**22.0**	22.0	-		26.0	(15%)
Funded assets	**27.5**	26.3	5%		28.0	(2%)
Total assets	**27.6**	26.5	4%		28.2	(2%)
Risk elements in lending						
- Mortgages	**3.4**	3.3	3%		3.2	6%
- Commercial real estate						
- investment	**0.3**	0.2	50%		2.3	(87%)
- development	**0.2**	0.2	-		0.5	(60%)
- Other corporate	**0.8**	0.9	(11%)		2.3	(65%)
- Other lending	**0.1**	0.2	(50%)		0.2	(50%)

Total risk elements in lending	**4.8**	4.8	-		8.5	(44%)
Provision coverage (2)	**57%**	60%	(300bp)		64%	(700bp)
Customer deposits	**20.6**	19.7	5%		21.7	(5%)
Loan:deposit ratio (excluding repos)	**107%**	112%	(500bp)		120%	(1,300bp)
Risk-weighted assets (3,4)						
- Credit risk						
- non-counterparty	**22.2**	22.2	-		28.2	(21%)
- counterparty	**0.1**	0.1	-		0.3	(67%)
- Market risk	**-**	0.1	(100%)		0.5	(100%)
- Operational risk	**1.5**	1.5	-		1.7	(12%)
Total risk-weighted assets	**23.8**	23.9	-		30.7	(22%)
Spot exchange rate - €/£	**1.285**	1.285			1.201	

Notes:

(1) 31 December 2014 includes £11.4 billion in relation to legacy tracker mortgages.
(2) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.
(3) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. RWAs on the end-point CRR basis as at 1 January 2014 were £28.2 billion.
(4) 31 December 2014 includes £10.7 billion in relation to legacy tracker mortgages.

Ulster Bank

Key points

Following completion of a strategic review, Ulster Bank was confirmed as a core part of RBS reflecting its fit with RBS's retail and commercial strategy; 2014 saw a return to profitability with significant progress made addressing legacy issues and the strengthening of its core business for the future.

The transfer of £4.4 billion of gross assets to RCR on 1 January 2014 and subsequent deleveraging has enabled Ulster Bank to focus on the development of its core business. This has had a material impact on the comparison of 2014 financial performance with 2013.

Ulster Bank recorded an operating profit of £606 million in 2014, the first annual profit since 2008. This represented a major turnaround from 2013 largely due to impairment releases supported by enhanced collections performance and an improvement in key macroeconomic indicators. Net interest margin also improved and operating expenses were reduced.

Considerable progress was made to improve Ulster Bank's service offering and to enhance the customer experience. The bank continued to re-shape its distribution network during 2014 while online and mobile banking services were further developed to support the upward trend in digital transactions, which now represent 57% of total transaction volumes. The bank's 'Web Chat' initiative, launched in 2012, is now handling over 15,000 customer enquiries each month. Ulster Bank in Northern Ireland recently launched its 'Bank on Wheels' service and extended its partnership with the Post Office which provides customers with 484 new points of presence.

There has been a significant increase in new lending activity during 2014 following the launch of the 'Big Yes' mortgage and 'Ahead for Business' campaigns. New mortgage lending increased by over 40% in 2014 while over £1 billion of new lending was made available to business customers, despite a challenging business environment.

The investment made to support customers in financial difficulty has resulted in a sustained reduction since Q1 2013 in the number of mortgage customers in arrears of 90 days or more and an increase in the number of business customers returning to mainstream management.

2014 compared with 2013

Ulster Bank recorded an operating profit of £606 million in 2014 compared with a loss of £1,609 million in 2013. The turnaround was driven by £365 million net impairment releases compared with impairment losses of £1,774 million in 2013. Operating profit excluding restructuring costs of £22 million (2013 - £39 million) and litigation and conduct provision releases of £19 million (2013 - £90 million) was £609 million compared with a loss of £1,480 million.

Profit before impairment losses was £241 million, £76 million higher than in 2013.

Total income decreased by £29 million to £830 million largely as a result of the non-recurrence of significant hedging gains on the mortgage portfolio in 2013. Net interest income increased by £17 million to £636 million, primarily driven by a significant reduction in the cost of deposits and a benefit from the recognition of income on certain previously non-performing assets, partly offset by the adverse impact on the tracker mortgage book of lower European Central Bank refinancing interest rates. Net interest margin increased 39 basis points to 2.27%.

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Ulster Bank

Key points (continued)

2014 compared with 2013 (continued)

The continued focus on costs resulted in a reduction in staff numbers and the bank's property footprint. Litigation and conduct costs decreased by £109 million reflecting the outcome of reviews relating to provisions on PPI and Interest Rate Hedging Products. These benefits were partly offset by higher regulatory charges and levies including a new bank levy introduced in the Republic of Ireland, of £15 million, and the impact of a realignment of costs following the creation of RCR, £44 million.

The transfer of assets to RCR coupled with improved credit quality across key portfolios resulted in a 44% reduction in risk elements in lending. Provision coverage reduced from 64% to 57% during 2014 reflecting the further de-risking of the balance sheet coupled with the impact of an increase in asset values. RWAs decreased by 22% reflecting an improvement in credit metrics and a reduced loan book.

The loan:deposit ratio decreased from 120% to 107% during 2014 mainly due to a 15% reduction in net loan balances to £22 billion reflecting the transfer of assets to RCR and continued customer deleveraging partly offset by growth in new lending. Customer deposits declined by 5% largely driven by exchange rate movements.

Q4 2014 compared with Q3 2014

Operating profit of £169 million in Q4 2014 was £213 million lower than Q3 2014 largely due to a reduction in impairment releases. Operating profit excluding restructuring provisions releases of £4 million (2013 – £12 million) and litigation and conduct provision releases of £19 million (2013 – nil) was £146 million compared with £394 million in Q3 2014.

The profit before impairment losses of £65 million was broadly stable with Q3 2014. Total income decreased by £10 million mainly as a result of the recognition of income on previously non-performing assets in Q3 2014. Operating expenses decreased by £11 million primarily due to the release of provisions relating to litigation, conduct and restructuring, partly offset by the impact of the UK bank levy (£14 million).

The loan:deposit ratio declined to 107% from 112% in Q3 2014 primarily reflecting a 5% increase in customer deposit balances.

Q4 2014 compared with Q4 2013

Operating profit of £169 million in 2014 included net impairment releases of £104 million compared with impairment losses of £1,067 million in Q4 2013, which included additional charges of £911 million arising from the creation of RCR. Operating profit excluding provisions releases of £4 million (2013 – costs of £12 million) and litigation and conduct costs provisions releases of £19 million (2013 – costs of £65 million) was £146 million compared with a loss of £1,012 million in Q4 2013.

Total income was broadly in line with Q4 2013. Operating expenses decreased by £85 million principally due to a reduction in litigation and conduct costs.

