Annual Report 2002

Rolls-Royce

1003142

Shareholder enquiries
Computershare Investor Services PLC
P O Box 82, The Pavilions
Bridgwater Road
Bristol BS99 7NH

Helpline
0870 702 0111

Rolls-Royce plc
Registered office:
65 Buckingham Gate
London SW1E 6AT

Telephone
020 7222 9020

Website
www.rolls-royce.com

Company number
1003142

Trent programme life-cycle and technology benefits

The aero Trent programme in our civil business, exemplifies our ability to maximise our research and development investments. We seek to invest once in creating technologies and methods but use these many times. We have spin-off programmes from the Trent in our defence, marine and energy businesses.

Technology spin-offs

40+ Years

Wide chord swept fan

Low NOx combustors

Low noise intakes

3D compressor designs

New high temperature alloys

Advanced predictive methods

Advanced single-crystal blades

Year of entry into service 1995 1996

Research and Development

We continue to place significant emphasis on research and development. Our long-term vision for this activity is set out in a structured approach over five, ten and 20-year time frames.

Trent 772

Trent 768
Trent 875
Trent 877

Trent 884
Trent 892

Trent 895

Trent 556
Trent 553

Trent 900

Aftermarket services

After a gas turbine enters service it can be in use for 40 years or more and as such the aftermarket is an extremely important area of our customer relationship. Our services activity is growing, with a global overhaul network – the latest addition to which is our joint venture with Lufthansa – and innovative e-business products being introduced. Our TotalCare packages are winning major contracts from key customers.

1997 2000 2002 2006

Product spin-offs from the Trent programme

MT30 Marine Trent
Derived from the Trent 800, this marine engine ran for the first time in 2002.

MT50 Marine Trent
This 50MW gas turbine is ideal for large high-speed transports or large naval ships.

Industrial Trent
The world's most powerful and efficient aero derivative gas turbine for power generation.

JSF engine
The F136 interchangeable engine for the Joint Strike Fighter (JSF) embodies world-leading technology drawn from the Trent.

Fuel cells
Civil aerospace technology from the Trent programme is also being used to develop world-leading fuel cell technology for the environmentally friendly generation of electricity.

Company profile

Rolls-Royce is a global company providing power for land, sea and air. The company has a balanced business portfolio with leading positions in civil aerospace, defence, marine and energy markets.

There are now some 54,000 Rolls-Royce gas turbines in service and these generate high-value services throughout their operational lives. Rolls-Royce is a technology leader, employing some 37,000 people and operating from 48 countries.

£5,788m
Group turnover

£255m
Underlying profit*

£17.1bn
Order book (firm and announced)

£1,090m
Average net debt

£595m
Year end net debt

Group financial highlights

For the year ended December 31, 2002	2002	2001
Group turnover	**£5,788m**	£6,328m
Underlying profit before taxation*	**£255m**	£475m
Firm order book	**£16.2bn**	£14.4bn
Return on capital employed	**10.5%**	19.3%
Equity shareholders' funds	**£2,035m**	£2,068m
Earnings per ordinary share:		
Underlying*	**11.10p**	20.20p
Basic	**3.29p**	6.67p
Dividend per ordinary share	**8.18p**	8.18p

* excluding exceptional and non-trading items, defined in note 2.

olls-Royce is well placed to manage
ne uncertainties of the short term
nd to secure shareholder value.
)ur achievements in the past decade
ave been formidable.

Rolls-Royce strategy

Group

£5,788m

Overview

Rolls-Royce operates in four global markets and invests in technology and capabilities that can be exploited in each of these sectors.

The Group order book is strong and the guidance we gave following the events of September 11 was broadly correct. We have made significant improvements in delivery performance, manufacturing lead time and costs.

Highlights

- Dealt effectively with the consequences of September 11.
- Aftermarket revenues and order book at record levels.
- Prudent financial management.

Civil aerospace

£2,739m

Overview

Deliveries of engines were down but we maintained our market share at 30 per cent. This consolidated our position as a strong number two in civil engines.

Highlights

- Installed base of engines increased to 9,900.
- Youngest engine fleet in service.
- Trent 500 entered service on A340-600.
- 1,000th Tay engine delivered.
- Trent family continues to win new customers.
- More TotalCare business secured.
- Total flying hours down two per cent but Rolls-Royce fleet flying hours up seven per cent.

Mike Terrett
President – Civil aerospace

Defence

£1,376m

Overview
Rolls-Royce has established its position as the number two defence aero engine manufacturer. We have a key presence in two of the world's largest combat aircraft programmes.

Highlights
- UK selects short take-off and vertical landing F-35 aircraft.
- Mission Ready Management Solutions (MRMS) continues to win business.
- Production of MTR390 helicopter engine started.
- Company received awards for performance in the US.

Colin Green
President – Defence aerospace

Marine

£984m

Overview
We have a world-leading position in cruise, fast vessel, naval and offshore markets. The marine business delivered steady growth during the year.

Highlights
- MT30 gas turbine for commercial and naval markets made successful first test run.
- Over 400 orders now achieved for the UT700 series ship design.
- Submarine business gave strong performance.
- Electrical systems capability enhanced.
- Developing a new high speed cargo vessel in Europe.

Dr Saul Lanyado
President – Marine

Energy

£639m

Overview
Our oil and gas business performed strongly. Offshore applications dominated the year's order intake. Business in power generation was slow.

Highlights
- Traditional markets were strong and new markets were secured in oil and gas.
- The Trent 60 now being marketed for sale.
- New Long-Term Service Agreements secured.
- Business re-structured and cost reduction processes introduced.

Tom Curley
President – Energy

Euan Baird
Chairman

he unstable political situation in the Middle ast, concerns about the spread of terrorism and ne deteriorating economic environment in the JS and Europe combined to make 2002 a very lifficult year for our civil aerospace customers. Jnless the Iraq crisis can be resolved quickly and leanly, 2003 will be equally challenging. In this ough environment our company has managed o produce very credible results, which were in ne with the forecasts we gave to the markets ust after the events of September 2001. This emarkable consistency, achieved in such a urbulent business environment, is a credit o the dedication and professionalism of the employees of Rolls-Royce.

2002 was also a year of change inside the company. First, Sir Ralph Robins announced his retirement from the company after 47 years. I believe it is no exaggeration to say that the company owes its very existence to his courage and leadership. During his term as Chairman, Sir Ralph has led the company's transformation into a leading global gas turbine business. I know you will all join me in wishing him and his family all health and happiness in the future. Second, Andrew Shilston was appointed Finance Director on January 1, 2003. Andrew was previously Finance Director of Enterprise Oil and he replaces Paul Heiden who, after ten years of invaluable service, left the company to become CEO at the engineering group FKI. Finally, Group Marketing Director Richard Turner retired in June 2002 after more than 30 years with the company. On behalf of the Board I would like to wish him a long and happy retirement.

My appointment as non-executive Chairman became effective on February 1, 2003. Previously, I had been with Schlumberger Ltd for more than 40 years and was its Chairman and CEO for 16 years. I have had the enormous satisfaction of being one of the principal architects behind turning a small family-owned company, with very specialised technology, into the global leader of its industry with 80,000 employees working in more than 100 countries. An impressive growth story achieved with negligible dilution of the original shareholders.

I am very respectful of the legacy and opportunities that the Ralph Robins generation has bequeathed to Rolls-Royce. The company has established an enviable position in the markets it serves. Our top priority is to convert these strengths into shareholder value.

We were all delighted that John Rose's achievements were appropriately recognised in the Queen's 2003 New Year's Honours list and I am looking forward to helping Sir John and his team as they work to improve further the performance of the company.

Euan Baird
Chairman
March 3, 2003

Sir John Rose
Chief Executive

In 2002, despite challenging conditions in civil aerospace we delivered in line with our guidance and continued to position the company for growth. We can report a sound order book, excellent progress with our restructuring programme and strong operating cash performance.

Our risk management process proved effective. Charges in respect of financing obligations and asset impairment were contained within guidance and we have taken a prudent approach in the area of provisions and charges. We ended the year with high levels of liquidity and reserves.

Following the tragic events of September 11, 2001, we had to adjust expectations radically, particularly in the civil aerospace sector, and respond to the changed circumstances. With the benefit of nearly 18 months hindsight, it is clear that the planning assumptions that underpinned our guidance, first issued on October 19, 2001, were broadly correct for 2002.

Since October 2001, two additional factors have increasingly influenced our assumptions about future performance: first, the uncertainties associated with the situation in Iraq and secondly, the impact of depressed financial markets and actuarial assumptions on the funding requirements for our pension funds. We are taking all reasonable actions to mitigate the impact of both.

Encouragingly, order intake at £8.7 billion remained strong during 2002. The firm order book was £16.2 billion (2001 £14.4 billion) at the year-end, with a further £0.9 billion of business announced. Turnover at £5,788 million was nine per cent less than in 2001 and underlying profit at £255 million* was in line with guidance. The year-end net debt balance was £595 million (2001 £501 million) with an average net debt balance of £1,090 million (2001 £990 million).

Operational performance
Since October 2001, we have resized the business to balance load and capacity. Despite the major changes in load and mix and the consequent rescheduling, we have achieved significant improvements in delivery performance, manufacturing lead time and operating cost.

The successful implementation in 2001 of our new Enterprise Resource Planning system, SAP, has provided a very effective tool for managing changes in demand. We have continued to restructure our supply chain and successfully completed pilots which confirm significant inventory reduction is achievable. Working capital was controlled effectively in 2002, reducing as a proportion of sales from 10.5 per cent to 6.8 per cent.

The company has implemented the restructuring programme announced in 2001, achieving a net headcount reduction of 4,900 during 2002, with a further 900 employees due to leave in the early part of 2003. The company is on target to achieve annual cost savings of £250 million from this programme. The headcount is expected to be reduced to around 35,000 by the year-end, with further restructuring charges of approximately £50 million in 2003. Overall, operating costs were ten per cent lower and overtime levels were significantly reduced compared to 2001.

* excluding exceptional and non-trading items, defined in note 2.

this activity was completed without any industrial ruption and with only temporary reductions productivity.

hank all our employees for their continued amwork, commitment and cooperation during is difficult period.

usiness model

lls-Royce operates in four global markets and invests technology and capability that can be exploited in ch of these sectors to create a competitive range products and services.

e success of these investments is demonstrated by ur gains in market share over recent years. We now ve an installed base of 54,000 gas turbine engines in rvice across all our businesses. The knowledge based vestments in product, capability and infrastructure gain this market position, have created high barriers entry. Successful implementation of the company's rvice strategy has enabled it to increase its aftermarket venues by 60 per cent (including joint ventures) er the last five years.

e large installed base of engines will generate an sured aftermarket demand for the provision of are parts and services. Our strategy continues to e to maximise aftermarket revenues through the evelopment of a comprehensive services capability. e installed base of engines, represents an annuity r the business and provides visibility as to future tivity levels. Aftermarket services revenues, at .5 billion, accounted for 44 per cent of sales in 2002.

rther visibility is provided through the substantial rward order book, which represents approximately ree years of Group sales.

alanced business

e benefits of our consistent strategy were evident in 02 as we continued to develop each of our businesses d position Rolls-Royce for long-term growth.

civil aerospace, despite the difficulties in the sector, e continued to broaden our customer base and were couraged by the continuing level of order activity. e have established ourselves as a clear number two the global civil aero-engine market, having won per cent of the market over the past three years. e have a well balanced civil business benefiting from e acquisition of the Allison Engine Company, in 1995, hich established our strong presence in the regional line sector. Despite the two per cent drop in the overall obal fleet flying hours in 2002, the Rolls-Royce fleet ing hours increased by seven per cent. Our young d growing installed base of civil engines provided edictable aftermarket revenue in 2002 and will enerate an increasing revenue contribution with e continuing growth and maturity of the engines service. This reflects the recent deliveries and the 2 year average age of the in-service fleet.

We have established a strong position in the defence aerospace sector. We serve 160 customers worldwide and are well placed on many of the world's major new programmes. The US Department of Defense is now our largest customer in this sector and we participate in five of its top nine aero programmes. The integrated nature of our business activities enables the transfer of capabilities from one sector to another. Our success in the Joint Strike Fighter is in no small part due to technology developed in the Trent programme and also builds on our strong US presence, following the Allison acquisition.

Our defence customers are benefiting from products and services that have been developed in the civil aerospace sector. Building on the success of TotalCare packages, strong progress has been made on long-term contracting for product support (Mission Ready Management Solutions) in the defence market.

The marine sector continues to build on the acquisition of Vickers to offer a more complete propulsion system capability than any competitor. There is also growing and tangible evidence of the benefits of our increased scope of supply in both naval and commercial markets. For instance, sales of Kamewa propulsion products into the naval sector have quadrupled. Aerospace technology is also being exploited in the marine sector. The marinisation of the Trent has been a successful programme, generating strong interest in naval and commercial marine markets. The MT30 has 80 per cent commonality, by parts count, with the Trent 800 civil aero engine and has recently been chosen by the US Navy for the Engineering Development Model of their DD(X) destroyer programme. It is also nominated for the UK Carrier programme and generating interest in the commercial marine sector.

We expect our energy business to return to profitability in 2003. The oil and gas sector remained strong in 2002, based on the well-proven industrialised RB211 and our successful acquisition in 1999 of the Cooper Energy compressor business. The financial performance of the energy business in 2002 was dominated by the significant additional costs of development work on the industrial Trent and Allen 5000. The industrial Trent situation was exacerbated by the consequential costs associated with the failure to meet in-service operational criteria. We now have a compliant and competitive product and are retro-fitting existing Trent facilities.

Aftermarket

All the company's businesses provide significant aftermarket services opportunities, with 54,000 gas turbines in service. We have continued to expand the scope of our services from traditional support, such as spare parts supply, to enhanced services such as engine health monitoring and predictive maintenance. Our competitive advantage in the provision of these services is derived from our unique knowledge of our products and the proprietary technology we have embedded in them. This has enabled us to offer tailored support packages, such as TotalCare and Mission Ready Management Solutions.

In 2002 we announced £2 billion of long-term support contracts and we have recently announced the 150th customer for **aeromanager.com**, our engine maintenance e-business portal. Aftermarket sales, including joint ventures, have increased from £1.9 billion to £3 billion over the last five years, benefiting from our growing installed base of engines and the successful acquisition in 1999 of National Airmotive and its integration into our extensive global network of repair and overhaul facilities and joint ventures.

Focus
During the year, we have continued to dispose of non-core activities. This process will be largely complete by the end of 2003. The most significant disposal during 2002 was that of Vickers Defence Systems (VDS) to Alvis. Overall VDS made a much better than anticipated contribution to both profit and cash flow during the period of ownership. The Vickers acquisition is now wholly focused on marine activities and has enabled us to create value by building a world-leading marine propulsion business.

We have continued to develop the senior management team and introduce new talent from outside the company. During the year, we recruited senior people from, among others, Alstom, EADS, Enterprise Oil, and GlaxoSmithKline. Forty per cent of the Group Executive have joined us from other companies in the last five years. In total, we now employ 37,300 people, of which approximately 22,000 are in the UK and 15,000 overseas. Our workforce comprises 40 nationalities in 48 countries.