Commercial Banking

	Year ended		Quarter ended		
	31 December	31 December	**31 December**	30 September	31 December
	2014	2013	**2014**	2014	2013
	£m	£m	**£m**	£m	£m
Income statement					
Net interest income	**2,041**	1,962	**521**	521	515
Net fees and commissions	**885**	944	**217**	220	235
Other non-interest income	**284**	251	**93**	70	66
Non-interest income	**1,169**	1,195	**310**	290	301
Total income	**3,210**	3,157	**831**	811	816
Direct expenses					
- staff costs	**(508)**	(513)	**(118)**	(124)	(132)
- other costs	**(249)**	(269)	**(73)**	(54)	(68)
Indirect expenses	**(882)**	(891)	**(284)**	(196)	(281)
Restructuring costs					
- direct	**(40)**	(18)	**-**	-	(1)
- indirect	**(53)**	(37)	**(13)**	(18)	(14)
Litigation and conduct costs	**(112)**	(247)	**(62)**	-	(222)
Operating expenses	**(1,844)**	(1,975)	**(550)**	(392)	(718)
Profit before impairment losses	**1,366**	1,182	**281**	419	98
Impairment losses	**(76)**	(652)	**(33)**	(12)	(277)
Operating profit/(loss)	**1,290**	530	**248**	407	(179)

Commercial Banking

	Year ended		Quarter ended		
	31 December	31 December	**31 December**	30 September	31 December
	2014	2013	**2014**	2014	2013
	£m	£m	**£m**	£m	£m
Analysis of income by business					
Commercial lending	**1,830**	1,911	**477**	459	481
Deposits	**353**	208	**105**	95	64
Asset and invoice finance	**740**	671	**186**	188	168
Other	**287**	367	**63**	69	103
Total income	**3,210**	3,157	**831**	811	816
Analysis of impairments by sector					
Commercial real estate	**(2)**	431	**5**	(1)	233
Asset and invoice finance	**11**	31	**7**	2	20
Private sector education, health, social work,					
recreational and community services	**(8)**	125	**-**	2	28
Banks & financial institutions	**-**	10	**-**	(1)	4
Wholesale and retail trade repairs	**20**	9	**4**	2	3
Hotels and restaurants	**7**	28	**6**	2	10
Manufacturing	**10**	1	**1**	2	3
Construction	**9**	(2)	**1**	4	(1)
Other	**29**	19	**9**	-	(23)
Total impairment losses (1)	**76**	652	**33**	12	277
Loan impairment charge as % of gross					
customer loans and advances by sector					
Commercial real estate	**-**	2.1%	**0.1%**	-	4.6%
Asset and invoice finance	**0.1%**	0.3%	**0.2%**	0.1%	0.7%
Private sector education, health, social work,					
recreational and community services	**(0.1%)**	1.6%	**-**	0.1%	1.4%
Banks & financial institutions	**-**	0.1%	**-**	(0.1%)	0.2%

Wholesale and retail trade repairs	**0.3%**	0.2%		**0.3%**	0.1%	0.2%
Hotels and restaurants	**0.2%**	0.8%		**0.7%**	0.2%	1.1%
Manufacturing	**0.3%**	-		**0.1%**	0.2%	0.3%
Construction	**0.5%**	(0.1%)		**0.2%**	0.8%	(0.2%)
Other	**0.1%**	0.1%		**0.1%**	-	(0.4%)
Total	**0.1%**	0.8%		**0.2%**	0.1%	1.3%

Note:

(1) Includes £123 million in 2013 pertaining to the creation of RCR and related strategy.

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Commercial Banking

Key metrics						
	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
Performance ratios						
Return on equity (1,2)	**12.6%**	4.9%		**9.6%**	16.0%	(6.7%)
Net interest margin	**2.74%**	2.64%		**2.77%**	2.78%	2.76%
Cost:income ratio	**57%**	63%		**66%**	48%	88%

Notes:

(1) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

(2) From Q1 2015 business segment return on equity will be calculated based on operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 13% of the monthly average RWAes). At 31 December 2014 the RWAes on this basis were £69.8 billion and the return on equity 9.5%.

	31 December	30 September		31 December	
	2014	2014		2013	
	£bn	£bn	Change	£bn	Change
Capital and balance sheet					
Loans and advances to customers (gross)					
- Commercial real estate	**18.3**	18.6	(2%)	20.2	(9%)
- Asset and invoice finance	**14.2**	14.3	(1%)	11.7	21%
- Private sector education, health, social work,					
recreational and community services	**6.9**	7.1	(3%)	7.9	(13%)
- Banks & financial institutions	**7.0**	7.0	-	6.9	1%
- Wholesale and retail trade repairs	**6.0**	6.0	-	5.8	3%
- Hotels and restaurants	**3.4**	3.4	-	3.6	(6%)
- Manufacturing	**3.7**	3.9	(5%)	3.7	-
- Construction	**1.9**	1.9	-	2.1	(10%)
- Other	**24.7**	23.8	4%	23.1	7%

Total loans and advances to customers (gross)	**86.1**	86.0	-	85.0	1%
Loan impairment provisions	**(1.0)**	(1.0)	-	(1.5)	(33%)
Net loans and advances to customers (1)	**85.1**	85.0	-	83.5	2%
Funded assets	**89.4**	89.7	-	87.9	2%
Total assets	**89.4**	89.7	-	87.9	2%
Risk elements in lending	**2.5**	2.6	(4%)	4.3	(42%)
Provision coverage (2)	**38%**	40%	(200bp)	38%	-
Customer deposits	**86.8**	87.0	-	90.7	(4%)
Loan:deposit ratio (excluding repos)	**98%**	98%	-	92%	600bp
Risk-weighted assets (3)					
- Credit risk (non-counterparty)	**57.6**	58.5	(2%)	59.7	(4%)
- Operational risk	**6.4**	6.4	-	6.1	5%
Total risk-weighted assets	**64.0**	64.9	(1%)	65.8	(3%)

Notes:

(1) December 2014 includes £15 billion third party assets and £12 billion risk-weighted asset equivalents in relation to the run-down legacy book.

(2) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

(3) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. RWAs on the end-point CRR basis as at 1 January 2014 were £61.5 billion.

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Commercial Banking

Key points

Commercial Banking implemented a simplified and delayered management structure in 2014. With over 120 products removed from sale and over 400 process improvements implemented, the segment is becoming easier to do business with.

Tangible progress is being made via a bank-wide strategic lending programme which will transform the end-to-end customer lending experience, ensuring faster decisions and a smoother application process. Over the year there has been an improvement in the Net Promoter Score and rating of overall service quality across the business, together with a continuing fall in complaints.

Commercial Banking continues to back UK businesses and communities, with over 8,400 Statement of Appetite letters issued in 2014 at a total value of £4.7 billion. As part of our plan to support entrepreneurs across the UK, the first of eight accelerator hubs opened in February 2015, offering free space, support and advice to high growth business owners. A series of customer campaigns were launched, proactively engaging customers on their international and asset finance needs.

Significant progress has been made to drive connectivity across the bank, with a focus on providing employees with the skills and tools they need to serve customers better. This has included investment in professional qualifications as well as the development of a suite of banking tools to be rolled out in 2015. The alignment of Commercial & Private Banking continues to yield benefits, with a pilot resulting in over 140 referrals between the businesses.

2014 compared with 2013

Commercial Banking recorded an operating profit of £1,290 million compared with £530 million in the prior year. This was driven by lower net impairment losses, down £576 million, lower operating expenses, down £131 million and higher income, up £53 million. Operating profit, excluding restructuring costs of £93 million (2013 - £55 million) and litigation and conduct costs of £112 million (2013 - £247 million) increased by £663 million to £1,495 million.

Net interest income increased by £79 million or 4%, largely reflecting re-pricing activity on deposits partly offset by the impact of reduced asset margins, a result of the net transfer in of lower margin legacy loans (after the cessation of Non-Core).

Non-interest income was down £26 million or 2% as lower Corporate & Institutional Banking revenue share income, restructuring fees and the transfer out of commercial cards income to UK Personal & Business Banking in August 2014 were only partially offset by higher fair value gains and operating lease income, along with lower close out costs of interest rate products associated with impaired loans.

Operating expenses were down £131 million or 7%, as a result of lower litigation and conduct costs of £112 million (2013 - £247 million), primarily relating to interest rate swap redress, and lower underlying direct costs reflecting the continued focus on cost saving. These reductions were partially offset by higher restructuring costs of £93 million (2013 - £55 million), as the business aligns itself to better support customers, and growth in operating lease depreciation. Operating expenses excluding restructuring costs and litigation and conduct costs declined by £34 million.

Commercial Banking

Key points (continued)

2014 compared with 2013 (continued)

Net impairment losses declined £576 million to £76 million, as 2013 included the impact of the creation of RCR. Excluding the RCR charges, underlying impairments declined by £453 million with fewer individual cases across the portfolio, reduced collectively assessed provisions and higher latent provision releases, reflecting improved credit conditions.