Sustainability
We are clear about our obligations to the environment, our workforce, our communities and to society in general. Perhaps the most significant impact we can make is to run a successful business that supports 37,300 employees and spends £1.5 billion on salaries and benefits for its employees and £3 billion on purchases from 7,000 suppliers. Through the multiplier effect, one job in Rolls-Royce sustains a further 4.9 jobs worldwide. We therefore participate financially and through our encouragement of the individual efforts of our workforce who contribute their time and expertise in the communities in which we are present. A high proportion of Rolls-Royce employees takes advantage of the opportunity we offer to make charitable donations through payroll-giving.

Rolls-Royce products provide reliable, affordable power and play an important role in a sustainable society. Our gas turbine engines are integral to commercial air travel which underpins global trade and business, and benefits economies through increased tourism. In global defence markets our engines contribute to the security of nations and support humanitarian missions. Our products provide heat, light and power to developed and developing countries and our marine products support more than 20,000 commercial and naval vessels in a wide number of industries. We are investing in new technologies, such as fuel cells which will offer significant efficiency and greenhouse gas advantages for the distributed generation of electricity.

Our environmental record is a good one and is underpinned by our investments in research and technology to ensure we continue to improve product and operational performance.

For several years, Rolls-Royce has been actively participating with the HRH Prince of Wales Business in the Environment Programme which explores solutions for business to respond to the sustainability challenge. As a measure of our own progress in this area, I was particularly pleased that in 2002 we were admitted to the Dow Jones Sustainability Index.

Prospects and priorities
Rolls-Royce is well placed to manage the uncertainties of the short term and to secure shareholder value. Our achievements in the past decade have been formidable. They have been founded on the significant investments in technology, product, capability and capacity which have enabled us to access long-term global markets and develop a substantial and diverse installed base. Our opportunity in the next decade will be influenced by decisions taken in the last. In this respect, I would like to pay tribute to Sir Ralph Robins who led the company through this period of transformation and laid the foundations of our future success.

Over the next decade the emphasis of our investment will inevitably change. We will continue to focus our expenditure on technology acquisition, which we have doubled in the past decade, and in support of new product development and in-service improvements. The pace of new product development has slowed, particularly in civil aerospace where fewer new aircraft are now being developed. While we will continue to develop new products that deliver value, the priority has therefore shifted to unit cost reduction, development of derivatives, improvement of in-service operation and the creation of capabilities which increase the scope and value of our service activities.

Rolls-Royce is in a sound financial position. At the year end, gearing stood at 29 per cent and total committed borrowing facilities amounted to £2.6 billion. The company's foreign exchange hedging policy minimises the impact of fluctuations in exchange rates. Total US dollar cover currently amounts to five years' net US dollar income.

For 2003, our priority is to manage uncertainty, in particular the consequences of any action in Iraq, and mitigate the impact of additional pension funding requirements. To do so we will build on the experience of 2001/2002 and continue our rationalisation activities with a particular focus on unit cost reduction, quality and supply chain restructuring. We will continue to refine our information technology platform to ensure that it is an effective and affordable enabler of our business, both operationally and in support of our portfolio of service products.

Our performance in 2002 has reinforced our confidence in the business model and our ability to manage the unexpected.

Rolls-Royce strategy at work

Addressing four global markets
The markets in which we operate are global and we continue to develop our position of strength in each:

Civil aerospace
World number two, consistently gaining over 30 per cent of the available business. There are 9,900 large Rolls-Royce jet engines in service.

Defence aerospace
World number two with 26 per cent of military engines currently installed. We have a leading position in Europe and have a 25 per cent share of the planned US Department of Defense aero engine purchases.

Marine
World number one in marine propulsion with the widest range of marine products on the market. We provide fully integrated systems and have an extensive global sales and customer support network.

Energy
World leader in provision of power to the oil and gas industry. We continue to develop new products to address the power generation market. Advanced low emissions technology on latest versions of the RB211 and on the industrial Trent.

perations

ur performance in 2002 was characterised by sharply nproved control in an environment where factory loads d product related procurement volumes were more an 30 per cent below the previous year. Operating sts were successfully reduced and significant nprovements in delivery performance, manufacturing d procurement lead times and product unit costs ere delivered. Operations were re-sized to match pacity with post-September 11 load and further ogress was made in the implementation of our ake/buy strategy. Changes were implemented faster an ever before and without any industrial disruption. this context I wish to pay tribute to the teamwork our entire workforce.

ur new Enterprise Resource Planning system (SAP) as central to our new capabilities. 2002 was its first ll year of operation in the UK and it is now universal our gas turbine operations. Scheduling can now be fected rapidly and parts delivery performance has een transformed. Lead times have been reduced nd this is leading to improved inventory performance. 2002, production inventories fell by some 19 per cent nd inventory turns improved by 23 per cent.

ogress was made in the rationalisation of facilities, articularly in the UK. Some smaller facilities were osed whilst construction work commenced on a ew factory at Inchinnan near Glasgow to replace e ageing Hillington facility. Operations will commence Inchinnan in the spring of 2003 with significant nprovements in working practices. These have been hieved through agreement with the workforce gether with process flow design which has been ded by Toyota Machine Works.

number of significant new agreements were reached ith our workforce in 2002. These generally combine exibility with team based working and are key to hieving our targeted productivity levels.

We introduced the Rolls-Royce Production System, a new standard set of principles and processes which will ensure greater consistency in our manufacturing operations around the world.

A key priority in 2002 has been the realisation of cost reduction programmes in the global supply chain, including the consolidation of major global commodity groups, cost improvement workshops and early supplier involvement in new product launch programmes. We also launched our Supply Chain Restructuring initiative, which is aimed at simplifying the complex supply chain that has developed over time. This process, which is initially focused on the Trent 500, will reduce the number of suppliers involved in each engine programme and consequently the number of transactions involved in making each engine.

Manufacturing lead times reduced in 2002 as a result of these combined improvement initiatives focused upon our 40-Day Engine goal.

Our participation in Exostar, the aerospace and defence industry's electronic trading exchange, has led to the achievement of significant improvements in the efficiency of critical transactional processes. More than 600 suppliers are now able to access key Rolls-Royce information, such as schedules and invoices status, via the internet.

In 2003 our priority will be to accelerate implementation of our improvement initiatives in order to secure unit cost reductions. We will maintain a strong focus on quality and will preserve long-term capability in the face of the significant uncertainty in the marketplace.

John Cheffins
Chief Operating Officer

Technology

During 2002, Rolls-Royce invested £590 million in research and development, continuing the policy of investing once, but using the results many times in our different markets. As the emphasis shifts from new product development to unit cost reduction and the development of the company's service activities, the company will retain a long-term vision for its research and technology activity. This vision has been set out in a strategy outlining a structured approach to developing technology for specific generations of products and services in five, ten and 20-year time frames.

The five-year time frame, Vision5, describes the technologies that we currently have available 'off-the-shelf'. These will be incorporated into our new products and services, such as the Trent 900 and the MT30 marine gas turbine. Some existing engines, such as the RB211-524G/H-T and the Trent 800, will be modified to incorporate these proven technologies where appropriate. The introduction of new technology into existing products is a key part of our strategy of keeping them constantly up to date.

The Joint Strike Fighter is an example of our Vision5 strategy where our proven expertise in short take-off and vertical landing technology is being applied to the world's largest fighter aircraft programme.

In marine the emphasis will be on developing our capability in electrical systems and building on our strength in hydrodynamics, while in energy the focus will be on reduced emissions with fuel flexibility.

We are continuing to develop our advanced solid oxide fuel cell technology, complemented by our gas turbine technology, systems integration skills and routes to market. Such fuel cells offer significant efficiency and greenhouse gas advantages for the distributed generation of electricity. We are currently running a programme to demonstrate our capability of installing a 1MW generator within a standard shipping container.

The ten-year time frame is outlined in Vision10 which describes the range of technologies currently at the validation stage and which will eventually be included in our range of products and services. Significant demonstration programmes are aimed at reducing noise and emissions from civil aircraft engines.

One such is the Affordable Near Term Low Emissions (ANTLE) engine which is being developed as part of a European Union programme led by Rolls-Royce and also supported by the UK Government. ANTLE will incorporate a range of technologies such as engine health monitoring and a lean burn combustor, validated on a Trent 500-style engine, and will be available for commercial use by 2008.

In defence aerospace, work is continuing on the development of propulsion systems for unmanned aerial vehicles, which are seen as the likely successors to today's military aircraft.

Advanced waterjets, which offer high-efficiency performance over a broad operating range, are being developed for marine applications.

Vision20 describes the range of technologies aimed at the 20-year time frame. These technologies are currently at the strategic research stage and include emerging or as yet unproven technologies such as advanced materials and intelligent systems for engine health monitoring. This focused approach promotes the research and development of specific technologies through our extensive research base.

This includes our network of University Technology Centres (UTCs) which was expanded in 2002 with the opening of a new centre at Chalmers University in Sweden for research into hydrodynamics. Since then we have opened the first UTC in North America at Purdue University in Indiana which will research technologies for future aircraft that use high Mach propulsion systems to travel as fast as seven times the speed of sound.

Our Vision20 technologies will make a major contribution towards achieving the Advisory Council for Aeronautic Research in Europe (ACARE) goals. This European initiative is aimed at halving the current perceived noise levels created by aircraft; halving the amount of CO produced per passenger kilometre; and cutting by 80 per cent the amount of NOx produced by aircraft.

In the marine business Vision20 will include further advances in electric technologies. This will lead to high efficiency electric systems combined with clean gas turbines, providing very high levels of energy recovery through regeneration.

Dr Michael Howse
Director – Engineering and Technology

vil aerospace
civil aerospace we have established ourselves as the ear number two aero engine manufacturer, having on 30 per cent of the market over the past three years. 2002, we were encouraged by the continuing level order activity among our customer base, although the epressed performance of the US airline sector continues impact sentiment and orders. The overcapacity in the arket must be resolved before we return to the level engine deliveries that we achieved in 2001.

2002, we delivered 856 engines (2001 1,362 engines) 56 airlines and 93 corporate customers. Whilst engine eliveries were down by 37 per cent against 2001, the stalled base of civil jet engines in service grew to 9,900. ur aftermarket sales were in line with our forecasts, £1.25 billion with long-term contracts worth £2 billion gned with 50 customers. Despite the two per cent op in overall flying hours, the Rolls-Royce fleet flying ours increased by seven per cent. This reflects the cent deliveries and the 8.2 year average age of the -service fleet.

the end of 2002 there were 2,000 parked aircraft, which 19 per cent were Rolls-Royce powered. e expect approximately half of these Rolls-Royce owered aircraft to return to service.

he Trent family continues to be successful in the high-rust segment with nearly 1,600 engines ordered by otal of 39 customers. New Trent customers included enya Airways for the Trent 800 on their Boeing 777s nd Middle East Airlines who chose Trent 700s for eir new Airbus A330 fleet.

The Trent 500 made its maiden development flight on the ultra-long-distance Airbus A340-500 before entering commercial service on the higher-capacity Airbus A340-600 with Virgin Atlantic in August.

At the year-end, preparations were well advanced for first build of the Trent 900 being developed for the Airbus A380 superjumbo. The Trent 900 is lead engine for the Airbus A380 and has secured 57 per cent of firm and option orders announced to date.

In the corporate sector, we delivered the 1,000th Tay engine for the 500th Gulfstream GIV.

We continued to develop our services activity. The recently announced joint venture with Lufthansa will further expand our Trent repair and overhaul network. This followed our success in winning orders for the Trent 500, 700 and 900 to power Lufthansa's new fleet of wide-bodied aircraft.

We introduced CorporateCare, the equivalent of TotalCare packages for the corporate aircraft sector and signed our 150th customer for **aero**manager.com, our e-business portal for engine services.

Rolls-Royce strategy at work

Investing in technology, capability and infrastructure
We have developed Trent civil aero technology for the new MT30 and MT50 marine gas turbines. These are world-class products, offering us new capabilities in the marine market.

Rolls-Royce is developing its position as the customers' partner for marine system solutions. The company offers the widest product range on the market, matched with in-service support through over 30 offices in our global service network.

As well as gas turbine, diesel and nuclear prime movers, Rolls-Royce marine equipment includes: propellers, thrusters, steering gear, stabilisers, waterjets, bearings, deck machinery, automated control and monitoring systems, and complete vessel designs.

This extensive product portfolio, service infrastructure and integrated systems mean we can provide a complete solution for customers from concept studies to design, equipment selection, interface management and in-service support.

Powering 39 out of the world's top 50 airlines

The Trent aero engine family is the most successful large engine family available today. Trent engines are the market leaders on the new generation of widebody aircraft.

The latest member, the Trent 500, entered service in 2002 and the Trent 900 for the new Airbus A380 is currently in development.

efence aerospace

lls-Royce further consolidated its position as the mber two defence aero engine manufacturer rough its strong positions on many of the world's w programmes, covering sectors from combat d trainer aircraft to transport, unmanned aerial rveillance, maritime patrol and helicopters.

e are a key partner in two of the world's largest mbat programmes, the Joint Strike Fighter (JSF) d the Eurofighter.

lls-Royce has unique experience of vertical take-off chnology and is responsible for the short take-off and rtical landing (STOVL) capability for JSF. We anticipate oduction revenue of approximately US$3 billion from successful UK/US JSF STOVL production programme. 2002, this programme took a major step forward when e UK Ministry of Defence (MoD) announced it would ke up to 150 STOVL F-35 JSF aircraft. We are also 40 per cent partner in the interchangeable main opulsion engine, the F136. The JSF design embodies orld-leading new technologies, including some of ose originally developed for the Trent civil aero engine. is programme will keep Rolls-Royce at the forefront advanced propulsion development and maintain ur leadership in this market. Development work during e year met all goals.

lls-Royce is also a major partner in the European llaboration which is responsible for the EJ200 engine r Eurofighter. The first production Eurofighter Typhoon craft flew powered by production EJ200 engines. e expect engine deliveries to grow over the next w years.

Rolls-Royce produces one of the broadest helicopter engine ranges available in the world, with 18,000 turboshaft engines in civil and military service and 160 million flying hours accumulated. Milestones in the helicopter market in 2002 included delivery of the first production MTR390s to Eurocopter and the completion of the initial two flights of the first Fire Scout unmanned helicopter, powered by the Model 250.

The defence business has a total of 34,000 aero engines in service, representing a significant aftermarket opportunity. We continued our focus on the provision of services, building upon the capabilities that we have developed in other sectors. A number of Mission Ready Management Solutions (MRMS) contracts were signed in 2002, including a Gnome agreement with the UK MoD and an AE 2100D Fleet Hour Agreement with the US Marine Corps in support of its growing KC-130J fleet. The US Navy announced its selection of Rolls-Royce as the provider of full contractor logistic support and engine maintenance for its F405 (Adour) engines fitted to its T-45 aircraft.

Our continuing drive for operational improvement was recognised by our customers. The US Defense Contracts Management Agency (DCMA) honoured the company with the inaugural Hubert Homer Award, given to the defense contractor who demonstrates the highest level of performance improvement while exhibiting desired teaming behaviours. For the sixth time, Rolls-Royce received the prestigious US Collier Trophy, this time as a member of the JSF–Liftfan Propulsion System Team. Tinker Air Force Base honoured the T56 Program Office as Supplier of the Year for significant operational achievements.

Rolls-Royce strategy at work

Developing a competitive product portfolio

The industrial RB211 has been upgraded with the introduction of new Trent technology. This engine, now rated at 33MW, also incorporates the latest DLE (dry low emissions) combustors achieving 25vppm, NOx and CO levels.

Our industrial Trent engine will also provide low emissions and is the most powerful and efficient aeroderivative gas turbine on the market.

We are strong in oil and gas and well placed to grow our power generation business as this market recovers.

These advanced products, coupled with the capabilities we have in producing gas compressors, control systems and innovative services such as Long-Term Service Agreements, mean that Rolls-Royce has a comprehensive capability in the energy market.

Services activities in our other businesses are also growing. For example, new e-business products such as **aeromanager.com** are operating in the civil area and through Data Systems & Solutions, our joint venture software company, we are providing engine health monitoring systems on Eurofighter for our defence business.

The power behind 160 armed forces

The company has unrivalled experience in vertical take-off technology which is being employed on programmes such as the F-35 JSF aircraft. The JSF design incorporates world-leading new technologies including some of those originally developed for the Trent civil aero engine.

arine
e marine business continued to deliver steady growth a competitive global marketplace. Our world-leading sition in cruise, fast vessel, naval and offshore oil d gas markets is based on the core strengths of the siness. We have a highly-skilled workforce, world-class chnological expertise and a comprehensive range products and capabilities.

e offshore oil and gas sector, which operates in cycles lated to oil and gas prices, held up well in 2002. Orders r the UT700 series of offshore support vessels reached 0. The ability to both design and equip these ships with r power, propulsion and motion control equipment ves us a unique systems capability.

e MT30 gas turbine is the first marine engine lls-Royce has developed for applications across both mmercial and naval markets. Based on the successful ent 800 aero engine, the MT30 has accumulated 200 urs of successful testing and is already attracting rong interest from potential customers. The engine as recently chosen by the US Navy for the Engineering evelopment Model of their DD(X) destroyer ogramme and is nominated for the UK Carrier ogramme. In addition we announced the joint evelopment of a new European High Speed Cargo essel with the Spanish shipbuilder and designer, Izar. e proposed monohull is intended to be powered two Rolls-Royce MT30 gas turbines and Rolls-Royce amewa waterjets.

The submarine propulsion business performed strongly and partnering with the UK Ministry of Defence (MoD) is delivering joint benefits. We have been able to develop new long-term support and service contracts with the MoD using experience gained in the civil aerospace business in providing TotalCare packages.

During 2002, the company's diesel business was restructured to allow it to play a full role in the supply of prime movers to a wide range of customers.

In line with regional shifts in shipbuilding, the marine business has continued to develop new markets in Asia while also pursuing new opportunities to grow our existing business in the United States.

During 2002 the marine organisation was further rationalised, a new President of the commercial sector was appointed and we formed a marine electrical systems group in order to further develop our power electronics and automation control capabilities for more electric vessels.

Rolls-Royce strategy at work

Growing market share
As the number two defence aero engine manufacturer in the world, we are a leading player in the defence arena.

Our range of defence aero products, strength in major markets such as the US and our developing service offering through Mission Ready Management Solutions (MRMS) is growing the Rolls-Royce position in this market sector. Through MRMS we are assisting customers by providing services tailored to their financial and operational needs.

Rolls-Royce has established strong positions on leading aircraft platforms in transport, trainer, combat, UAV and helicopter markets.

We have customers in 160 armed forces around the world.

We have also grown our market share in civil aerospace to establish ourselves as the number two in this market.

In marine systems we are an established number one and in energy we have a leading position in oil and gas and are growing in power generation.

World number one in marine propulsion systems

ergy
02 was another strong year for our oil and gas business. fshore applications dominated the year's order intake th RB211, Avon and 501 power and compression ckages sold to traditional markets such as Europe, orth America and Asia-Pacific. We also continued to crease our global installed base with sales to frontier and gas areas such as the Caspian Sea, West Africa d offshore Newfoundland. These emerging markets ll play an important role in the worldwide oil and as industry.

expected, 2002 was a slow year for independent ower generation. The industry is still weathering the termath of the September 11 tragedy, followed by e collapse of several major energy provider companies. owever, we have effectively used this time of slower arket activity to restructure our business, streamline ur business processes and reduce the cost and lead mes of our product offerings. This positions our usiness not only for the realities of today but also e anticipated market recovery.

evelopment of the industrial Trent 60 WLE (Wet Low missions) product was completed, and good progress as achieved on the retrofit programme for the new ent 50 DLE (Dry Low Emissions) industrial gas turbine, th the first unit now in service. The Trent is the most owerful and efficient aeroderivative gas turbine product the world and will play a significant role in the future owth of our power generation business. Although wholesale electricity prices are very depressed, it is nticipated that they will recover over the medium-term.

We are continuing to develop our advanced solid oxide fuel cell technology, complemented by our gas turbine technology, systems integration skills and routes to market.

In 2002, we continued our focus on service business growth by establishing a new unit focused on developing and marketing engineered equipment upgrades for all of our products. We also increased our focus on long-term service agreements which enable customers to achieve improved system availability. Technologies such as remote monitoring and diagnostics help ensure the success of these contracts. In 2002, revenues from such agreements increased by 52 per cent.

Our challenge for 2003 is to continue to drive cost reduction and improve processes in order to return the Rolls-Royce Energy business to profitability. We will capitalise on a currently strong oil and gas market, effectively position our power generation business, and continue to build our aftermarket business.

Rolls-Royce strategy at work

Capturing aftermarket and service opportunities
A US$200 million service agreement with South African Airways took the total civil engine service business signed in the 12-month period, to January 2003, to nearly £2 billion.

These TotalCare packages allow airlines to select from a menu of aftermarket services on an agreed scale of costs per flight hour. In these deals Rolls-Royce maintains the airline's engines on a planned maintenance basis on behalf of the customer.

Four Trent 500 TotalCare agreements have been signed so far, with China Eastern, Lufthansa, South African Airways and Virgin Atlantic. The value of the contracts is US$840 million. TotalCare deals were also signed last year with Air Canada and Cathay Pacific involving Trent 700 engines for their Airbus A330 fleets. These agreements were worth an additional US$780 million.

The company has a similar offering in the business jet market called CorporateCare. This is the most comprehensive engine care programme in corporate aviation and during 2002 orders totalling US$124 million were received from 34 new customers.

Our defence business customer service package is known as Mission Ready Management Solutions (MRMS) and in energy and marine we are providing Long-Term Service Agreements.

Clean energy using low emissions technology

We have low-emissions combustion systems for our latest industrial gas turbines. New products such as the industrial Trent also benefit from the latest technology derived from Trent aero engine programmes.

Andrew Shilston
Finance Director

n 2002 we met our targets in spite of lifficult market conditions. We ended ne year in a sound financial position, vith gearing of 29 per cent, committed oorrowing facilities of £2.6 billion, a ecord order book and US dollar cover mounting to five years' net US dollar ncome. Our risk management systems proved to be robust and a prudent pproach has been taken in the area of provisions and charges.

Results for the year

Underlying profit before tax was £255 million*, compared to £475 million in 2001.

Underlying earnings per share were 11.10p*(2001 20.20p).

Group turnover reduced by nine per cent to £5,788 million, largely as a result of the predicted decline in the civil aerospace sector.

- Civil aerospace engine deliveries declined by 37 per cent to 856 engines and the civil aftermarket was relatively stable, in line with our guidance.
- Defence turnover reduced somewhat as a result of declining sales in Vickers Defence Systems (VDS), due to the completion of the large Challenger 2 contract. VDS was sold to Alvis during the year.
- Marine sales grew by 19 per cent, reflecting the continuing strength of the offshore oil and gas support market sector.
- Energy sales increased by five per cent, reflecting a strong year for the oil and gas sector.

The Group is increasingly broadening its business base with engine deliveries in civil aerospace now accounting for only 25 per cent of turnover.

The company reinforced its position as a global business, with 85 per cent of sales to customers outside the UK.

Underlying trading margins, before risk and revenue sharing partner receipts and net research and development, reduced from 9.9 per cent to 7.5 per cent, as a result of the difficult trading conditions in the civil aerospace sector and a number of charges against asset values. All of the businesses continue to be focused on improving productivity, through factory rationalisation, changes in working practices and further outsourcing of production.

The net interest charge reduced from £119 million to £107 million. This reflected a higher proportion of floating rate debt compared to fixed interest rate debt.

Group interest was covered 4.1 times, based upon underlying profit before interest, excluding joint ventures.

The company has implemented the restructuring programme announced in 2001 without industrial disruption. At the end of 2002, the company headcount was 37,300, representing a net reduction of 4,900 during the year. As part of this programme a further 900 employees are due to leave in the early part of 2003. The company is therefore on target to achieve annual cost savings of £250 million from this restructuring exercise. The headcount is expected to be reduced to around 35,000 by the year-end, with further restructuring charges of approximately £50 million in 2003.

* excluding exceptional and non-trading items, defined in note 2.

The Group made an underlying profit before tax of £255 million (2001 £475 million).

After charging exceptional and non-trading items, profit before tax was £105 million (2001 £192 million).

Net working capital reduced as a percentage of sales, from 10.5 per cent to 6.8 per cent.

A final dividend of 5.0p per share is proposed, making a total of 8.18p per share for the year, (2001 8.18p). The dividend is covered 1.3 times by underlying earnings and 0.4 times after exceptional and non-trading items.

Included within underlying earnings were a number of charges taken against asset values:

- In the civil aerospace sector, charges against the profit and loss account in respect of aircraft values and an increase in the customer financing provision, amounted to £50 million. A further £23 million charge related to a financial guarantee to AFT, which is part of Pembroke Group, the company's aircraft leasing joint venture.
- In the energy sector, charges of £31 million were taken against the Allen 5000 diesel engine.
- In the financial services sector, impairment charges of £30 million were taken against industrial Trent power projects, reflecting current depressed electricity prices. In addition, a £12 million charge was taken relating to AFT's fleet of 29 Fokker aircraft.

Order book
The order book was £16.2 billion (2001 £14.4 billion). Items are included in the order book when a signed contract exists.

In civil aerospace it is common for a customer to take options for future orders in addition to firm orders placed. Such options are excluded from the order book until they become firm, signed orders.

In defence aerospace, long-term programmes are often ordered for only one year at a time. In such circumstances, even though there may be no alternative engine choice available to the customer, only the contracted business is included in the order book.

Long-Term Service Agreements, including TotalCare packages for aftermarket services, represented 21 per cent of the order book. These are long-term contracts where only the first seven years' revenue is included in the order book.

Business which has been announced but for which contracts have not yet been signed is excluded from the order book. This amounted to a further £0.9 billion at the year end (2001 £2.3 billion).

Aftermarket services
The company has been successful in selling TotalCare packages, covering long-term support for customers' engines. This is leading to an increase in long-term contracts where the engine maintenance agreement is linked to, and entered into, at the same time as the original equipment sale. In such cases, the original equipment sale and support activities, including the sale of spare parts, will form part of the same long-term contract. The pricing of such contracts differs from conventional engine sales and reflects the long-term nature of the contract. Profit is taken progressively on a prudent basis resulting in a net asset of £384 million on the balance sheet.

Cash
The Group cash flow statement is shown on pages 42 and 43 of the financial statements.

Net debt for the year increased by £94 million, to £595 million (2001 £501 million), after assuming £133 million additional debt relating to the purchase of six aircraft in connection with sales financing activities. The average net debt level increased by less than originally forecast from £990 million to £1,090 million.

The average net debt is expected to remain relatively level in 2003. This reflects the expected full year impact of the increased number of aircraft on the balance sheet.

Net cash flow from operating activities was £778 million, before £167 million which was expended on restructuring activities (2001 £504 million). Major uses of funds were capital expenditure including the acquisition of aircraft.

Taxation
The overall tax charge on the profit before tax was £52 million (2001 £86 million), a rate of 50 per cent (2001 45 per cent). This relatively high overall Group tax rate was primarily due to the impact of goodwill charged against profits for which no tax relief is available.

The rate was also affected by losses in certain overseas businesses for which tax relief will only be available against future profits in the same jurisdiction. No relief has been taken for such losses in the accounts.

The tax charge was reduced by £6 million in respect of the anticipated benefit of the UK research and development tax credit that was introduced with effect from April 1, 2002.

The tax charge on underlying profits was £76 million (2001 £154 million), a rate of 30 per cent (2001 32 per cent).

Acquisitions and disposals
During the year, the Group disposed of its interests in Vickers Defence Systems (see note 32). This is subject to agreement of the completion accounts, which may result in an adjustment to the disposal proceeds received. The Group also made a number of smaller acquisitions and disposals during the year.

nsions
hough the full implementation of FRS 17 (Post tirement Benefits) has been deferred pending the roduction of International Accounting Standards, rtain disclosures are required (see note 30). As for e 2001 accounts, this includes the value of pension heme assets and liabilities using the new rules ecified by FRS 17. Under this standard a snapshot is ken of pension fund assets and liabilities at a specific oint in time. Thus, movements in equity markets and scount rates are expected to create volatility in the lculation of scheme assets and liabilities. Additionally r 2002, a memorandum analysis of the profit and loss harge under FRS 17 is required.

ı this basis, at December 31, 2002, and after taking count of deferred taxation, for the UK schemes, there as a net shortfall of assets over respective liabilities nounting to £1,117 million (2001 £284 million). This eficit has been assessed at a point in time when equity arkets are depressed and discount rates are low, both which have a material impact on scheme valuations.

ıe deficit has had no impact on 2002 funding. The oup's funding requirements for the schemes are erived from triennial actuarial valuations, the next which is due to commence in March 2003. While e company intends to continue to provide a defined enefit scheme, it has commenced consultations with nployees over a number of other mitigating actions connection with the provision of pension benefits. ıe objective of these actions is to contain the additional nding costs within the guidance provided in 2002.

ıe shortfall, net of deferred tax, on overseas schemes nounted to £158 million (2001 £113 million), which nder current accounting standards, is substantially overed by existing provisions on the balance sheet.

vestments
ıe Group continues to subject all investments rigorous examination of risks and future cash flows ensure that they create shareholder value. All major vestments require Board approval.

ıe Group has a portfolio of projects at different ages of their life cycles. Discounted cash flow analysis the remaining life of projects is performed on a gular basis. Sales of engines in production are assessed gainst criteria in the original development programme ensure that overall value is enhanced.

oss research and development investment amounted £590 million (2001 £636 million). Net research and evelopment was £297 million (2001 £358 million). ıe reduction was largely attributable to the mix of oducts under development. Investment in training as maintained at £26 million (2001 £26 million).

Over the next decade the pace of new product development will slow, particularly in civil aerospace where fewer new aircraft are now being developed. The emphasis will be on unit cost reduction, development of derivatives, improvement of in-service operation and the creation of capabilities which increase the scope and value of the company's service activities.

Capital expenditure, was £344 million (2001 £221 million), which included the purchase of six aircraft.

Partnerships
The development of effective partnerships continues to be a key feature of the company's long-term strategy. Major partnerships are of two types: joint ventures and risk and revenue sharing partners.

Joint ventures
Joint ventures are an integral part of our business. They are involved in engineering and manufacturing, repair and overhaul, and financial services. They share risk and investment, bring expertise and access to markets, and provide external objectivity. Our joint ventures have become substantial businesses, as shown in the table opposite. A major proportion of the debt of the joint ventures is secured on the assets of the respective companies and is non-recourse to Rolls-Royce plc. The recourse financing obligations total £35 million and are included in contingent liabilities (see note 28).