The loan:deposit ratio increased to 98%, from reduced deposits, down 4%, reflecting the rebalancing of the bank's liquidity position, and a 2% increase in net loans and advances, as reductions in the commercial real estate and restructuring portfolio were offset by growth across other businesses.

RWAs were £1.8 billion lower at £64.0 billion, primarily reflecting net transfers to RCR, effective 1 January 2014, and improving credit quality on the back of UK economic recovery, offset by loan growth.

Q4 2014 compared with Q3 2014

Operating profit declined by £159 million to £248 million. This was driven by higher operating expenses coupled with higher net impairment losses only partially offset by an increase in income. Operating profit excluding restructuring costs and litigation and conduct costs of £75 million (Q3 2014 - £18 million) was £323 million compared with £425 million in the preceding quarter.

Net interest income was broadly flat as a decline in asset margins offset an increase in current account balances.

Non-interest income increased by £20 million or 7% to £310 million, from higher fair value gains partially offset by lower disposal gains. Fee income remained broadly stable.

Operating expenses increased by £158 million to £550 million, primarily driven by a £62 million provision for litigation and conduct costs coupled with the annual bank levy (£84 million). A donation of £10 million was made to the bank's social finance charity.

Net impairment losses increased by £21 million to £33 million, reflecting an uplift in a small number of individual cases and higher latent charges, partially offset by reduced collectively assessed provisions.

RWAs declined by 1% to £64.0 billion, as a result of improving risk parameters.

Q4 2014 compared with Q4 2013

Operating profit was £248 million compared with a loss of £179 million in Q4 2013 primarily driven by lower litigation and conduct costs, down £160 million, and lower net impairment losses, down £244 million. Operating profit excluding restructuring costs and litigation and conduct costs of £75 million (Q4 2013 - £237 million) increased from £58 million to £323 million.

Income increased by £15 million or 2% to £831 million, with higher net interest income, up 1%, and higher non-interest income, up 3%. Net interest income benefited from the re-pricing activity on deposits partially offset by the impact of lower asset margins reflecting the transfer of lower margin loans from Non-Core. Non-interest income was positively affected by higher fair value gains in the quarter, partially offset by the transfer of commercial cards income to UK Personal & Business Banking.

Operating expenses decreased by £168 million or 23% to £550 million, primarily driven by lower litigation and conduct costs, coupled with lower direct costs. This was partially offset by the social finance charity donation.

Net impairment losses decreased by £244 million to £33 million, reflecting fewer significant individual cases coupled with the non-repeat of the RCR related charges.

Private Banking

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m
Income statement						
Net interest income	**691**	658		**175**	172	173
Net fees and commissions	**335**	355		**78**	85	85
Other non-interest income	**56**	64		**14**	13	18
Non-interest income	**391**	419		**92**	98	103
Total income	**1,082**	1,077		**267**	270	276
Direct expenses						
- staff costs	**(317)**	(317)		**(78)**	(79)	(63)
- other costs	**(72)**	(84)		**(21)**	(19)	(33)
Indirect expenses	**(439)**	(475)		**(129)**	(105)	(134)
Restructuring costs						
- direct	**(8)**	(18)		**(6)**	-	(14)
- indirect	**(10)**	(9)		**(2)**	(7)	(3)
Litigation and conduct costs	**(90)**	(206)		**(90)**	-	(206)
Operating expenses	**(936)**	(1,109)		**(326)**	(210)	(453)
Profit/(loss) before impairment losses	**146**	(32)		**(59)**	60	(177)
Impairment releases/(losses)	**4**	(29)		**-**	4	(21)
Operating profit/(loss)	**150**	(61)		**(59)**	64	(198)
Of which: international private banking activities (1)						
Total income	**230**	267		**55**	53	61
Operating expenses	**(257)**	(357)		**(76)**	(62)	(161)
Impairment losses	**-**	(20)		**-**	-	(20)
Operating loss	**(27)**	(110)		**(21)**	(9)	(120)

	Year ended		Quarter ended

	31 December 2014	31 December 2013		31 December 2014	30 September 2014	31 December 2013
	£m	£m		£m	£m	£m
Analysis of income by business						
Investments	**176**	198		**42**	44	52
Banking	**906**	879		**225**	226	224
Total income	**1,082**	1,077		**267**	270	276

Key metrics						
	Year ended			Quarter ended		
	31 December 2014	31 December 2013		31 December 2014	30 September 2014	31 December 2013
Performance ratios						
Return on equity (2,3)	**7.8%**	(3.1%)		**(12.5%)**	13.3%	(41.0%)
Net interest margin	**3.71%**	3.47%		**3.74%**	3.65%	3.68%
Cost:income ratio	**87%**	103%		**122%**	78%	164%

Notes:

(1) Private banking and wealth management activities outside of the British Isles, broadly indicative of the businesses being exited.

(2) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

(3) From Q1 2015 business segment return on equity will be calculated based on operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 13% of the monthly average RWAes). At 31 December 2014 the RWAes on this basis were £11.5 billion and the return on equity 6.1%.

Private Banking

	31 December 2014	30 September 2014		31 December 2013	
	£bn	£bn	Change	£bn	Change
Capital and balance sheet					
Loans and advances to customers (gross)					
- personal	**5.4**	5.6	(4%)	5.5	(2%)
- mortgages	**8.9**	8.8	1%	8.7	2%
- other	**2.3**	2.4	(4%)	2.6	(12%)
Total loans and advances to customers (gross)	**16.6**	16.8	(1%)	16.8	(1%)
Loan impairment provisions	**(0.1)**	(0.1)	-	(0.1)	-
Loans and advances to customers	**16.5**	16.7	(1%)	16.7	(1%)
Funded assets	**20.4**	21.0	(3%)	21.0	(3%)
Total assets	**20.5**	21.1	(3%)	21.2	(3%)
Assets under management	**28.3**	28.9	(2%)	29.7	(5%)
Risk elements in lending	**0.2**	0.2	-	0.3	(33%)
Provision coverage (1)	**34%**	35%	(100bp)	43%	(900bp)
Customer deposits	**36.1**	36.2	-	37.2	(3%)
Loan:deposit ratio (excluding repos)	**46%**	46%	-	45%	100bp
Risk-weighted assets (2)					
- Credit risk					
- non-counterparty	**9.5**	10.2	(7%)	10.0	(5%)
- counterparty	**0.1**	0.1	-	-	-
- Market risk	**-**	-	-	0.1	(100%)
- Operational risk	**1.9**	1.9	-	1.9	-
Total risk-weighted assets	**11.5**	12.2	(6%)	12.0	(4%)
Of which: international private banking activities (3)					

Net loans and advances to customers	**3.0**	3.1	(3%)	3.1	(3%)
Assets under management	**14.5**	15.0	(3%)	15.6	(7%)
Customer deposits (excluding repos)	**7.3**	7.8	(6%)	8.0	(9%)
Risk-weighted assets (2)	**2.2**	2.6	(15%)	2.5	(12%)

Notes:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.
(2) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. RWAs on the end-point CRR basis at 1 January 2014 were £12.0 billion.
(3) Private banking and wealth management activities outside of the British Isles, broadly indicative of the businesses being exited.

Key points

During 2014, Private Banking has continued to provide excellent service to clients against the background of a major business review and significant organisational change.

Following the announcement of RBS's new strategy in February 2014, Private Banking set out a new vision and strategic direction in August. Coutts and Adam & Company will focus on growing the UK based high net worth client franchise. All private banking and wealth management activities where the primary relationship management is conducted outside the British Isles will be exited to align better with RBS's stated UK focus.

The ambition of the business is to be the leading UK based private bank and wealth manager for wealthy individuals seeking exceptional private banking and wealth management. Private Banking has gathered significant momentum behind its ambition, supported by a straightforward plan centred around five key priorities: an improved banking proposition; a refocused advice and wealth management model; an enhanced proposition for international clients managed from the UK; an integrated client approach across RBS; and increased client engagement.

Since September, good progress has been made towards the sale of the business outside the British Isles. A primary focus of the transaction is to execute the deal with minimal disruption for clients and staff.

Private Banking

Key points (continued)

Private Banking has made tangible steps towards working more closely with Commercial Banking, which includes an energetic approach to client cross referrals as well as functional synergies.

The business has progressed well against key priorities in 2014. Improvements are evidenced by several industry awards including: ‘Best private bank in the UK’ (PWM/The Banker) and ’Most innovative digital offering’ (Private Banker International).Coutts continues to be recognised as a leader in philanthropy, with its’ $1 million donors’ report receiving significant media coverage, and its expertise as an adviser for family businesses and entrepreneurs remains a strong point of differentiation.

2014 compared with 2013

Private Banking recorded an operating profit of £150 million compared with a loss of £61 million in the prior year. This was driven by reduced operating expenses, down £173 million, net impairment releases of £4 million compared with a net £29 million loss in 2013, and higher income, up £5 million.
Operating profit excluding restructuring costs of £18 million (2013 - £27 million) and litigation and conduct costs of £90 million (2013 - £206 million) increased by £86 million to £258 million.
Net interest income increased by £33 million or 5% as improved deposit margin reflected the full year impact of the 2013 deposit re-pricing initiative.
Non-interest income was down £28 million or 7%, with lower transactional and investment activity due to subdued market volatility across the international business.
Operating expenses declined by £173 million or 16% primarily driven by lower restructuring costs and litigation and conduct costs. Operating expenses excluding restructuring costs of £18 million (2013 - £27 million) and litigation and conduct costs of £90 million (2013 - £206 million) declined by £48 million or 5% to £828 million, reflecting lower technology costs and one-off benefits from the exit of a number of London properties.
Net impairment releases of £4 million, compared with a net impairment loss of £29 million in the prior year reflected the non-repeat of a single £20 million provision, coupled with improved economic conditions and higher UK property prices.
Client deposits decreased by £1.1 billion or 3% reflecting the rebalancing of the bank’s liquidity position.
Assets under management decreased by £1.4 billion or 5% to £28.3 billion, driven by low margin custody outflows.

Q4 2014 compared with Q3 2014

Operating loss was £59 million compared with a profit of £64 million in the prior quarter principally driven by a £90 million increase in litigation and conduct costs and the cost of the UK bank levy.

Operating profit excluding restructuring costs and litigation and conduct costs of £98 million (Q3 2014 - £7 million) declined by £32 million to £39 million, primarily due to the annual bank levy.
Assets under management decreased by £0.6 billion or 2%, due to outflows of low margin assets in both the UK and international businesses.

Q4 2014 compared with Q4 2013

Operating loss decreased by £139 million to £59 million, primarily driven by lower litigation and conduct costs coupled with the non-repeat of a single impairment provision. Operating profit increased by £14 million excluding restructuring costs and litigation and conduct costs of £98 million (Q4 2013 - £223 million).
Non-interest income fell by £11 million or 11% as a result of lower transactional and investment activity due to subdued market volatility across the international business.
Operating expenses declined by £127 million or 28%, largely driven by the £116 million reduction in litigation and conduct costs. Indirect costs declined with lower technology and property costs.
Net impairment loss decreased by £21 million reflecting the non-repeat of the single provision in the international business in Q4 2013.

Corporate & Institutional Banking

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m
Income statement						
Net interest income	**817**	684		**222**	230	208
Net fees and commissions	**972**	1,109		**219**	263	265
Income from trading activities	**2,023**	3,074		**212**	329	549
Other operating income	**137**	141		**38**	9	26
Non-interest income	**3,132**	4,324		**469**	601	840
Total income	**3,949**	5,008		**691**	831	1,048
Direct expenses						
- staff costs	**(729)**	(979)		**(63)**	(179)	(138)
- other costs	**(400)**	(688)		**(100)**	(50)	(267)
Indirect expenses	**(2,432)**	(2,900)		**(659)**	(593)	(959)
Restructuring costs						
- direct	**(93)**	(76)		**(49)**	(22)	(25)
- indirect	**(202)**	(126)		**(39)**	6	35
Litigation and conduct costs	**(994)**	(2,441)		**(382)**	(562)	(1,932)
Operating expenses	**(4,850)**	(7,210)		**(1,292)**	(1,400)	(3,286)
Loss before impairment losses	**(901)**	(2,202)		**(601)**	(569)	(2,238)
Impairment releases/(losses)	**9**	(680)		**(42)**	12	(429)
Operating loss	**(892)**	(2,882)		**(643)**	(557)	(2,667)

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m

Analysis of income by product						
Rates	**975**	1,075		**79**	240	202
Currencies	**754**	903		**210**	193	192
Credit	**1,088**	1,639		**116**	198	343
Global Transaction Services	**818**	881		**190**	207	227
Portfolio	**653**	623		**171**	164	156
Total (excluding revenue share and run-off businesses)	**4,288**	5,121		**766**	1,002	1,120
Inter-segment revenue share	**(236)**	(261)		**(59)**	(58)	(57)
Run-off businesses	**(103)**	148		**(16)**	(113)	(15)
Total income	**3,949**	5,008		**691**	831	1,048

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Corporate & Institutional Banking

Key metrics	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
Performance ratios						
Return on equity (1)	**(4.2%)**	(12.9%)		**(13.6%)**	(11.0%)	(53.1%)
Net interest margin	**0.99%**	0.80%		**1.11%**	1.08%	0.97%
Cost:income ratio	**123%**	144%		**187%**	168%	314%

Notes:

(1) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

(2) From Q1 2015 business segment return on equity will be calculated based on operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 13% of the monthly average RWAes). At 31 December 2014 the RWAes on this basis were £108.9 billion and the return on equity (4.8%).

	31 December	30 September		31 December	
	2014	2014		2013	
	£bn	£bn	Change	£bn	Change
Capital and balance sheet					
Loans and advances to customers (gross, excluding	**73.0**	73.3	-	69.1	6%
reverse repos)					
Loan impairment provisions	**(0.2)**	(0.2)	-	(0.9)	(78%)
Total loans and advances to customers (excluding					
reverse repos)	**72.8**	73.1	-	68.2	7%
Net loans and advances to banks (excluding reverse					

repos) (1)	**16.9**	19.5	(13%)	20.5	(18%)
Reverse repos	**61.6**	72.9	(16%)	76.2	(19%)
Securities	**57.0**	65.6	(13%)	72.1	(21%)
Cash and eligible bills	**23.2**	18.9	23%	20.6	13%
Other	**9.6**	24.9	(61%)	11.0	(13%)
Funded assets	**241.1**	274.9	(12%)	268.6	(10%)
Total assets	**577.2**	572.9	1%	551.2	5%
Provision coverage (2)	**105%**	175%	(7,000bp)	59%	4,600bp
Customer deposits (excluding repos)	**59.4**	57.1	4%	64.8	(8%)
Bank deposits (excluding repos)	**33.3**	32.2	3%	30.2	10%
Repos	**61.1**	67.2	(9%)	74.8	(18%)
Debt securities in issue	**14.1**	15.8	(11%)	21.5	(34%)
Loan:deposit ratio (excluding repos)	**122%**	128%	(600bp)	105%	1,700bp
Risk-weighted assets (3)					
- Credit risk					
- non-counterparty	**51.3**	57.2	(10%)	61.8	(17%)
- counterparty	**25.1**	28.5	(12%)	17.5	43%
- Market risk	**18.9**	25.7	(26%)	26.4	(28%)
- Operational risk	**11.8**	11.8	-	14.7	(20%)
Total risk-weighted assets	**107.1**	123.2	(13%)	120.4	(11%)

Notes:

(1) Excludes disposal groups.