Investment in the aircraft leasing and management joint venture, Pembroke, amounts to £30 million and substantially all of its debt is non-recourse to Rolls-Royce plc. The investment in a subsidiary of Pembroke, AFT, a company owning and leasing Fokker aircraft, was written off during the year.

Investment in the engine leasing joint venture, Rolls-Royce & Partners Finance amounts £21 million and all of its debt is non-recourse to Rolls-Royce plc.

Risk and revenue sharing partners (RRSPs)
RRSPs have enabled Rolls-Royce to build a broad portfolio of engines, thereby reducing the exposure of the business to individual product risk. The primary financial benefit is a reduction of the burden of research and development (R&D) expenditure on new programmes. The related R&D expenditure is expensed through the profit and loss account and the receipts from partners are also recorded in the profit and loss account, as other operating income.

RRSP agreements are a standard form of cooperation in the civil aero-engine industry. They bring benefits to the engine manufacturer and the partner. For the manufacturer they bring some or all of the following benefits: additional financial and engineering resource; sharing of risk; and initial programme investment contribution. As appropriate, the partner supplies components free of charge and subsequently receives a share of the long-term revenues generated by the engine programme in proportion to its purchased programme share.

Joint ventures Rolls-Royce share £m

	Repair and overhaul	Financial services	Engineering and manufacturing	Total
Gross assets	119	620	427	1,166
Debt	(50)	(511)	(55)	(616)
Other liabilities	(34)	(57)	(264)	(355)
Gross liabilities	(84)	(568)	(319)	(971)
Net assets	35	52	108	195

The sharing of risk is fundamental to RRSP agreements. In general, partners share financial investment in the programme; they share market risk as they receive their return from future sales; they share currency risk as their returns are denominated in US dollars; they share sales financing obligations; they share warranty costs; and, where they are manufacturing or development partners, they share technical and cost risk.

All receipts from RRSPs are recorded as 'other operating income'. Payments to RRSPs are recorded within cost of sales. In 2002 other operating income in respect of RRSP agreements amounted to £158 million (2001 £239 million). Payments to RRSPs, charged in cost of sales, amounted to £139 million (2001 £113 million). As new programme activity declines, payments which relate to existing programmes, will ultimately exceed receipts on new programmes.

Intangible assets

The Group carried forward £868 million of intangible assets. Purchased goodwill increased from £769 million to £786 million due mainly to exchange adjustments of £68 million exceeding annual amortisation of £52 million.

Engine certification costs carried forward amounted to £45 million.

Application engineering costs carried forward amounted to £37 million.

Risk management

The Board has established a structured approach to risk management. The risk committee of the Board has accountability for the system of risk management and reporting the key risks and associated mitigating actions. The Director of Operational Risk reports to the Finance Director. The Group's policy is to preserve the resources upon which its continuing reputation, viability and profitability are built, in order to enable the corporate objectives to be achieved through the operation of the Rolls-Royce business processes. Risks are formally identified and recorded in a corporate risk register, which is reviewed and updated on a regular basis, with risk mitigation plans identified for all significant risks.

Financial risk management

The Group uses various financial instruments in order to manage the exposures that arise from its business operations as a result of movements in financial markets. All treasury activities are focused on the management and hedging of risk. It is the Group policy not to trade financial instruments or to engage in speculative financial transactions. There have been no significant changes in the Group's policies in the last year.

The principal economic and market risks continue to be movements in foreign currency exchange rates, interest rates and commodity prices. The Board regularly reviews the Group's exposures and risk management and a specialist committee also considers these in detail. All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework described in the report of the directors.

The Group's policy is to monitor and manage its exposure to counterparties. Credit limits are set to cover all financial instruments for each counterparty. The Group's policy is that it is exposed only to those counterparties that have a long-term credit rating of A3/A- or better.

Funding and liquidity risk

The Group finances its operations through a mixture of shareholders' funds, bank borrowings, bonds, notes and finance leases. The Group borrows in the major global markets in a range of currencies. It employs derivatives where appropriate to generate the desired currency and interest rate profile.

During 2002 the Group, through the normal course of business, refinanced £923 million of borrowing facilities in a number of currencies and a range of maturities. As at December 31, 2002 the Group had total committed borrowing facilities of £2.6 billion. In January 2003 the Group concluded the last part of its current planned refinancing with the completion of a £103 million revolving credit facility.

Assuming no further refinancing activity the Group will have total borrowing facilities of £2.5 billion at December 31, 2003 and £1.9 billion at December 31, 2004.

The terms for the recently completed refinancings are substantially similar to the Group's previous facilities.

There are no rating triggers contained in any of the Group's facilities that could require the Group to accelerate or repay any facility for a given movement in the Group's credit rating and no material impact on the Group's interest charge is expected to arise from a movement in the Group's credit rating.

The Group holds financial investments and maintains undrawn committed facilities at a level sufficient to ensure the Group has available funds to meet its medium-term capital and funding obligations and to meet any unforeseen obligations and opportunities. The Group from time to time holds cash and short-term investments which, together with the undrawn committed facilities, enable the Group to manage its liquidity risk.

ırrency risk
e Group is exposed to movements in exchange ıes for both foreign currency transactions and the ınslation of net assets and profit and loss accounts foreign subsidiaries.

ıe Group does not hedge the translation effect of change rate movements on the profit and loss count or balance sheet as it regards its interest in ıerseas subsidiary companies as long-term investments.

ıe Group is exposed to a number of foreign currencies. ıe most significant transactional currency exposure is e US dollar followed by the Euro. US dollar income, net expenditure, represents 38 per cent of the UK turnover.

ıe Group operates a hedging policy using a variety financial instruments with the objective of minimising e impact of fluctuations in exchange rates on future ansactions and cash flows.

ıe permitted range of the amount of cover taken is etermined by the written policies set by the Board, ased on known and forecast income levels. The forward over is managed within the parameters of these policies order to achieve the Group's objectives, having regard the Group's view of long-term exchange rates. Forward over extends for periods of up to eight years and is in e form of standard foreign exchange contracts and struments on which the exchange rates achieved ay be dependent on future interest rates. The Group so writes currency options against a portion of the nhedged dollar income at a rate which is consistent ith the Group's long-term target rate. The premium ceived from the sale of the options is included in the roup's achieved exchange rate. Total US dollar cover pproximated to five years' net US dollar income at ecember 31, 2002 (2001 five years).

ıe consequence of this policy has been to maintain relatively stable long-term foreign exchange rate. ote 24, financial instruments, includes the impact of evaluing forward currency contracts at market values n December 31, 2002, showing an increase in value of 151 million. This figure, which for 2001 was a reduction in alue of £550 million, will fluctuate over time and have no ctual impact on the results. The Group has entered into ıese forward contracts as part of the hedging policy, escribed above, in order to mitigate the impact of olatile exchange rates.

nterest rate risk
ıe Group uses fixed rate bonds and floating rate debt s funding sources. The Group's policy is to maintain higher proportion of net debt at fixed rates of interest aving regard to the prevailing interest rate outlook. To nplement this policy the Group utilises a combination f interest rate swaps, forward rate agreements and nterest caps to manage the exposure.

Commodity risk
The Group has an ongoing exposure to the price of jet fuel arising from business operations. The Group's objective is to minimise the impact of price fluctuations. The exposure is hedged in accordance with parameters contained in a written policy set by the Board. Hedging is conducted using commodity swaps that extend for periods up to four years.

Sales financing
In connection with the sale of its products, the Group will on some occasions provide financing support for its customers. This may involve the Group guaranteeing financing for customers, providing asset value guarantees on aircraft for a proportion of their expected future value, or entering into leasing transactions.

The Group manages and monitors its sales finance related exposures to customers and products within written policies approved by the Board and within the internal framework described in the report of the directors. The permitted levels of gross and net exposure are limited in aggregate by counterparty, by product type and by calendar year.

The Board regularly reviews the Group's sales finance related exposures and risk management activities. Each financing commitment is subject to a credit and asset review process and prior approval by the Chief Executive, and Finance Director. The Group operates a sophisticated risk-pricing model to assess risk and exposure. Costs and exposures associated with providing financing support are incorporated in any decision to secure new business.

The Group's exposure management process falls into three phases:

1. minimising the level of exposure that is assumed by the Group from sales finance commitments through the use of third party non-recourse debt where appropriate or through other arrangements;
2. reducing the level of exposure that has been assumed by the Group through the transfer, sale, or re-insurance of risks; and
3. ensuring the proportionate flow down of risk and exposure to relevant risk and revenue sharing partners.

Each of the above forms an active part of the Group's exposure management process.

Where exposures arise, the strategy has been, and continues to be, to assume where possible liquid forms of financing commitment that may be sold or transferred to third parties when the opportunity arises.

Contingent liabilities
Note 28 to the accounts describes the Group's contingent liabilities under sales financing arrangements.

The gross contingent liability increased to £1,093 million (2001 £857 million), of which £35 million (2001 £78 million) relates to sales financing support provided to joint ventures. The gross contingent liability figure is calculated by aggregating the maximum exposure on all such sales financing commitments, before applying the value of the underlying security, but offsetting sums separately insured and sums provided for in the balance sheet. In 2002 provisions against customer financing exposures were increased by £31 million and £49 million of existing provisions were utilised. Provisions of £64 million were carried forward in respect of sales financing commitments (see note 22).

The Group's contingent liabilities are divided approximately 60/40 between asset value guarantees (AVGs) and credit guarantees. They spread over many years and relate to a number of customers and a broad product portfolio. The contingent liabilities represent the maximum aggregate gross and net exposure that the Group has in respect of delivered aircraft, regardless of the point in time at which such exposures may arise. Exposures are not reduced to a net present value for the purposes of reporting the Group's contingent liabilities.

The Group uses Airclaims Limited as an independent appraiser to value its security portfolio at both the half-year and year-end. Airclaims provides specific values (both current and forecast future values) for each asset in the security portfolio. These values are then used to assess the Group's net exposure. They incorporate Airclaims' assessment of the current depressed level of aircraft values.

After taking account of the underlying security, the Group's net contingent liability decreased to £186 million (2001 £206 million). The year on year movement in reported contingent liabilities reflects the utilisation of sales finance commitments in the last year, the attrition of existing contingent liabilities through natural debt retirement or risk transfer, and, additionally in the case of net contingent liabilities, the changes in the level, form, and value of any underlying security.

In reporting the Group's contingent liability with respect to sales financing, the Group includes a net exposure stress test which incorporates the impact of a 20 per cent fall in the value of all securities compared to the Airclaims current and future values. This represents a cautious view, as the Airclaims' values already reflect the current depressed market. Application of this stress test results in a net contingent liability of £251 million (2001 £283 million).

The directors regard the possibility that there will be any significant loss arising from these contingencies as remote.

Asset Value Guarantees require a period of notice to be given before they can be exercised. No such notice has been received that would enable AVGs to crystallise in 2003. The company took charges and made prudent provisions against credit exposures in 2002.

International accounting standards
All European Union listed groups are required to adopt International Accounting Standards (IAS) for their financial statements from 2005, which will include comparative information for 2004. The Group is currently undertaking a detailed review of the impact of IAS on its published financial statements. Although these standards are themselves evolving and undergoing improvement, a preliminary review shows that there may be a significant impact on the Group's accounts, particularly in relation to the mark-to-market of financial instruments and capitalisation of a portion of research and development expenditure.

Share price
During the year Rolls-Royce shares fell by 36 per cent from 166.5p to 107.0p per share, compared to a 36 per cent fall for the aerospace and defence sector and a 24 per cent fall for the FTSE 100.

The company's shares ranged in price from 95.25p in October to 203.5p in April.

The number of shares in issue at the end of the year was 1,617 million, an increase of 16 million of which one million related to share options and 15 million related to scrip dividends.

The average number of shares in issue was 1,612 million (2001 1,589 million). Underlying earnings per share were 11.10p a reduction of 45 per cent over 2001. The proposed final dividend per share will result in a total payment of 8.18p per share.

Financial services
Rolls-Royce aims to provide its customers with a range of services, from financing support to ongoing maintenance and after sales support. The financial services businesses comprise: engine leasing (Rolls-Royce & Partners Finance), aircraft leasing (Pembroke) and electrical power project development (Rolls-Royce Power Ventures).

The financial services businesses made a reduced contribution, following asset impairment adjustments in the aircraft leasing and power ventures businesses.

Rolls-Royce & Partners Finance, the Group's joint venture engine leasing business, owns a portfolio of 257 engines with 32 customers. The proportion of engines on lease remains high, at 98 per cent, by value.

Pembroke Group, the Group's joint venture aircraft leasing business, owns 58 aircraft on lease to 17 customers in 14 countries. 94 per cent, by value, of the owned aircraft fleet is on lease. Impairment adjustments of £12 million were made in respect of the company's fleet of 29 Fokker aircraft.

Rolls-Royce Power Ventures, the Group's power project developer, has 13 power generation projects in operation and seven in construction or commissioning. The business is being restructured, reflecting the general weakness in power generation markets. Impairment adjustments of £30 million were made against the company's portfolio of industrial Trent power projects, reflecting the current weakness in electricity prices.

an Baird MA, DSc Non-executive Chairman
ppointed to the Board in 2002 and appointed non-executive Chairman in bruary 2003. He is a director of Areva (France), Société Générale (France), d a non-executive director of Scottish Power plc (UK). He was formerly airman and Chief Executive Officer of Schlumberger Limited (France and A), a director of Banque Paribas from May 1994 until October 1999 and a n-executive director of The BOC Group plc from July 1995 until January 99. He is a member of the Advisory Committee of Banque de France and e Prime Minister's Council of Science and Technology. He is a trustee of the rnegie Institution of Washington. Age 65.

r John Rose Chief Executive
ppointed to the Board in 1992. He joined Rolls-Royce in 1984 and was anaging Director – Aerospace Group from 1995 to 1996 when he was ppointed Chief Executive. He is a Fellow of the Royal Aeronautical Society nd a Council Member of The Prince's Trust as Chairman of the Prince's Trust usiness. Age 50.

ord Moore of Lower Marsh PC, BSc Non-executive Deputy Chairman nd Senior Independent non-executive director
ppointed to the Board in 1994 and appointed Deputy Chairman in 1996. e is European Chairman of Monitor Company Inc., a director of Marvin & almer Inc. and a member of the board of directors of Private Client Bank AG. e is a former President of the Energy Saving Trust. Age 65.

eter J Byrom BSc, FCA Non-executive director
ppointed to the Board in 1997. He was a director of N M Rothschild & Sons mited from 1977 to 1996. He is Chairman of Domino Printing Sciences plc nd of Molins PLC, and a non-executive director of Wilson Bowden plc. He is a ellow of the Royal Aeronautical Society. Age 58.

ohn P Cheffins BSc, Ing, FREng, FRAeS Chief Operating Officer
ppointed to the Board in 2001. He joined Rolls-Royce in 1967, became esident and Chief Executive Officer of Rolls-Royce Industries Canada Inc. in 991, Director, Civil Engine Business in 1993, President – Civil Aerospace in 998 and Chief Operating Officer in 2001. He is a Fellow of the Royal Academy Engineering and of the Royal Aeronautical Society. He is a member of the stitution of Electrical Engineers and of the Order of Engineers of Quebec. ge 55.

olin H Green BSc, CEng, FREng, FIMechE, FRAeS resident – Defence Aerospace
ppointed to the Board in 1996. He joined Rolls-Royce in 1968, became irector – Military Engines in 1989, Executive Vice President – Business perations Allison Engine Company, Inc. in 1995, Managing Director – erospace Group in 1996, Director – Operations in 1998 and was appointed esident – Defence Aerospace in 2001. He is a non-executive director of A plc. He is a Fellow of the Royal Academy of Engineering, the Royal eronautical Society and the Institution of Mechanical Engineers. He is also ce President of the Society of British Aerospace Companies and airman of the UK Council for Electronic Business. Age 54.

ames M Guyette BSc President and Chief Executive Officer of olls-Royce North America Inc.
ppointed to the Board in 1998. He became President and Chief Executive fficer of Rolls-Royce North America Inc., in October 1997. Until 1994 he was ecutive Vice President, Marketing and Planning of United Airlines. He serves n the United States National Research Council Aeronautics and Space ngineering Board and he is a director of the Private Bank and Trust Company Chicago, Illinois. Age 57.