(2) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

(3) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. On the end-point CRR basis risk-weighted assets at 1 January 2014 were £147.1 billion.

Corporate & Institutional Banking

Key points

Corporate & Institutional Banking (CIB) focused on its strengths in core product areas during 2014, reducing the scale of the business and simplifying the operating model. This allowed CIB to better serve customers while deploying fewer resources. The commitment to customers was demonstrated by the award of The Banker's Most Innovative Bank in Risk Management in Q3 2014 and by winning IFR magazine's Sterling Bond House of the year award in Q4 2014. The drive to concentrate on core products is evidenced by the 27% fall in RWAs (compared with 1 January 2014 on a CRR basis) and the 22% year on year fall in expenses excluding litigation and conduct costs of £994 million (2013 - £2,441 million) and restructuring costs of £295 million (2013 - £202 million).

2014 compared with 2013

CIB recorded an operating loss of £892 million compared with a loss of £2,882 million in 2013. This included litigation and conduct costs of £994 million compared with £2,441 million a year before. The operating result excluding these litigation and conduct costs and restructuring costs improved from a loss of £239 million in 2013 to a profit of £397 million in 2014. This movement was primarily driven by substantial reductions in expenses, partially offset by lower income. Net impairment releases totalled £9 million compared with a net impairment charge of £680 million in 2013.

Total income declined by 21%, reflecting reduced deployment of resources and difficult trading conditions, characterised by subdued levels of client activity and limited market volatility:

- Rates suffered from a weak trading performance in Q4 2014. This, combined with subdued client flow and balance sheet de-risking, reduced income.
- Currencies income declined in a highly competitive market as both market volatility and client activity remained subdued for much of the year. Some volatility returned in Q4 2014, boosting income in the Options business in particular.
- Credit reduced RWAs by 61% in 2014, including the wind-down of Credit Trading and the US asset- backed products (ABP) business. This impacted income, as did the year on year weakening in corporate investment grade debt capital market issuance in EMEA.
- Income from Global Transaction Services dipped by 7%, primarily as a result of the disposal of the Global Travel Money Service business in Q4 2013. The underlying business was stable.
- Run-off and recovery businesses incurred a loss of £103 million.

Operating expenses fell by £2,360 million driven primarily by lower litigation and conduct costs. Operating expenses excluding litigation and conduct costs of £994 million (2013 - £2,441 million) and restructuring costs of £295 million (2013 - £202 million), decreased by £1,006 million, or 22%, reflecting the continued focus on cost savings across both business and support areas.

Net impairment releases totalled £9 million compared with a net impairment charge of £680 million in 2013, reflecting a reduction in latent loss provisions and a low level of new impairments. This contrasted with 2013 which included substantial impairments related to the establishment of RCR.

Funded assets fell by 10% reflecting the focus on core product areas including the wind-down of Credit Trading and the US ABP businesses.

RWAs were managed down by £40.0 billion from £147.1 billion on 1 January 2014 to £107.1 billion on 31 December 2014. The 27% reduction was driven by a sustained programme of risk and business reductions, notably in Credit due to the wind-down of the US asset-backed products business (down £15 billion over the same period to £4 billion).

Corporate & Institutional Banking

Key points (continued)

Q4 2014 compared with Q3 2014

An operating loss of £643 million, compared with a loss of £557 million in Q3 2014, primarily reflected lower income, higher restructuring and indirect costs, partially offset by lower litigation and conduct costs of £382 million compared with £562 million in Q3 2014. Operating loss excluding litigation and conduct costs of £382 million (Q3 2014 - £562 million) and restructuring costs of £88 million (Q3 2014 - £16 million), totalled £173 million compared with a profit of £21 million in Q3. RWAs continued to fall, down 13% to £107.1 billion in Q4 2014.

Reduced income, most notably in Rates and Credit, was driven by a weak trading performance as markets reacted to increasing concerns about the Eurozone economy and challenging macroeconomic conditions more broadly. This was partially offset by Currencies, where higher income was driven by increased currency volatility.

Operating expenses fell by £108 million, driven by lower litigation and conduct costs and lower staff expenses. This was partially offset by higher restructuring costs and indirect expenses, the latter reflecting the timing of the UK bank levy, which cost £93 million in the quarter.

RWAs fell by 13%, driven by risk reduction and specific business initiatives, notably in Credit where the US asset-backed products business is being wound down.

Q4 2014 compared with Q4 2013

Operating loss declined from £2,667 million in Q4 2013 to £643 million in Q4 2014. The improvement was driven by lower expenses, primarily litigation and conduct costs, and lower impairments, partially offset by reduced income.

Lower income, primarily in Rates and Credit, reflected risk and balance sheet reductions since the end of 2013 and a weak trading performance in Q4 2014.

Operating expenses fell by £1,994 million, driven by lower litigation and conduct costs. Operating expenses excluding litigation and conduct costs of £382 million (Q4 2013 - £1,932 million) and restructuring costs of £88 million (Q4 2013 - £10 million gain), declined by £542 million reflecting the continued focus on reducing the cost base.

Explanation of Responses:

Central items

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m
Central items not allocated	**(850)**	647		**(622)**	(319)	(61)

Funding and operating costs have been allocated to operating segments based on direct service usage, the requirement for market funding and other appropriate drivers where services span more than one segment.

Residual unallocated items relate to volatile corporate items that do not naturally reside within a segment.

Key points

2014 compared with 2013

Central items not allocated represented a charge of £850 million compared with a credit of £647 million in 2013. The change includes lower gains on the disposal of available-for-sale securities in Treasury, which were down £575 million to £149 million in 2014, along with a £309 million higher restructuring charge relating to the Williams & Glyn franchise. In addition 2014 includes a charge of £247 million write-down of previously capitalised software development expenditure and £134 million lower income from investments in associates. In addition, unallocated Treasury funding costs, including volatile items under IFRS, were £437 million in the year versus £282 million in 2013.

Q4 2014 compared with Q3 2014

Central items not allocated represented a charge of £622 million in Q4 2014 compared with a charge of £319 million in Q3 2014. Q4 included a £247 million software write-down. In addition, unallocated Treasury funding costs, including volatile items under IFRS, were £323 million in the quarter versus £111 million in Q3 2014. The previous quarter also included £72 million of available-for-sale disposal losses.

Q4 2014 compared with Q4 2013

Central items not allocated represented a charge of £622 million in Q4 2014 compared with a charge of £61 million in Q4 2013. This reflected the software write off, higher restructuring charges relating to the Williams & Glyn franchise and lower gains on the disposal of available-for-sale securities in Treasury, which were down £108 million to £6 million in Q4 2014.

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Citizens Financial Group (£ Sterling)

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	£m	£m		**£m**	£m	£m
Income statement						
Net interest income	**2,013**	1,892		**533**	493	468
Net fees and commissions	**709**	761		**185**	174	182
Other non-interest income	**359**	312		**48**	41	58
Non-interest income	**1,068**	1,073		**233**	215	240
Total income	**3,081**	2,965		**766**	708	708
Direct expenses						
- staff costs	**(1,030)**	(1,091)		**(263)**	(255)	(249)
- other costs	**(990)**	(986)		**(258)**	(231)	(251)
Indirect expenses	**-**	(111)		**-**	-	(31)
Restructuring costs	**(103)**	(16)		**(21)**	(13)	(11)
Operating expenses	**(2,123)**	(2,204)		**(542)**	(499)	(542)
Profit before impairment losses	**958**	761		**224**	209	166
Impairment losses	**(197)**	(156)		**(47)**	(46)	(46)
Operating profit	**761**	605		**177**	163	120
Average exchange rate - US$/£	**1.647**	1.565		**1.582**	1.669	1.619

Key metrics	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013

Performance ratios						
Return on equity (1)	**6.6%**	5.7%		**5.7%**	5.6%	4.7%
Net interest margin	**2.88%**	2.91%		**2.86%**	2.82%	2.91%
Cost:income ratio	**69%**	74%		**71%**	71%	77%
Loan impairment charge as % of gross customer						
loans and advances	**0.3%**	0.3%		**0.3%**	0.3%	0.4%

Notes:

(1) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

(2) From Q1 2015 business segment return on equity will be calculated based on operating profit after tax adjusted for preference share dividends divided by average notional equity (based on 13% of the monthly average RWAes). At 31 December 2014 the RWAes on this basis were £68.6 billion and the return on equity 6.1%.