Dr Michael G J W Howse OBE, FREng, FIMechE, FInstP, FRAes, CEng, PhD Director – Engineering and Technology
Appointed to the Board in 2001. He joined Rolls-Royce in 1968 and has held a variety of positions within Engineering, including Chief Development Engineer RB211 Development, Head of Advanced Engineering for the Aerospace Group, Director of Engineering and Technology – Civil Aerospace. He is a Fellow of the Royal Academy of Engineering, Royal Aeronautical Society, Institution of Mechanical Engineers and the Institute of Physics, a former Chairman of the Technical Board of the Society of British Aerospace Companies and Visiting Professor in the School of Mechanical Engineering at Cranfield University. Age 60.

Sir Robin Nicholson FREng, FRS Non-executive director
Appointed to the Board in 1986. Until 1996 he was an executive director of Pilkington plc. He is a Fellow of the Royal Academy of Engineering, a Fellow of the Royal Society, a non-executive director of BP p.l.c. and he is a Pro-Chancellor of UMIST. He was a member of the UK Government's Council for Science and Technology from its inception in 1993 until 2000. Age 68.

Andrew B Shilston MA, ACA, MCT Finance Director
Appointed to the Board as Finance Director in January 2003, having joined Rolls-Royce in 2002. He was Finance Director of Enterprise Oil plc from 1993 until 2002. He is a non-executive director of AEA Technology plc. Age 47.

Carl G Symon BSc, MSc Non-executive director
Appointed to the Board in 1999. He was previously Chairman and Chief Executive Officer, IBM UK. He held numerous executive positions in IBM Corp. in Canada, USA, Latin America and Asia during a 32 year international career. He is Chairman of a number of private companies, Vice-Chairman of Cross Atlantic Capital Partners, and Managing Director, Global Business Development and Alliances, DiamondCluster International Inc. He is also a non-executive director of BT Group plc. Age 56.

Sir John Weston KCMG Non-executive director
Appointed to the Board in 1998. During his Diplomatic Service career he has lived and worked in Europe, the USA and Asia. In London he was Deputy Secretary to the Cabinet and Political Director in the Foreign Office. He served as British Ambassador to NATO 1992 to 1995, and subsequently as British Ambassador to the United Nations in New York until July 1998. Formerly a non-executive director of BT Group plc from 1998 to 2002. He is currently a non-executive director of Hakluyt & Co Ltd, Hon President of the Community Foundation Network (UK), Chairman of Governors of Sherborne School and Honorary Fellow of Worcester College Oxford. Age 64.

Charles Blundell MA Company Secretary
He joined Rolls-Royce in 1993 and was appointed Company Secretary in 1995. Age 51.

Membership of principal Board committees:
Audit committee –
P J Byrom (Chairman), Lord Moore of Lower Marsh and Sir Robin Nicholson.
Remuneration committee –
C G Symon (Chairman) and all non-executive directors.
Nominations committee –
D E Baird (Chairman), Sir John Rose and all non-executive directors.

Report of the directors

The directors present their report and the financial statements of the Group for the year ended December 31, 2002.

Principal activities

The Group's principal activities are described in the Company profile on page 1.

Results for the year

The Chairman's statement, the Chief Executive's review and the Finance Director's review describe the year's operations, research and development activities and future prospects.

The directors recommend a final dividend of 5.00p a share. With the interim dividend of 3.18p a share, paid on January 6, 2003, this will make a total dividend of 8.18p a share for the year. Subject to the approval of the recommended final dividend by shareholders, the total cost of dividends for 2002 is £133 million. If approved, the Company will pay the final dividend on July 7, 2003 to shareholders registered on April 25, 2003.

New holding company

On March 4, 2003, the Company will announce its intention to introduce a new holding company for the Group using a Scheme of Arrangement under Section 425 of the Companies Act 1985.

At flotation in 1987, the Group's business was primarily focused on the aerospace sector. Since then, whilst remaining a focused power systems company, the Group has developed its operations, particularly following a series of acquisitions, so that it now operates globally in a number of complementary markets – civil aerospace, defence, marine and energy. As the Group's corporate structure has remained largely unchanged since flotation, there is, increasingly, a divergence between the existing corporate structure and the operational and reporting structure commonly put in place for the management of an international business. The directors believe that the proposed non-trading, holding company structure with operating subsidiaries underneath will provide flexibility for the Group to align its corporate structure more closely with that of its operational divisions and management reporting lines. In addition, the new structure will place the Group in a better position to address operational, accounting and legal issues which may arise in the future.

The Company will issue a circular to shareholders containing full details of this proposal at the same time as the annual report and will be seeking shareholder approval for it at the forthcoming Annual General Meeting. If approved, it is expected that the change will become effective on June 23, 2003.

Directors

Directors who held office during 2002 are listed on page 24, with the exception of Mr R T Turner who retired from the Board with effect from May 30, 2002 and Mr P Heiden who resigned from the Board with effect from December 31, 2002. Mr D E Baird was appointed as a non-executive director of the Company with effect from November 1, 2002 and, as non-executive Chairman, with effect from February 1, 2003. Mr A B Shilston was appointed as a director of the Company with effect from January 1, 2003.

Under the Company's Articles of Association, one third of the directors are subject to re-election every year, with each director also being subject to re-election at intervals of not more than three years. Any director appointed during the year is required to retire and seek re-election by the shareholders at the next Annual General Meeting. The Board has recently reviewed its policy with respect to the re-election of directors and has concluded that all the directors should retire each year and be subject to re-election. The Board intends to pursue this policy at the 2003 Annual General Meeting.

Corporate governance

The Group is committed to the highest standards of corporate governance. This report (and, where appropriate, the Directors' remuneration report) describes how it applies the principles, and complies with the provisions, of the Combined Code. The Board will be considering its response to the recommendations contained in the Higgs and Smith reports which are expected to come into effect in July 2003.

Compliance

The Board confirms that in 2002, the Company complied with all the provisions of the Combined Code.

The Board

The Board comprises a non-executive chairman, a chief executive, five other executive directors and five non-executive directors. Biographies of the directors appear on page 24. Lord Moore of Lower Marsh has held the position of non-executive Deputy Chairman since 1996 and is the Group's Senior Independent director. All the non-executive directors are considered by the Board to be independent of management and free of any relationship which could materially interfere with the exercise of their independent judgement. They are appointed by the Board for specified terms on the basis of recommendations put to the Board by the nominations committee.

The Board meets regularly throughout the year. It considers all issues relating to the strategy, direction and future development of the Group. It has a schedule of matters reserved to it for decision, which is regularly updated. The requirement for Board approval on these matters is understood and communicated widely throughout the Group.

To enable the Board to function effectively and the directors to discharge their responsibilities, full and timely access is provided to all relevant information.

There is an agreed procedure for directors to take independent professional advice at the Company's expense. This is in addition to the access every director has to the Company Secretary and to the General Counsel. Where appropriate, training is offered to newly appointed directors.

The Group Executive

The Group Executive is responsible for the running of the Company within the strategy determined by the Board.

The Group Executive is chaired by Sir John Rose, Chief Executive.
Its other members are:
Mr A Arendt, Chairman – Rolls-Royce Deutschland Ltd & Co KG
Mr J P Cheffins, Chief Operating Officer
Mr E T Curley, President – Energy Business
Mr C H Green, President – Defence Aerospace
Mr J M Guyette, President and Chief Executive Officer of Rolls-Royce North America Inc.
Mr C J Hole, Director of Procurement
Dr M G J W Howse, Director – Engineering and Technology
Dr S Lanyado, President – Marine Business
Mr I A Lloyd, Managing Director – Aero Repair and Overhaul
Dr M Lloyd, Director – Gas Turbine Operations
Mr J R Rivers, Director – Human Resources
Mr A B Shilston, Finance Director
Mr M J Terrett, President – Civil Aerospace

ard committees
e Board has delegated certain powers and duties to Board committees, of which operate within defined terms of reference. In 2003, the Board will undertaking a review of the operation and membership of Board mmittees in light of the recommendations contained in the Higgs and nith reports.

ominations committee
ne nominations committee makes recommendations to the Board on the pointment of executive and non-executive directors. During 2002 the mmittee was chaired by Sir Ralph Robins who retired as its Chairman llowing his retirement from the Company on January 31, 2003. Mr D E Baird as subsequently appointed by the Board as Chairman of the nominations mmittee with effect from February 1, 2003. The other members of the minations committee are Mr P J Byrom, Lord Moore of Lower Marsh, Robin Nicholson, Sir John Rose, Mr C G Symon and Sir John Weston.

muneration committee
ne remuneration committee's membership and principal terms of reference e set out in the Directors' remuneration report on pages 31 to 39.

dit committee
ne audit committee has responsibility for reviewing the Group's financial porting, including its accounting policies. It is also responsible for the ompany's relationship with the external auditors and for the business surance function.

ne committee, which consists exclusively of independent non-executive rectors, is chaired by Mr P J Byrom and its other members are Lord Moore Lower Marsh and Sir Robin Nicholson. It meets three times a year, with the ternal auditors also in attendance.

uring the year the committee's role in relation to the external auditors has een widened in order to meet evolving corporate governance quirements and recommended best practice.

ne committee is responsible for recommending to the Board the pointment of the auditors. It is also responsible for reviewing the scope of e audit, approving the audit fee and, on an annual basis, satisfying itself that e auditors are independent.

order to safeguard auditor independence and objectivity, the following olicy is applied in respect of the non-audit services provided by the auditors:

dit related services – These are undertaken by the auditors, as it is work that ey must, or are best suited, to perform. It includes formalities relating to orrowings, shareholder and other circulars, risk management services, rious regulatory reports and work in respect of acquisitions and disposals.

x, accounting and mergers and acquisitions – The auditors are used for this ork where they are best suited to undertake it. All other significant onsulting work in these areas is put out to tender.

l other advisory services/consulting – The auditors are generally prohibited om providing these services.

addition, the committee monitors throughout the year the cost of on-audit work undertaken by the auditors and is therefore in a position to ke action if it believes at any time that there is a risk of the auditors' dependence being undermined through the award of this work.

ne committee reviews and approves the Company's business assurance ork programmes and ensures that the business assurance function is dequately resourced and that its work is coordinated with the work of the xternal auditors.

Risk committee
The risk committee is accountable for the Company's risk management and for reporting key risks and the associated mitigating actions to the Board. The committee is chaired by Sir John Rose and its other members are Mr J P Cheffins, Mr C H Green, Mr J M Guyette, Dr M G J W Howse and Mr A B Shilston.

Health, safety and environment committee
The health, safety and environment committee is chaired by Mr J P Cheffins and its other members are Mr P J Byrom, Mr C H Green, Mr J M Guyette and Dr M G J W Howse. The committee is responsible for policy development and assurance; setting Group objectives and targets; performance review; management system review; and reporting. Further information on its work is set out in the Group's Environmental Report.

Nuclear propulsion assurance committee
The nuclear propulsion assurance committee is responsible for the health, safety and environment aspects of the Company's nuclear facilities. During 2002 the committee was chaired by Sir Ralph Robins. Other members of the committee are Dr M G J W Howse, Sir Robin Nicholson and Sir John Rose.

Community investment committee
The community investment committee is responsible for administering the Company's policy on charitable donations. The committee is chaired by Sir John Weston and its other members are Sir Robin Nicholson and Mr J R Rivers, Director – Human Resources. The policy pursued by the committee when considering charitable appeals is set out on page 29.

Political donations
In line with its established policy, the Group made no political contributions in 2002.

Communication with shareholders
The Company attaches great importance to the effectiveness of its communication with shareholders. It publishes a concise annual review and summary financial statement as well as a full report and accounts and there is a separate environmental report. There is regular dialogue with individual institutional shareholders as well as general presentations after the interim and preliminary results. All shareholders can gain access to these presentations, as well as to the annual report and other information about the Group, through the Group's website at www.rolls-royce.com. They may also attend the Company's Annual General Meeting at which the key business developments during the financial year are highlighted and at which they have an opportunity to ask questions.

Internal controls and risk management

Directors' responsibilities
The directors are responsible for the Group's system of internal control and for maintaining and reviewing its effectiveness from both a financial and operational perspective. The system of internal control is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and to provide reasonable but not absolute assurance against material misstatement or loss. The Group's approach to internal control is based on the underlying principle of line management's accountability for control and risk management.

In reviewing the effectiveness of the system of internal control the Board has taken account of the results of the work carried out to audit and review the activities of the Group.

There is an on-going process to identify, assess and manage risk, including those risks affecting the Company's reputation and corporate social responsibility. This process is subject to continuous improvement and has been in place throughout the financial year to which these statements apply and up to the date of their approval.

The Board has reviewed the process in 2002 and confirms that it complies with the Turnbull Committee Guidance on Internal Control issued in September 1999.

The Board has established a risk committee, chaired by the Chief Executive, with specific accountability for the system of risk management and for reporting key risks and their associated mitigating actions to the Board. Details of the membership of the committee are set out at page 26.

Organisation

The Group has a clearly defined organisation structure within which operational management have detailed responsibilities and levels of authorisation, supported by written job descriptions and operating manuals. The Group also has a code of business conduct.

The risk management system

The risk management system is an integral part of management's approach to delivering business objectives and is a systematic process designed to identify, assess, treat, manage and communicate risks. It also provides a method of escalation and delegation to the appropriate level within the organisation and ensures actions are owned, defined, resourced and effective.

Management are responsible for the ongoing identification and evaluation of significant risks within their areas of responsibility and, using a common process, for the operation of suitable controls or mitigation actions. Risks may arise from a variety of internal and external sources. They may be associated with regulations, customer requirements, and competitor actions or could result from the capability of the processes used to execute our business or from external and largely unpredictable events such as terrorist activity or war. All risks, irrespective of source, are managed through processes operated by project and functional teams. Management report regularly to the risk committee on their view of risks and how they are managed, so that the Board can then consider and review these risks in terms of their potential impact.

During 2002, the communication and understanding of risk have continued to be enhanced throughout the business, including the on-going development of plans to address the risks identified in areas such as business continuity. Management have continued to perform comprehensive risk reviews for all key projects, programmes and business change plans.

All the processes operated by the Company are subject to continuous improvement activity. However, during 2002, particular attention has continued to be paid to four key processes:

Planning the business: in a changing world, it is essential that the methods used to plan the business are robust and flexible. In 2002, the planning and review process has been strengthened and risk principles embedded into the Company's strategic plans and short and long-term forecasts.