Citizens Financial Group (£ Sterling)

	31 December 2014	30 September 2014			31 December 2013	
	£bn	£bn	Change		£bn	Change
Capital and balance sheet						
Loans and advances to customers (gross)						
- residential mortgages	**7.7**	7.1	8%		5.8	33%
- home equity	**12.0**	11.8	2%		12.1	(1%)
- SBO home equity	**1.2**	1.2	-		-	100%
- corporate and commercial	**27.9**	25.8	8%		24.1	16%
- other consumer	**11.3**	10.3	10%		8.6	31%
Total loans and advances to customers (gross)	**60.1**	56.2	7%		50.6	19%
Loan impairment provisions	**(0.5)**	(0.5)	-		(0.3)	67%
Net loans and advances to customers	**59.6**	55.7	7%		50.3	18%
Funded assets	**84.5**	80.5	5%		71.3	19%
Total assets	**84.9**	80.9	5%		71.7	18%
Investment securities	**15.8**	15.3	3%		12.9	22%
Risk elements in lending						
- retail	**1.2**	1.1	9%		0.9	33%
- commercial	**0.1**	0.2	(50%)		0.1	-
Total risk elements in lending	**1.3**	1.3	-		1.0	30%
Provision coverage (1)	**40%**	41%	(100bp)		26%	1,400bp
Customer deposits (excluding repos)	**60.6**	56.9	7%		55.1	10%
Bank deposits (excluding repos)	**5.1**	4.3	19%		2.0	155%
Loan:deposit ratio (excluding repos)	**98%**	98%	-		91%	700bp
Risk-weighted assets (2)						
- Credit risk						
- non-counterparty	**62.4**	58.6	6%		50.7	23%
- counterparty	**0.9**	0.7	29%		0.5	80%
- Operational risk	**5.1**	5.1	-		4.9	4%
Total risk-weighted assets	**68.4**	64.4	6%		56.1	22%

Spot exchange rate - US$/£	**1.562**	1.622			1.654	

Notes:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.
(2) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. RWAs on the end-point CRR basis as at 1 January 2014 were £60.6 billion.

Key point

Sterling weakened during the year, with the spot exchange rate at 31 December 2014 decreasing 6%.

Citizens Financial Group (US dollar)

	Year ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
	$m	$m		**$m**	$m	$m
Income statement						
Net interest income	**3,317**	2,960		**846**	824	763
Net fees and commissions	**1,168**	1,190		**293**	291	298
Other non-interest income	**589**	489		**69**	68	97
Non-interest income	**1,757**	1,679		**362**	359	395
Total income	**5,074**	4,639		**1,208**	1,183	1,158
Direct expenses						
- staff costs	**(1,697)**	(1,707)		**(417)**	(425)	(409)
- other costs	**(1,631)**	(1,544)		**(408)**	(388)	(412)
Indirect expenses	**-**	(173)		**-**	-	(50)
Restructuring costs	**(169)**	(24)		**(32)**	(22)	(16)
Operating expenses	**(3,497)**	(3,448)		**(857)**	(835)	(887)
Profit before impairment losses	**1,577**	1,191		**351**	348	271
Impairment losses	**(324)**	(244)		**(73)**	(77)	(75)
Operating profit	**1,253**	947		**278**	271	196

Key metrics						
	Years ended			Quarter ended		
	31 December	31 December		**31 December**	30 September	31 December
	2014	2013		**2014**	2014	2013
Performance ratios						
Return on equity (1)	**6.6%**	5.7%		**5.7%**	5.6%	4.7%

Net interest margin	**2.88%**	2.91%		**2.86%**	2.82%	2.91%
Cost:income ratio	**69%**	74%		**71%**	71%	77%
Loan impairment charge as a % of gross customer						
loans and advances	**0.3%**	0.3%		**0.3%**	0.3%	0.4%

Note:

(1) Return on equity is based on operating profit after tax divided by average notional equity (based on 12% of the monthly average of RWAs; RWAs in 2013 are on a Basel 2.5 basis).

Citizens Financial Group (US dollar)

	31 December 2014	30 September 2014			31 December 2013	
	$bn	$bn	Change		$bn	Change
Capital and balance sheet						
Loans and advances to customers (gross)						
- residential mortgages	**12.1**	11.5	5%		9.6	26%
- home equity	**18.8**	19.1	(2%)		20.1	(6%)
- SBO home equity	**1.8**	1.9	(5%)		-	100%
- corporate and commercial	**43.6**	41.8	4%		39.8	10%
- other consumer	**17.6**	16.9	4%		14.1	25%
Total loans and advances to customers (gross)	**93.9**	91.2	3%		83.6	12%
Loan impairment provisions	**(0.8)**	(0.8)	-		(0.4)	100%
Net loans and advances to customers	**93.1**	90.4	3%		83.2	12%
Funded assets	**132.0**	130.7	1%		117.9	12%
Total assets	**132.6**	131.2	1%		118.6	12%
Investment securities	**24.7**	24.9	(1%)		21.3	16%
Risk elements in lending						
- retail	**1.8**	1.8	-		1.5	20%
- commercial	**0.3**	0.2	50%		0.2	50%
Total risk elements in lending	**2.1**	2.0	5%		1.7	24%
Provision coverage (1)	**40%**	41%	(100bp)		26%	1,400bp
Customer deposits (excluding repos)	**94.6**	92.4	2%		91.1	4%
Bank deposits (excluding repos)	**8.0**	7.0	14%		3.3	142%
Loan:deposit ratio (excluding repos)	**98%**	98%	-		91%	700bp
Risk-weighted assets (2)						
- Credit risk						
- non-counterparty	**97.4**	95.0	3%		83.8	16%
- counterparty	**1.4**	1.2	17%		0.8	75%
- Operational risk	**8.0**	8.3	(4%)		8.2	(2%)

Total risk-weighted assets	**106.8**	104.5	2%		92.8	15%

Notes:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.
(2) Risk-weighted assets at 31 December 2013 are on a Basel 2.5 basis. RWAs on the end-point CRR basis as at 1 January were $100.2 billion.

Key points

In accordance with a commitment to the EC to sell Citizens by 31 December 2016, RBS disposed of 29.5% of its interest in Citizens Financial Group, Inc. during the second half of 2014 primarily through an initial public offering in the USA. In accordance with IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations', Citizens is presented with effect from 31 December 2014 as a discontinued operation, with comparatives restated, and as a disposal group.

Although CFG has been reclassified as a discontinued operation it continues to be a reportable operating segment.

FY 2014 and Q4 2014 results are not directly comparable with prior year periods; prior year results exclude Non-Core operations and include indirect expenses. In the context of the planned disposal of Citizens Financial Group, indirect expenses are no longer allocated to the segment.

Citizens Financial Group (US dollar)

Key points (continued)

2014 compared with 2013

Operating profit increased by £156 million ($306 million), or 26%, to £761 million ($1,253 million), reflecting the Q2 2014 gain on the sale of the Illinois franchise. The former Non-Core portfolio is now included and indirect expenses are no longer allocated on a prospective basis from 1 January 2014.

Net interest income was up £121 million ($357 million), or 6%, to £2,013 million ($3,317 million) driven by a larger investment portfolio, loan growth including the transfer of assets from Non-Core, the benefit of interest rate swaps and deposit pricing discipline. This was partially offset by a reduction in loan spreads, reflecting the impact of the relatively persistent low-rate environment on loan yields, higher borrowing costs related to subordinated debt issuances and the impact of lost revenue from the Illinois franchise sale.

Higher rates led to investment security purchases resulting in average portfolio growth of £3.3 billion ($5.4 billion) over the year.

Average loans and advances were up 17% driven by the £2.1 billion ($3.4 billion) transfer of assets from Non-Core, commercial loan growth, auto loan organic growth and purchases of residential mortgages and auto loans, which were partially offset by a reduction in home equity loans.

Average customer deposits were up 4%. On a US dollar basis average customer deposits were down 2% with planned run-off of high priced deposits.

Loan:deposit ratio improved 700 basis points to 98%.

Excluding the gain on the sale of the Illinois franchise of £170 million ($283 million), non-interest income was down £175 million ($205 million), or 16%, to £898 million ($1,474 million) reflecting lower securities gains of £70 million ($116 million), lower mortgage banking fees of £32 million ($52 million), as refinancing volumes have slowed, lower deposit fees of £32 million ($52 million) due to a change in the posting order of transactions and the impact of lost revenue from the Illinois franchise sale. This was partially offset by underlying strength in commercial banking fee income. Mortgage origination activity has slowed as market rates have risen, leading to lower applications combined with lower levels of gains on sales of mortgages.

Excluding restructuring costs of £103 million ($169 million) (2013 - £16 million ($24 million)), total expenses were down £168 million ($96 million), or 3%, to £2,020 million ($3,328 million) driven by the removal of indirect costs in 2014 and the impact of the Illinois franchise sale partially offset by lower mortgage servicing rights impairment release and higher consumer regulatory compliance costs.

Restructuring costs include costs related to the sale of the Illinois franchise, separation from RBS, as well as efforts to improve processes and enhance efficiency.

Impairment losses increased by £41 million ($80 million) to £197 million ($324 million) due to charge-offs related to assets transferred from Non-Core.

Citizens Financial Group (US dollar)

Key points (continued)

Q4 2014 compared with Q3 2014

Operating profit increased by £14 million ($7 million), or 9%, to £177 million ($278 million) due to higher revenue largely offset by higher expenses.

Net interest income was up £40 million ($22 million), or 8%, to £533 million ($846 million) driven largely by a $2.4 billion increase in average loans and leases, higher investment portfolio income and a reduction in pay-fixed swap costs partially offset by higher subordinated debt borrowing costs and deposit costs.

Average loans and advances were up 8% due to commercial loan growth and retail loan growth driven by higher auto, residential mortgage and student loans partially offset by home equity run-off.

Average deposits were up 9% with growth across all deposit products.

Loan:deposit ratio remained stable at 98% despite strong loan growth.

Non-interest income was up £18 million ($3 million), or 8%, to £233 million ($362 million) primarily reflecting the weakening of Sterling against the US dollar. In US dollar terms, non-interest income was up 1% driven by commercial banking fee income.

Operating expenses were up £43 million ($22 million), or 9%, to £542 million ($857 million) due to higher restructuring costs and a mortgage servicing rights impairment in Q4 2014 versus a release in Q3 2014.

Impairment losses decreased by £1 million ($4 million) to £47 million ($73 million) for the quarter as the benefit of continued improvement in asset quality and a reduction in net charge-offs was somewhat offset by the effect of loan growth.

Q4 2014 compared with Q4 2013

Operating profit increased by £57 million ($82 million), or 48%, to £177 million ($278 million) due to higher net interest income and lower expenses partially offset by lower non-interest income.

Net interest income increased £65 million ($83 million), or 14%, to £533 million ($846 million) as the benefit of growth in average earning assets, a reduction in pay-fixed swap costs and improved security yields was partially offset by continued pressure from the relatively persistent low-rate environment on loan yields and mix, higher borrowing costs related to subordinated debt issuances and the effect of the Illinois franchise sale.

Non-interest income was down £7 million ($33 million), or 3%, to £233 million ($362 million) largely due to lower securities gains and the impact of the Illinois franchise sale partially offset by growth in commercial banking fees.

Excluding restructuring costs and indirect costs of £21 million ($32 million) (Q4 2013 - £11 million ($66 million)) expenses remained broadly flat at £521 million ($825 million).

Impairment losses were broadly in line with prior year despite the Non-Core transfer.

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RBS Capital Resolution

RCR is managed and analysed in four asset management groups - Ulster Bank (RCR Ireland), Real Estate Finance, Corporate and Markets. Real Estate Finance excludes commercial real estate lending in Ulster Bank.

	Year ended	Quarter ended			
	31 December	31 December	30 September	30 June	31 March
	2014	2014	2014	2014	2014
	£m	£m	£m	£m	£m
Income statement					
Net interest income	**(24)**	(17)	(18)	16	(5)
Funding costs of rental assets	**(23)**	(6)	(5)	(9)	(3)
Net interest income	**(47)**	(23)	(23)	7	(8)
Net fees and commissions	**58**	15	12	17	14
Income from trading activities (1)	**(217)**	(206)	42	(69)	16
Other operating income (1)	**251**	29	86	80	51
Non-interest income	**92**	(162)	140	28	81
Total income	**45**	(185)	122	35	73
Direct expenses					
- staff costs	**(167)**	(41)	(37)	(51)	(38)
- other costs	**(85)**	(29)	(24)	(14)	(18)
Indirect expenses	**(104)**	(25)	(24)	(32)	(23)
Restructuring costs	**(7)**	(3)	(4)	-	-
Operating expenses	**(363)**	(98)	(89)	(97)	(79)
(Loss)/profit before impairment losses	**(318)**	(283)	33	(62)	(6)
Impairment releases/(losses) (1)	**1,306**	681	605	128	(108)
Operating profit/(loss)	**988**	398	638	66	(114)
Total income					
Ulster Bank	**(20)**	8	(29)	14	(13)
Real Estate Finance	**222**	59	67	13	83

Corporate	**(17)**	(75)	72	(12)	(2)
Markets	**(140)**	(177)	12	20	5
Total income	**45**	(185)	122	35	73
	`	`	`	`	`
Impairment (releases)/losses					
Ulster Bank	**(1,106)**	(712)	(379)	(67)	52
Real Estate Finance	**(183)**	10	(159)	(123)	89
Corporate	**(21)**	10	(70)	73	(34)
Markets	**4**	11	3	(11)	1
Total impairment (releases)/losses	**(1,306)**	(681)	(605)	(128)	108
Loan impairment charge as % of gross loans					
and advances (2)					
Ulster Bank	**(10.1%)**	(25.9%)	(12.0%)	(1.9%)	1.3%
Real Estate Finance	**(4.5%)**	1.0%	(11.6%)	(6.6%)	4.1%
Corporate	**(0.3%)**	0.6%	(4.0%)	3.7%	(1.5%)
Markets	**(1.7%)**	-	(0.6%)	(3.6%)	-
Total	**(6.0%)**	(12.6%)	(9.5%)	(1.7%)	1.2%

Notes:

(1) Asset disposals contributed £291 million (Q3 2014 - £332 million; Q2 2014 - £225 million; Q1 2014 - £56 million) to RCR's operating profit: impairment provision releases of £321 million (Q3 2014 - £232 million; Q2 2014 - £257 million; Q1 2014 - £64 million); £11 million loss in income from trading activities (Q3 2014 - £97 million gain; Q2 2014 - £6 million gain; Q1 2014 - £5 million loss) and £19 million loss in other operating income (Q3 2014 - £3 million gain; Q2 2014 - £38 million; Q1 2014 - £3 million).

(2) Includes disposal groups.