Resourcing the business: better communication of objectives to employees and their representatives and improved recruitment, training, benchmarking, deployment and development of people. A common health, safety and environment (HS&E) policy implemented across Rolls-Royce and all parts of the business, with HS&E management systems in place.

Fulfiling customer orders: improvement initiatives in areas such as quality, strategic sourcing and production planning and control.

Creating customer solutions: risks identified across a number of projects are being mitigated by rigorous application of a standardised gated product development process, which takes due account of technical and business issues.

Systems of internal control

The general managers of individual businesses are aware of their responsibility to operate systems of internal control which provide reasonable assurance of effective and efficient operations, reliable financial information and compliance with laws and regulations. In addition, financial managers are required to acknowledge in writing that their routine financial reporting is based on reliable data and that their results are properly stated in accordance with Group requirements.

The Group has a comprehensive budgeting system with an annual budget approved by the Board. Revised forecasts for the year are reported at least quarterly. Actual results are reported monthly against budget and variances reviewed. In view of the long-term nature of the business, the Group also prepares, annually, a detailed five year plan which is also reviewed by the Board. The activities of the Group are subject to review by the risk management organisation and the assurance functions of health, safety and environment, quality, engineering and business assurance. These functions operate to work programmes agreed by the appropriate Board member or Board committee.

The business assurance function, which works closely with the external auditors, undertakes a programme agreed by the audit committee covering all Group activities. The programme includes independent reviews of the systems of internal control and risk management. Findings are reported to the audit committee three times a year and to the risk committee, twice a year.

Corporate Social Responsibility

The Group attaches great importance to the pursuit of excellence as a corporate citizen in its operations throughout the world.

Rolls-Royce continues to develop its approach to Corporate Social Responsibility (CSR), recognising it as a key issue in the way it conducts its business. By far the greatest contribution which Rolls-Royce makes in this area comes from the wealth creation and the maintenance of highly skilled jobs which are underpinned by our business activities. The Group believes that progress in this area will deliver competitive advantage and will contribute to long-term success. Since the publication of last year's annual report, the Board has reviewed the conclusions of a Company-wide working group established by the Board to further strengthen our approach in ensuring that CSR is integral to the way in which we conduct our business activities. The Group has well developed policies on issues such as health, safety and environment, charitable donations, community involvement, employment policy and employee learning and development. Details of these policies are set out on pages 28 to 30. The Board will continue to keep shareholders informed of progress in this area.

During the year the Board also confirmed the procedures for managing risks associated with CSR. It is important that significant risks with a potential impact on shareholder value are promptly drawn to the Board's attention, with proposals for mitigating action. As described on this page, the Group already has in place effective procedures for identifying, assessing and managing risk, which are fully in line with the requirements of the Turnbull Committee Guidance on Internal Controls. These procedures ensure that risks associated with CSR are regularly reported to the Board.

As an integral part of the corporate risk process, the Board has commissioned further work on CSR risk management to provide a framework for structured decision making and increased focus on those activities which contribute to shareholder value.

pply chain
ring the year, the Group's supply chain has been engaged in improvement tivities stimulated by the Rolls-Royce Supplier Advanced Business quirements system (SABRe). The SABRe system enables approved lls-Royce suppliers to understand the key performance criteria required them. These standards embrace: the need to comply with legal and gulatory requirements; acceptable supplier performance levels; and provement 'toolkits' to assist suppliers in strengthening their business rformance.

everal joint Rolls-Royce/supplier improvement initiatives have also been rried out to identify business and environmental improvements. Examples clude the introduction of a dedicated parts collection service reducing ansportation mileage, the increased use of re-usable packaging and joint provement activities in areas such as energy consumption and the wider e of recycling material.

ealth, safety and environment (HS&E)
e HS&E committee (see page 26) is responsible for policy development d assurance; setting Group objectives and targets; performance review; anagement system review; and reporting.

e Group's HS&E policy, was reviewed, updated and re-issued in April 2002, was the HS&E management system standard which defines how HS&E ill be managed in all Group companies.

e corporate HS&E audit programme provides an independent assessment the level of implementation of the Group's HS&E management system.

everal HS&E audits were completed including five UK-based businesses and operational sites in North America. Good progress continues to be made the implementation of the Group-wide standard for an integrated HS&E anagement system.

uring 2002, an internal audit of HS&E performance reporting data systems as undertaken to obtain an independent assessment of the accuracy and mpleteness of reported data.

ur initial external report on the environment *'Powering a better world'*, blished in 1999, set a range of HS&E targets to be achieved by the end of 03. Good progress has been made although the target to reduce waste has oved particularly challenging. Work will continue during 2003 with the aim meeting or exceeding these targets.

n update of *'Powering a better world'*, containing operational performance ata for 2002 for all Rolls-Royce businesses worldwide, will be published on e Company's website in 2003.

lls-Royce conducts nuclear licenced operations in Derby, closely regulated both the Nuclear Installations Inspectorate and the Environment Agency. e continue to maintain a very good safety record. Health, safety and vironmental issues are managed as an integral part of our activities and an proving trend has been seen in all key HS&E measures.

e Group has made significant investments throughout 2002 in order to date plant and equipment and improve waste management practices in nuclear operations. This has resulted in a reduction of 50 per cent in the lume of waste disposed compared to previous years.

ealth and safety management
e Group experienced no fatalities during 2002 and lost-time injuries were gnificantly below the engineering-sector average. The increasing plication of a structured risk-management approach to safety should able further improvements in performance to be made.

The safety review programme for 2002 covered machinery safety, with attention also being given to the close-out of the previous year's review of oxygen gaseous fuel systems. Other initiatives included an assessment of training, measures to improve contractor management and the integration of safety aspects into the design process for facilities' plant and equipment. Specific training was provided in incident investigation and in the control of substances hazardous to health.

Environment
The Group's businesses are certified to the international standard ISO 14001 and it is Company policy that any newly acquired business should achieve certification within two years of acquisition. Implementation programmes are currently under way in the UK, the Nordic countries, Poland and North America. During 2002 certification was awarded to Rolls-Royce Power Ventures Ltd and to the Commercial Marine operations in Brattvaag and Ulsteinvik, Norway.

In 2002, Rolls-Royce was placed first in its business sector amongst those companies completing the Business in the Environment index of corporate environmental management and 39th out of 192 total participants. This favourable result demonstrates our commitment to addressing environmental issues through an integrated management system approach.

As well as monitoring and setting environmental targets for its operational activity, the Group has also set targets for the environmental performance of its products. For example, the Trent 500, our latest aero engine to enter service, has significantly improved fuel efficiency, noise and emissions performance. Challenging long-term product targets were initially set out in the Group's first external environment report.

During 2002, Rolls-Royce joined the UK Emissions Trading Scheme. Under this initiative, the Group accepted targets for the reduction of carbon dioxide emissions from its operations in the UK.

The Environmental Advisory Board includes external members who are respected authorities in their fields and it reviews and makes independent recommendations on the environmental and sustainability aspects of Rolls-Royce activities.

Occupational Health
The Group operates a modern preventative Occupational Health service with a strategy emphasising our approach to managing key health issues, monitoring key targets and the training of people.

Well considered policies and supporting guidelines demonstrate a responsible approach to employee health. There are Occupational Health facilities at major locations worldwide. Health promotion campaigns on managing workplace pressure, cancer awareness, alcohol and substance misuse were delivered in 2002. Our approach to training on workplace pressure, with the use of a stress risk assessment toolkit, has received international recognition. Managers have also received awareness training in support of our alcohol and drugs policy.

An annual Occupational Health report is produced based on the results of health surveillance surveys against set Company targets. Active rehabilitation and support for employees with disabilities or those who require workplace adjustment, has led to a 20 per cent reduction in total absence in the UK over the last three years. A working group, chaired by the Director of Engineering and Technology – Operations, was set up by the Company HS&E committee and has been promoting the use of engineering measures to reduce employee exposure to potentially harmful levels of vibration.

The Group considers health research is important and supports a Medical Research Committee chaired by the Group's Chief Medical Officer.

Employment policy

The number of Group employees at the end of the year was 37,255 (2001 43,500).

The Group's employment policies and practices support overall business objectives by motivating and developing employees to meet the requirements of the business and its customers. Policies continue to be reviewed and developed to support the changing needs and international nature of the business.

A strong emphasis is placed on effective worldwide employee communications and each business has its own programme of communication adapted to its particular needs.

The Group consults with employees and employee representatives on a wide range of topics relating to its overall business objectives. Regular meetings are held in each business to discuss opportunities and issues of common interest.

Over the past two years, senior employee representatives have worked closely with management to improve the quality of consultation and communication, resulting in a jointly agreed framework. A Company and Union Forum is now held at least twice a year involving senior management and employee representatives from across the Group followed by supporting communication in each business.

Considerable efforts have been made to mitigate the impact of job reductions in the businesses and the Company has established a network of Resource Centres dedicated to support the redeployment and training of affected employees.

The Company has long had an equal opportunities policy and recognises the importance of developing a diverse and inclusive workforce. A new global policy on 'equality and diversity' has been developed and will be introduced during 2003, supported by an ongoing programme of communication and training.

It is the Group's policy, wherever possible, to provide employment, training and development opportunities for disabled people. It is also committed to supporting employees who become disabled and to helping disabled employees make the best possible use of their skills and potential.

Learning and development

It is a fundamental value of the Company that achieving business performance and promoting individual development go hand in hand.

The Company invests in improving individual and business capability by offering training programmes and development opportunities which ensure effective business learning and continuous professional development. We have enhanced the frameworks for leadership, professional and business management development by strengthening their global application. Working with academic partners around the world, we have a broad range of programmes including managerial, technical and operating skills. In 2002, Rolls-Royce spent £25.7 million on the education and training of employees and recruited 150 graduate trainees and 99 modern apprentices. In addition, there have been 268 undergraduate students in the Group for training periods of between two and 12 months. At the end of 2002 there were 298 graduates on formal training programmes and 400 apprentices and technicians worldwide.

Working on local community projects forms a key part of our development programmes for employees on trainee and management schemes. These community projects involve working with our external partners in education, the arts, the environment and regeneration.

We offer free places on internal training programmes to partners in our local communities. We have actively pursued a policy of sharing Company learning facilities and, in partnership with Derby College, now have two Learning Resource Centres in Derby. They have attracted over 2,200 enrolments from community learners.

We work closely with schools and colleges to promote science and technology. Our policy is to work with government, local and national institutions and education establishments to widen students' experience of industry and promote careers in the Aerospace, Energy and Marine businesses. The Company supports a wide range of education projects and initiatives, including: Open Industry; Specialist Colleges; Education Action Zones; Arkwright Scholarships and engineering education schemes.

We continue to be active in supporting international education, sponsoring international students wishing to work in the UK or students in the UK wishing to broaden their international experience. Through the UK Government's Chevening scheme, we are currently sponsoring students from China, Indonesia, Korea, Vietnam and Malaysia.

During the year, Rolls-Royce won a National Training Award for its approach to team based working within the Aero Repair and Overhaul business.

Community investment

The Group promotes charitable donations, which make an important contribution to the Group's involvement in the community. In 2002, the Group's total charitable donations amounted to £924,000.

In the UK, the Company's annual charitable donations budget is administered by the community investment committee (see page 26) and by regional site committees. The policy the committee follows when considering charitable appeals is set out below:

'As a forward-looking, innovative and global company, Rolls-Royce plc is committed to being a good corporate citizen in its operations throughout the world. The Group's policy on donations is to direct its support primarily to causes with educational, engineering and scientific objectives, as well as to social objectives connected with the Company's business and place in the wider community.'

During 2002, charitable donations in the UK amounted to £411,000. This included continuing support for the Derbyshire Community Foundation and the development of new relationships with both the Greater Bristol and London Community Foundations.

Elsewhere, Rolls-Royce made charitable donations amounting to £513,000 in those countries in which it has a significant presence. In North America, this included support for the work of United Way, Habitat for Humanity and the American Heart Association. In Germany the Group supported the Federal President's Annual Summer Festival and in the Nordic countries it supported a number of local arts-based projects.

A list of the principal donations made in 2002 is available on written request to the Company Secretary.

In addition to our charitable donations, contributions in excess of £449,000 were made to projects through the Group's corporate sponsorship committee and through education programmes.

e Company has a long and successful history of community involvement. part of our commitment to being a good corporate citizen, Rolls-Royce sists the communities in which our businesses operate and our employees e and work. We also encourage our employees to play their own role in the mmunity. Our community involvement is designed to support our values reliability, integrity and innovation and is directed towards supporting lucation, the environment, the arts and economic and social regeneration.

amples of our activities include:
ponsoring ViVA, an orchestra resident in Derby, through which the Company pports concert giving and music education programmes in schools;
tablishing a UK-wide partnership with The Prince's Trust to support their lunteers and business start-up programmes;
eveloping an environmental education project with The National Forest ompany;
istol-based trainees working on a community project with Business ynamics to develop an educational workshop;
dianapolis-based employees supporting Habitat for Humanity by helping construct a home for a local family;
upporting the Royal Aeronautical Society's centenary events.

olls-Royce also finances the administration of the Payroll Giving Scheme for K employees through which, in 2002, over £360,000 of employee donations ave been paid directly to over 200 charities of employees' choice. This high vel of UK employee participation, in excess of 20 per cent, was highlighted best practice in the UK Chancellor of the Exchequer's Giving Campaign.

s part of our community investment activities, employees are encouraged take up opportunities for development within local community based ojects by working with recognised brokers who deliver a wide range of pportunities. Examples of this include:
lucation business partnerships running successful mentoring programmes r school pupils;
oviding support to employees who are school governors;
orking with organisations such as The Prince's Trust and Young Enterprise to ovide business mentors and advisers.

ne Company is also able to offer support in-kind to local initiatives. This may clude the provision of places on in-house training programmes; the onation of surplus computer equipment and furniture; and offering the free se of meeting rooms and premises.

olls-Royce is also a member of Business in the Community and actively upports Common Purpose programmes across the UK. These two ganisations aim to promote greater business awareness and involvement wider community issues and encourage greater employee participation.

ayment to suppliers
ne Company is guided by the Supply Chain Relationships in Aerospace CRIA) initiative. It seeks the best possible terms from suppliers and when ntering into binding purchasing contracts, gives consideration to quality, elivery, price and the terms of payment. In the event of disputes, efforts are ade to resolve them quickly.

ne Company had the equivalent of 52 days purchases outstanding at ecember 31, 2002, based on the average daily amount invoiced by suppliers uring the year.

Going concern
After making enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Share capital
The following have a notifiable interest in the Company's ordinary shares at March 3, 2003:

	% of issued share capital
BMW AG	9.78
Franklin Resources, Inc.	14.16

Auditors
A resolution to reappoint the auditors, KPMG Audit Plc, and to authorise the directors to determine their remuneration, will be proposed at the Annual General Meeting.

By order of the Board

Charles Blundell, Company Secretary
March 3, 2003

This report provides the information required by the Directors' Remuneration Report Regulations 2002 (the Regulations) which apply to the Company for the first time this year. It also describes how the principles of the Combined Code in relation to executive directors' remuneration are applied by the Company. The Company confirms that it complies with the requirements of the Combined Code.

Rolls-Royce operates in a highly competitive, international market. Its business is complex, technologically advanced and has long time horizons. The Group is committed to achieving sustained improvements in performance and this depends crucially on the individual contributions made by the executive team and by employees at all levels. The Board therefore believes that an effective remuneration strategy plays an essential part in the future success of the Group by providing incentives which create a close identity of interest with shareholders.