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RBS Capital Resolution

	31 December	30 September	30 June	31 March
	2014	2014	2014	2014
	£bn	£bn	£bn	£bn
Capital and balance sheet				
Loans and advances to customers (gross) (1)	**21.9**	25.8	30.0	34.0
Loan impairment provisions	**(10.9)**	(12.6)	(14.4)	(15.7)
Net loans and advances to customers	**11.0**	13.2	15.6	18.3
Debt securities	**1.0**	1.7	1.9	2.2
Funded assets	**14.9**	17.9	20.9	24.3
Total assets	**29.0**	31.3	34.4	38.8
Risk elements in lending (1)	**15.4**	17.4	20.4	23.0
Provision coverage (2)	**71%**	72%	71%	68%
Risk-weighted assets				
- Credit risk				
- non-counterparty	**13.6**	18.7	22.6	29.6
- counterparty	**4.0**	8.2	8.2	5.7
- Market risk	**4.4**	3.7	4.3	5.2
Total risk-weighted assets	**22.0**	30.6	35.1	40.5
Gross loans and advances to customers (1)				
Ulster Bank	**11.0**	12.6	13.9	15.5
Real Estate Finance	**4.1**	5.5	7.4	8.6
Corporate	**6.2**	7.0	7.8	9.1
Markets	**0.6**	0.7	0.9	0.8
	21.9	25.8	30.0	34.0
Funded assets - Ulster Bank				
Commercial real estate - investment	**1.2**	1.5	1.9	2.4
Commercial real estate - development	**0.7**	0.7	0.7	0.8
Other corporate	**0.7**	0.7	0.9	1.2
	2.6	2.9	3.5	4.4

Funded assets - Real Estate Finance				
UK	**2.5**	3.2	4.4	4.7
Germany	**0.4**	0.8	1.0	1.4
Spain	**0.5**	0.5	0.5	0.6
Other	**0.8**	0.9	0.8	1.0
	4.2	5.4	6.7	7.7
Funded assets - Corporate				
Structured finance	**1.7**	1.7	2.0	2.2
Shipping	**1.8**	1.9	1.9	2.0
Other	**2.3**	3.1	3.5	4.4
	5.8	6.7	7.4	8.6
Funded assets - Markets				
Securitised products	**1.8**	2.3	2.7	3.0
Emerging markets	**0.5**	0.6	0.6	0.6
	2.3	2.9	3.3	3.6

Notes:

(1) Includes disposal groups.
(2) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

RBS Capital Resolution

Funded assets and RWAe															
	Non-performing (1)					**Performing (1)**					**Total**				
	Funded assets				**Capital**	**Funded assets**				**Capital**	**Funded assets**				
	Gross	**Net**	**RWAe**	**RWA**	**deducts**	**Gross**	**Net**	**RWAe**	**RWA**	**deducts**	**Gross**	**Net**	**RWAe (2)**	**RWA**	
31 December 2014	**£bn**	**£bn**	**£bn**	**£bn**	**£m**	**£bn**	**£bn**	**£bn**	**£bn**	**£m**	**£bn**	**£bn**	**£bn**	**£bn**	
Ulster Bank	**10.7**	**2.2**	**3.4**	**-**	**340**	**0.5**	**0.4**	**0.5**	**1.3**	**(82)**	**11.2**	**2.6**	**3.9**	**1.3**	
Real Estate Finance	**3.2**	**2.0**	**1.0**	**-**	**98**	**2.2**	**2.2**	**4.8**	**4.7**	**13**	**5.4**	**4.2**	**5.8**	**4.7**	
Corporate	**2.2**	**1.1**	**1.6**	**-**	**161**	**4.7**	**4.7**	**6.7**	**7.2**	**(49)**	**6.9**	**5.8**	**8.3**	**7.2**	
Markets	**0.1**	**0.1**	**0.1**	**-**	**12**	**2.2**	**2.2**	**9.2**	**8.8**	**41**	**2.3**	**2.3**	**9.3**	**8.8**	
Total RCR	**16.2**	**5.4**	**6.1**	**-**	**611**	**9.6**	**9.5**	**21.2**	**22.0**	**(77)**	**25.8**	**14.9**	**27.3**	**22.0**	
30 June 2014															
Ulster Bank	13.0	2.6	4.4	-	446	1.1	0.9	0.1	2.3	(229)	14.1	3.5	4.5	2.3	
Real Estate Finance	5.0	2.7	4.1	0.3	389	4.1	4.0	6.4	6.1	16	9.1	6.7	10.5	6.4	
Corporate	2.6	1.2	1.8	-	184	6.3	6.2	14.8	15.1	(28)	8.9	7.4	16.6	15.1	
Markets	0.1	0.1	0.5	0.2	34	3.2	3.2	11.4	11.1	30	3.3	3.3	11.9	11.3	
Total RCR	20.7	6.6	10.8	0.5	1,053	14.7	14.3	32.7	34.6	(211)	35.4	20.9	43.5	35.1	
1 January 2014															
Ulster Bank	14.8	3.7	7.6	0.2	738	1.4	1.1	1.3	3.1	(179)	16.2	4.8	8.9	3.3	
Real Estate Finance	7.2	4.2	6.1	0.3	580	5.8	5.3	12.5	13.2	(75)	13.0	9.5	18.6	13.5	
Corporate	3.3	1.7	2.9	0.2	269	8.1	8.1	18.2	16.2	208	11.4	9.8	21.1	16.4	
Markets	0.2	0.1	0.6	-	58	4.7	4.7	15.8	13.5	233	4.9	4.8	16.4	13.5	
Total RCR	25.5	9.7	17.2	0.7	1,645	20.0	19.2	47.8	46.0	187	45.5	28.9	65.0	46.7	

Notes:

(1) Performing assets are those with an internal asset quality band of AQ1 - A9; and non-performing assets are in AQ10 with a probability of default being 100%.
(2) RWA equivalent (RWAe) is an internal metric that measures the equity capital employed in segments. RWAe converts both performing and non-performing exposures into a consistent capital measure, being the sum of the regulatory RWAs and the regulatory capital deductions, the latter converted to RWAe by applying a multiplier. RBS applies a CET1 ratio of 10% for RCR; this results in an end point CRR RWAe conversion multiplier of 10.
(3) The most significant component of capital deductions relate to expected loss less impairment provisions of £518 million (30 June 2014 - £823 million; 1 January 2014 - £1,774 million). The negative capital deductions for performing exposures are a result of the latent loss provisions held in respect of the performing portfolio.

RBS Capital Resolution

Funded assets						
	Beginning					**End of**
	of period	Repayments	Disposals (1)	Impairments	Other	**period**
Year ended 31 December 2014	£bn	£bn	£bn	£bn	£bn	**£bn**
Ulster Bank	4.8	(0.2)	(2.8)	1.1	(0.3)	**2.6**
Real Estate Finance	9.5	(2.3)	(2.9)	0.1	(0.2)	**4.2**
Corporate	9.8	(2.3)	(1.9)	-	0.2	**5.8**
Markets	4.8	(1.1)	(1.5)	-	0.1	**2.3**
Total	28.9	(5.9)	(9.1)	1.2	(0.2)	**14.9**
Quarter ended 31 December 2014						
Ulster Bank	2.9	-	(1.0)	0.7	-	**2.6**
Real Estate Finance	5.4	(0.2)	(1.0)	-	-	**4.2**
Corporate	6.7	(0.2)	(0.8)	-	0.1	**5.8**
Markets	2.9	(0.1)	(0.5)	-	-	**2.3**
Total	17.9	(0.5)	(3.3)	0.7	0.1	**14.9**
Quarter ended 30 September 2014						
Ulster Bank	3.5	-	(0.8)	0.4	(0.2)	2.9
Real Estate Finance	6.7	(0.5)	(0.8)	0.1	(0.1)	5.4
Corporate	7.4	(0.6)	(0.4)	0.1	0.2	6.7
Markets	3.3	(0.4)	(0.1)	-	0.1	2.9
Total	20.9	(1.5)	(2.1)	0.6	-	17.9

Risk-weighted assets						
	Beginning			Risk		Other (3)	**End of**