A resolution will be put to Shareholders at the Annual General Meeting on May 29, 2003 inviting them to consider and approve this Report.

The remuneration committee
The remuneration committee (the committee) has responsibility for making recommendations to the Board on the Group's policy towards executive remuneration. The committee meets regularly and determines, on the Board's behalf, the specific remuneration packages of the executive directors and a number of senior executives.

The committee consists exclusively of independent, non-executive directors. It is chaired by Mr C G Symon and its other members are Mr P J Byrom, Lord Moore of Lower Marsh, Sir Robin Nicholson and Sir John Weston.

In 2002 Sir Ralph Robins (who was Chairman of the Company throughout the year) and the Chief Executive attended meetings by invitation but were not present during any discussion of their own emoluments. Mr D E Baird, who became Chairman on February 1, 2003, and the Chief Executive will attend meetings by invitation during 2003 on the same basis as in 2002.

Advice to the remuneration committee
The committee appoints its own consultant to provide it with independent advice. During 2002 the committee's consultant was Mrs N Demby who was a partner at Andersen before joining Ernst & Young on August 1, 2002. From January 1, 2003 the committee's consultant has been Mr S Patterson of Mercer Human Resource Consulting (Mercer). Support is also received from other employees of these companies.

The committee may also call for information and advice from other advisors inside and outside the Company. In 2002, the then Chairman and the Chief Executive made recommendations to the committee relating to the performance of their direct reports and on the appropriateness of particular remuneration proposals to the Company's needs. Internal support was provided primarily by the Director – Human Resources, Mr J R Rivers, advised by Mr R McNeil who was a partner at Andersen before joining Deloitte & Touche on August 1, 2002. The Company Secretary, Mr C E Blundell, also provided support to the committee. Ad hoc advice has been provided by employees from Human Resources, Finance and Business Development when required.

During 2002, Andersen provided consulting advice to the Company on taxation matters for expatriates, transfer pricing and all employee share plans. Deloitte & Touche advised the Company on corporate tax, transfer pricing, customs duties, pension matters and risk management. Ernst & Young provided advice on financial accounting for overseas offices and Mercer provided support on insurance matters and compensation and pensions in the US.

Remuneration policy

The policy framework
The Board has adopted, on the recommendation of the committee, a remuneration policy reflecting the following broad principles, which it will continue to apply in 2003:

i) the remuneration of executive directors and other senior executives should reflect their responsibilities and contain incentives to deliver the Group's performance objectives; it must also be capable of attracting and retaining the individuals necessary for business success;

ii) a significant proportion of total remuneration should be based on Group and individual performance, both in the short and long term; and

iii) the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the acquisition of a significant shareholding in the Company.

The policy takes into account pay and employment conditions elsewhere in the Group.

The committee regularly reviews both the competitiveness of the Group's remuneration structure and its effectiveness in incentivising executives to enhance value for shareholders over the longer term. It considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the Company's business environment and in remuneration practice. The effectiveness of the Group's long-term incentive arrangements is currently being reviewed by the committee. It is not envisaged that any changes to these arrangements will be introduced before 2004.

The main components of remuneration
The main components of remuneration currently comprise: base salary, annual incentive arrangements, long-term share based incentives and pension and life assurance benefits. Executive directors and senior executives are also entitled to a company car or car allowance, private medical insurance, financial counselling and, in the case of Mr J M Guyette, a housing allowance.

In determining the relative importance of these elements of remuneration, the committee believes that base salaries should be set at levels required to recruit and retain high quality senior executives. It also considers that there should be a continuing and increasing emphasis on those elements of remuneration, such as annual and long-term incentives, which directly influence the performance of senior executives.

The committee believes that base salaries should be set with reference to the median-level of the relevant marketplace. Performance-related incentive plans should provide the opportunity of increasing total earnings to the upper quartile of the marketplace if performance justifies it. For executive directors, no less than 44 per cent of their total annual cash remuneration opportunity is performance related, either through linkage to annual performance or to longer term performance targets and the share price. All salary increases are required to be justified on the basis of performance and are not automatic. Other benefits would generally be at the median of market practice.

entives and rewards linked to annual performance
cutive directors and senior executives participate in the Annual formance Related Award plan (APRA). Under APRA as operated in 2002, y were eligible for awards of up to 60 per cent of base salary on the ievement of predetermined targets. APRA awards do not form part of nsionable earnings. Following reviews of APRA's competitiveness in 2002 d 2003, the committee decided that the maximum award should be reased in respect of 2003 to 80 per cent of base salary and, in the case of e Chief Executive, to 100 per cent.

e APRA performance targets set by the committee are based on the oup's annual operating plans. For 2002, the measures for executive directors luded earnings per share, average cash balance and personal rformance. In the case of Mr C H Green, the award also reflected the rformance of the specific business sector for which he is responsible, easured by profit after a levy for capital employed.

r 2003, the performance targets for APRA will relate to underlying profit fore tax, average cash balances, cash flow and the achievement of personal jectives. For most executive directors, the financial measures will relate to erall corporate performance, but for Mr C H Green it will be partly pendent on the performance against these same measures of the siness sector for which he is responsible.

ere is a long-term incentive element in APRA as one third of the value is livered in the form of a deferred share award over Rolls-Royce shares. A rticipant who is granted a deferred share award under APRA must rmally continue to hold these shares and remain an employee of the oup for a period of two years from the date of the award in order to retain e full number of shares, although shares will be released early in certain cumstances including redundancy. The value of any deferred share awards derived from the annual bonus criteria and is therefore dependent on rporate performance; the release of deferred share awards is not pendent on the achievement of any further performance conditions. This ferred share element was operated for 2002, resulting in the share awards scribed on page 35. The committee will continue to operate a deferred are scheme in respect of 2003 and future years. This arrangement provides trong link between performance and remuneration, promotes a culture of are ownership amongst the Group's senior management and encourages cisions in the long-term interest of shareholders.

llowing a review of the competitiveness of remuneration in 2002, the mmittee concluded that for certain key executives, the current annual entive arrangements did not achieve retention and shareholder gnment objectives sufficiently strongly. A deferred share incentive plan SIP) was introduced for 2002 which was restricted to a small number of key ecutives, including the executive directors. Under DSIP, awards of shares th a value of up to 40 per cent of salary may be made. The performance gets applicable to DSIP awards are identical to those used in the Company ement of APRA.

ceipt of the shares awarded under the DSIP is deferred for three years. vards are forfeited on leaving the Company except at the discretion of the mmittee. As with the APRA element of the annual incentive arrangements, e release of the deferred share awards is not dependent on the satisfaction further performance conditions. No awards will be made under the DSIP in spect of 2003 and its role is being reviewed as part of the committee's going consideration of share-based and long-term remuneration.

ng-term incentives
e committee is aware that market practice for long-term incentives is bject to change. It therefore continues to review market practice and to velop plans appropriate to the nature of the business which will courage improved performance to the benefit of shareholders.

Executive share option plan
Depending on performance, executives are eligible to receive executive share options on an annual basis. The normal practice is to grant options annually in March following the announcement of the Company's results.

In line with the committee's view that a significant proportion of remuneration should be performance related, the exercise of options is subject to a performance condition that the Group's growth in earnings per share (EPS), as defined by Financial Reporting Standard 14, must exceed the UK retail price index by an average of three per cent per annum over a rolling three-year period. These performance conditions apply to all the executive directors. The committee continues to believe that an EPS measure on this basis is an effective one as it demands that there should be a real and stretching improvement in the Company's performance before any executive can benefit from an increase in the share price. Achievement of the EPS target is reviewed annually by the committee.

In 2001 the committee concluded that in order to help meet a series of demanding challenges facing the business at that time, key members of the executive team, many of whom had recently been appointed, should receive more significant incentives under the executive share option plan. As a major employer in the US, the Company also had a need to provide rewards for strong performance, which were more in line with US practice.

Accordingly, as described in the 2001 annual report, the Company made a special award of options in March 2001 to key executives, including the executive directors (see pages 36 and 38), but with more demanding performance criteria and personal share ownership requirements (see page 38).

Long-term incentive plan
The Company has in place a long-term incentive plan which was approved by shareholders in 1997. There are no grants outstanding under this plan.

All employee share plans
The committee believes that share-based plans make a significant contribution to the close involvement and interest of all employees in the Group's performance. Executive directors are eligible to participate in the Company's all-employee share schemes on the same terms as other employees. There are three main elements to these arrangements:

i) the Sharesave Scheme – a savings-related share option scheme available to all employees. This scheme operates within specific tax legislation (including a requirement to finance the exercise of the option using the proceeds of a monthly savings contract). The exercise of the option is not subject to the achievement of a performance target;

ii) the 'Free Share' element of the Share Incentive Plan, under which UK employees receive shares equivalent to one week's pay as part of the Company component of any bonus paid for 2002; and

iii) the 'Partnership Share' element of the Share Incentive Plan under which UK employees may make regular purchases of shares from pre-tax income.

The effect of corporate restructuring on share plans
At the Annual General Meeting in May 2003, shareholder approval will be sought for a revised corporate structure for the Group involving the creation of a new holding company (see page 25). The committee has considered the implications of this proposal for the Company's share plans and has concluded that the introduction of the new holding company should not provide any advantages or disadvantages to participants in any of the current share plans. Accordingly, the committee has exercised its powers under the relevant rules to prevent any holders of executive share options from being able to exercise their options on an accelerated basis as a result of the restructuring. Participants will also have to agree that all existing performance conditions will continue to apply if they do not wish their existing options to lapse. In the case of the Sharesave Scheme, participants will have a statutory

right to exercise their options early to the extent of their savings. However, if they decide to adopt this course, they will be prevented from being able to complete their savings contract and they will lose the ability to exercise in full. For all other share plans, participants will be able to exchange their rights over Rolls-Royce plc shares for rights of an equivalent value over the shares of the new holding company.

So that future grants under existing share plans can be delivered in the shares of the new holding company, shareholders will be asked at the Annual General Meeting to approve a series of minor technical amendments to the existing plans. These amendments will replace all references to the Company with references to the new holding company and will make other minor changes. The new holding company will then be able to grant options and awards under these plans for the remainder of each plan's original ten-year life.

Service contracts

In the light of the Combined Code, the committee has a policy that new appointees to the Board are offered notice periods of one year. The committee recognises that in the case of appointments to the Board from outside the Company, it may be necessary to offer a longer initial notice period, which would subsequently reduce to 12 months after that initial period.

The committee has a defined policy on compensation and mitigation to be applied in the event of a UK director's contract being prematurely terminated. In these circumstances, steps are taken to ensure that poor performance is not rewarded. When calculating termination payments, the committee takes into account a range of factors such as age, length of service contract and the director's obligation to mitigate his own loss.

Sir Ralph Robins, who retired as Chairman of the Company on January 31, 2003, had a service agreement with Rolls-Royce plc dated February 25, 1999, terminable by 12 months written notice by either party. He worked for the Company at the equivalent rate of three days a week. He was entitled to participate in the Company's performance related bonus arrangement with a maximum bonus payable of 60 per cent of his basic salary. One third of the value of any bonus was payable in the form of Rolls-Royce plc shares. Sir Ralph Robins was also eligible to participate in the Rolls-Royce plc executive share option plan. Sir Ralph Robins was provided with a company car (the Company bearing the maintenance and running costs) and cover under the Company's private health scheme (for himself and his wife). No compensation for loss of office was paid to Sir Ralph Robins on his retirement.

Sir John Rose and Mr C H Green have service agreements with Rolls-Royce plc dated December 4, 1992 and March 1, 1991 respectively. These agreements are terminable by 24 months' written notice by the Company and six months' written notice by the executive and were entered into prior to the introduction of the policy described above. Alternatively, the Company has the discretion to terminate the service agreement by paying salary and the value of all other contractual benefits in lieu of notice or pro rata in lieu of any unexpired period of notice. With effect from January 1, 2004, the notice required to be given by the Company will reduce from 24 months to 12 months. In the event of the executives' contracts being terminated after that date by the Company other than in accordance with the contracts' terms they will be entitled to receive a liquidated sum calculated as 12 months' salary and benefits. Performance related payments are not covered in this arrangement though an annual bonus may be paid if the executive is in post at the end of the year. The executives are entitled to participate in the Company's performance related bonus arrangement with a maximum bonus of 100 per cent of basic salary in the case of Sir John Rose and 80 per cent of basic salary in the case of Mr C H Green. One third of the value of any bonus is paid in the form of Rolls-Royce plc shares. The executives are also eligible to participate in the Rolls-Royce plc executive share option scheme and are entitled to membership of an appropriate Rolls-Royce pension scheme and life assurance benefits. They are provided with a company car (the Company bearing maintenance and running costs) or a monthly car allowance and cover under the Company's private health scheme (for the executive, his wife and dependant children) and financial counselling.

Mr J P Cheffins has a service agreement with the Company dated May 4, 2001 terminable by 12 months' written notice by the Company and six months' written notice by Mr J P Cheffins. Eligibility for performance related bonus arrangements, executive share options, pensions and benefits are identical to those described above for Mr C H Green.

Mr J M Guyette has a contract, dated September 27, 1997, with Rolls-Royce North America Inc., drawn up under the laws of the State of Virginia. It is for an indefinite term and provides that on termination without cause he is entitled to one year's severance pay without mitigation and in addition appropriate relocation costs. He is entitled to participate in the Company performance related bonus arrangement with a maximum bonus of 80 per cent of his salary. One third of the value of any bonus is paid in the form of Rolls-Royce plc shares. He is also eligible to participate in the Rolls-Royce executive share option scheme and is entitled to membership of an appropriate Rolls-Royce North America pension scheme. Mr Guyette is provided with a company car (the Company bearing the maintenance and running costs), or a monthly car allowance, housing allowance and appropriate club membership fees and cover, under Rolls-Royce North America's private health scheme (for himself, his wife and dependant children) and financial counselling.

Mr P Heiden, who resigned as a director of the Company on December 31, 2002, had a service agreement with the Company dated November 5, 1997. Mr R T Turner, who retired as a director of the Company on May 30, 2002, had a service agreement dated April 1, 1994. Both agreements were terminable by 24 months' written notice by the Company and six months' written notice by the executive. All other provisions of these agreements were identical to those described for Mr C H Green above except that the maximum bonus was 60 per cent of basic salary. No compensation for loss of office was paid to either Mr Heiden or Mr Turner on their resignation and retirement respectively from the Board.

Dr M G J W Howse has a service agreement with the Company dated October 12, 2001 terminable by 12 months' written notice by the Company and 12 months' written notice by Dr M G J W Howse. Eligibility for performance related bonus arrangements, executive share options, pensions and benefits are identical to those described for Mr C H Green above.

The non-executive directors do not have service contracts. No compensation is payable to any non-executive director if their appointment is terminated early. The following table sets out the terms of appointment for the non-executive directors:

	Appointment date of current 3 year term	Expiry date of current 3 year term
Mr D E Baird [1]	November 1, 2002	January 31, 2006
Mr P J Byrom	November 22, 2002	November 21, 2005
Lord Moore of Lower Marsh	January 15, 2001	January 14, 2004
Sir Robin Nicholson	January 1, 2001	December 31, 2003
Mr C G Symon	June 1, 2002	May 31, 2005
Sir John Weston	October 1, 2001	September 30, 2004

[1] Mr D E Baird served as a non-executive director of the Company from November 1, 2002 to January 31, 2003 before his appointment as non-executive Chairman on February 1, 2003.

n-executive directors' fees

e fees paid to non-executive directors (see page 35) are determined by Board who are informed by independent market surveys. Each n-executive director receives an annual fee and a fee in relation to mmittee work. Non-executive directors do not participate in any of the mpany's share schemes, performance pay arrangements or pension nemes.

2003, the Board will be reviewing the non-executive directors' fees and their ucture in the light of the conclusions of the Higgs report.

rformance graphs

der the Regulations, the report is required to contain a graph showing the mpany's 'total shareholder return' (TSR) performance over the previous e years compared to a broad equity market index. The graph below shows e performance of Rolls-Royce compared to the FTSE 100. The FTSE 100 s been chosen as the comparator index because it represents the most ective measure of performance of other leading companies listed the UK.

e strategic intent of Rolls-Royce is to develop a broadly-based business th leading market positions based on its unique gas turbine technology. e graphs opposite underline the significant progress made by the mpany despite the industry-wide impact of the tragic events of ptember 11, 2001.

otal shareholder return (index)

— Rolls-Royce total return (rebased to 100) — FTSE 100 total return (rebased to 100)

Order book – firm and announced £bn

Underlying EPS pence

Group turnover – per employee £'000

Underlying pre-tax return on average capital employed %

Installed base – civil jet engine units

Individual directors' emoluments and compensation

The individual directors' emoluments are analysed as follows:

	Basic salaries £000	Board and committee fees £000	Cash bonus £000	Bonus in deferred shares: Deferred – two years [1] £000	Deferred – three years [2] £000	Total deferred shares £000	SERS payments [3] £000	Taxable benefits £000	2002 Aggregate emoluments excluding pensions contributions [4] £000	2001 Aggregate emoluments excluding pensions contributions [3,4] £000
Sir Ralph Robins [5]	404	—	126	63	—	63	—	21	614	648
Sir John Rose	605	—	189	95	210	305	—	11	1,110	952
Mr J P Cheffins	378	—	118	59	131	190	—	22	708	601
Mr C H Green	353	—	127	64	123	187	—	27	694	480
Mr J M Guyette [6]	405	—	126	63	140	203	—	36	770	668
Mr P Heiden [7]	379	—	118	—	—	—	363	8	868	679
Dr M G J W Howse	272	—	92	46	—	46	—	24	434	182
Mr P C Ruffles [8]	—	—	—	—	—	—	—	—	—	421
Mr R T Turner [9]	129	—	43	22	—	22	179	8	381	520
Mr D E Baird [10]	—	4	—	—	—	—	—	—	4	—
Mr P J Byrom	—	37	—	—	—	—	—	—	37	37
Lord Moore of Lower Marsh	—	45	—	—	—	—	—	—	45	45
Sir Robin Nicholson	—	40	—	—	—	—	—	—	40	42
Mr C G Symon	—	33	—	—	—	—	—	—	33	32
Sir John Weston	—	30	—	—	—	—	—	—	30	30
	2,925	189	939	412	604	1,016	542	157	5,768	5,337

[1] Shares forming part of the bonus under APRA have been valued at date of award.
[2] Shares forming part of the bonus under DSIP have been valued at date of award.
[3] Payments made to Mr P Heiden and Mr R T Turner in connection with their participation in the Rolls-Royce 1994 Senior Executive Retirement Scheme (SERS) (see page 38), enabling them to discharge the income tax liability incurred by them on the contributions made by the Company into the SERS. 2001 aggregate emoluments for Mr Heiden and Mr Turner have been restated to enable a comparison on a similar basis.
[4] Details of the directors' pensions are set out on pages 38 and 39.
[5] 40% of Sir Ralph Robins' taxable benefits for 2002 was reimbursed by Cable & Wireless plc, in respect of his position as former non-executive Chairman of that Company.
[6] Mr J M Guyette was paid in US dollars translated at $1.50 = £1.
[7] Mr P Heiden resigned as a director with effect from December 31, 2002.
[8] Mr P C Ruffles retired as a director with effect from October 18, 2001.
[9] Mr R T Turner retired as a director with effect from May 30, 2002.
[10] Mr D E Baird was appointed to the Board with effect from November 1, 2002.

The table of long-term incentive awards on page 38 indicates that the deferred shares releaseable in 2003 were placed in trust at a value of £2.148 per share.

Non-executive directors' fees

Each non-executive director receives an annual fee of £25,000. In addition, fees of £5,000 per annum are paid to members of the audit and remuneration committees, with the chairmen of these committees receiving a further £2,500 per annum. Non-executive directors do not participate in any of the Company's share schemes, performance pay arrangements or pension schemes.

Lord Moore of Lower Marsh is Chairman of the Trustees of the Rolls-Royce Pension Fund and receives an annual fee of £10,000 for performing this role. Sir Robin Nicholson is Chairman of the Company's Environmental Advisory Board and receives an annual fee of £5,000 for performing this role.

The annual fee for Mr D E Baird, who was appointed non-executive Chairman of Rolls-Royce plc with effect from February 1, 2003, is £257,400. In addition, the Company makes available an apartment for Mr Baird's use. The annualised cost of this to the Company is £67,600. The Company also pays the expenses relating to the apartment.

Mr D E Baird is not entitled to participate in any of the Company's share schemes, performance pay arrangements or pension schemes. No compensation is payable in the event of his appointment being terminated.

Payments made to former directors of the Company

Following their retirement from the Board on May 30, 2002 and October 18, 2001 respectively, Mr R T Turner and Mr P C Ruffles continued to be employed by the Company on a part-time basis. The Board considered it to be in the interests of the Company to retain Mr R T Turner's expertise in marketing and Mr P C Ruffles' expertise in engineering. Mr R T Turner has been employed for a fixed-term until June 2003. Mr P C Ruffles' employment is terminable on six months notice. During the year they received respectively salaries of £81,000 and £204,000, and taxable benefits of £8,000 and £19,000 in respect of their employment.

Following his retirement on January 31, 2003, Sir Ralph Robins has been retained on a consultancy contract to give his support to the planning and preparation of the centenary celebrations for Rolls-Royce plc and for the centennial of powered flight. For these services he will be paid an annual fee of £25,000. This arrangement will end on December 31, 2004.

irectors' share interests

e directors, including their immediate families, at December 31, 2002, had beneficial interests in the ordinary shares of the Company, as shown in the lowing tables:

	January 1, 2002 *	Changes in 2002	December 31, 2002 §
Ralph Robins	103,607	46,693	150,300
John Rose	153,824	62,072	215,896
J P Cheffins	66,000	43,945	109,945
C H Green	104,632	24,466	129,098
J M Guyette	79,466	47,645	127,111
P Heiden [1]	42,739	31,329	74,068
M G J W Howse	18,446	37,243	55,689
R T Turner [2]	39,249	28,969	68,218
D E Baird	—	254,500	254,500
P J Byrom	31,887	1,592	33,479
d Moore of Lower Marsh	38,620	21,923	60,543
Robin Nicholson	17,036	—	17,036
C G Symon	5,500	273	5,773
John Weston	3,208	160	3,368

r date of appointment if later.
r date of retirement if earlier.

r P Heiden resigned as a director with effect from December 31, 2002.
r R T Turner retired as a director with effect from May 30, 2002.

Ralph Robins, Mr C H Green, Mr J M Guyette, Dr M G J W Howse, Mr P J Byrom, Lord Moore of Lower Marsh, Mr C G Symon and Sir John Weston took 4,875; 4,194; 3,862; 1,540; 18; 1,839; 176 and 103 shares respectively instead of cash dividends in January 2003.
John Rose and Mr C H Green both purchased 108 and 134 shares each respectively on January 17, 2003 and February 10, 2003 under the Inland Revenue approved are Incentive Plan.
herwise there have been no other changes in the directors' interests between December 31, 2002 and March 3, 2003.

addition the directors are for Companies Act purposes technically interested in the 401,283 Rolls-Royce plc shares held by the Rolls-Royce Qualifying nployee Share Trust and the 1,589,466 Rolls-Royce plc shares held in the Rolls-Royce Employee Share Trust.

ares held in trust

	Shares held in trust under the annual profit sharing share scheme [1]				Shares held in trust under the share incentive plan [2]			
	January 1, 2002	Vested during 2002	Granted during 2002	December 31, 2002 §	January 1, 2002	Vested during 2002	Granted during 2002	December 31, 2002
Ralph Robins	6,076	—	4,086	10,162	—	—	—	—
John Rose	7,332	—	4,260	11,592	—	—	192	192
J P Cheffins	4,274	—	3,830	8,104	—	—	—	—
C H Green	5,409	—	3,575	8,984	—	—	192	192
J M Guyette	—	—	—	—	—	—	—	—
P Heiden [3]	5,505	—	3,830	9,335	—	—	—	—
M G J W Howse	2,414	—	2,554	4,968	—	—	—	—
R T Turner [4]	4,357	—	2,860	7,217	—	—	—	—

r date of retirement if earlier.

Under the profit sharing share scheme, shares vest after three years.
Under the share incentive plan, shares vest on the fifth anniversary of each monthly purchase.
r P Heiden resigned as a director with effect from December 31, 2002.
r R T Turner retired as a director with effect from May 30, 2002.

The directors, at December 31, 2002, held the following options under the Rolls-Royce plc Executive Share Option Scheme, the Rolls-Royce 1999 Executive Share Option Plan and the Rolls-Royce International Share Save Plan.

Share options

	January 1, 2002	Granted in 2002	Lapsed in 2002	Exercised in 2002	December 31, 2002 §[1]	Exercise price	Market price at date exercised	Aggregate gains 2002 £000	Aggregate gains 2001 £000	Exercisable dates
Sir Ralph Robins	164,737				164,737	194p				2003-2010
	171,297				171,297	216p				2004-2011
	685,186				685,186 [2]	216p				2004-2011
	4,398				4,398 [3]	108p				2005
	1,025,618				1,025,618	212p [4]				
Sir John Rose	116,750				116,750 *	176p				1998-2005
	283,141				283,141	194p				2003-2010
	254,630				254,630	216p				2004-2011
	1,018,519				1,018,519 [2]	216p				2004-2011
	7,662				7,662 [3]	108p				2007
	—	638,298			638,298	188p				2005-2012
	1,680,702	638,298			2,319,000	203p [4]				
Mr J P Cheffins	72,250				72,250 *	176p				1998-2005
	15,444				15,444	194p				2003-2010
	118,405				118,405	194p				2003-2010
	173,612				173,612	216p				2004-2011
	694,445				694,445 [2]	216p				2004-2011
	4,398				4,398 [3]	108p				2005
	—	398,936			398,936	188p				2005-2012
	1,078,554	398,936			1,477,490	204p [4]				
Mr C H Green	67,250				67,250 *	176p				1998-2005
	4,756				4,756 [3]	205p				2005
	4,053				4,053 [3]	194p				2007
	154,441				154,441	194p				2003-2010
	162,038				162,038	216p				2004-2011
	648,149				648,149 [2]	216p				2004-2011
	551				551 [3]	108p				2007
	—	279,255			279,255	188p				2005-2012
	1,041,238	279,225			1,320,493	205p [4]				
Mr J M Guyette	114,581				114,581 *	269p				2002-2009
	2,721		2,721		—	194p				—
	167,799				167,799	194p				2003-2010
	179,161				179,161	216p				2004-2011
	716,641				716,641 [2]	216p				2004-2011
	4,398				4,398 [3]	108p				2005
	—	450,140			450,140	188p				2005-2012
	1,185,301	450,140	2,721		1,632,720	209p [4]				
Mr P Heiden [5]	66,750				66,750 *	176p				—
	162,163				162,163	194p				—
	173,612				173,612	216p				—
	694,445				694,445 [2]	216p				—
	7,662				7,662 [3]	108p				—
	—	398,936			398,936	188p				—
	1,104,632	398,936			1,503,568	204p [4]				

are options continued

	January 1, 2002	Granted in 2002	Lapsed in 2002	Exercised in 2002	December 31, 2002 §[1]	Exercise price	Market price at date exercised	Aggregate gains 2002 £000	Aggregate gains 2001 £000	Exercisable dates
M G J W Howse	41,250				41,250 *	176p				1998-2005
	15,444				15,444	194p				2003-2010
	48,392				48,392	194p				2003-2010
	3,395				3,395 [3]	194p				2003
	69,445				69,445	216p				2004-2001
	138,889				138,889 [2]	216p				2004-2011
	1,407				1,407 [3]	108p				2005
	—	199,468			199,468	188p				2005-2012
	318,222	199,468			517,690	199p[4]				
R T Turner [6]	105,750				105,750 *	176p				1998-2005
	1,697				1,697 [3]	194p				2003
	120,979				120,979	194p				2003-2010
	120,371				120,371	216p				2004-2011
	481,482				481,482 [2]	216p				2004-2011
	2,920				2,920 [3]	188p				2005
	833,199				833,199	207p				

or date of retirement if earlier.
Performance target achieved. Option capable of exercise. All other executive share options listed above are subject to stringent targets which have yet to be achieved.

Unless otherwise indicated all the above options were granted under the executive share option scheme and are subject to the achievement of performance targets (see page 32). All options granted under the executive share option scheme were granted at the market value on the date of issue and no discount was applied. No options were varied during the year and no consideration was paid for the grant of options. The market price of the Company's ordinary shares ranged between 95.25p and 203.5p during 2002. The closing price on December 31, 2002 was 107p.
Supplementary options – vesting of these options is subject to the attainment of significant personal share holding targets and the requirement that growth in EPS exceeds an average of 6% year on year as well as exceeding the UK RPI by 3% per annum over a rolling three year period. The increases are measured from the year 2000 or the base year of the rolling three year period, whichever is the more stringent.
Sharesave schemes.
Weighted average exercise price of December 31, 2002 balance.
Mr P Heiden's share options lapsed when he resigned as a director with effect from December 31, 2002.
Mr R T Turner retired as a director with effect from May 30, 2002

ong-term incentive awards

he directors as at December 31, 2002 had the following share awards in the Annual Performance Related Award Scheme:

	Shares held in trust under the annual performance related award scheme [1]			
	January 1, 2002	Vested during 2002	Granted during 2002	December 31, 2002 §
Ralph Robins	30,907	(17,113)	43,740	57,534
John Rose	45,906	(25,402)	65,610	86,114
J P Cheffins	33,824	(15,883)	41,007	58,948
C H Green	27,786	(16,043)	19,137	30,880
J M Guyette	31,858	(17,431)	46,270	60,697
P Heiden [2]	27,916	(15,241)	41,007	53,682
M G J W Howse	18,179	(8,952)	21,949	31,176
R T Turner [3]	22,260	(12,567)	30,618	40,311

or date of retirement if earlier.

Under the annual performance related award scheme, shares vest after two years see page 32. Shares went in to Trust in 2000, 2001 and 2002 at prices of £1.869, £2.148 and £1.829 respectively. At the date of this report, the amounts stated in the emoluments table on page 35 representing APRA and DSIP entitlements had not yet been applied by the Trustee to purchase shares. An investment is expected to be made by March 31, 2003 when the Trustee will procure the acquisition of the required number of shares at the prevailing market price.
Mr P Heiden's rights to these shares lapsed when he resigned as a director with effect from December 31, 2002.
Mr R T Turner retired as a director with effect from May 30, 2002.

ensions

r J M Guyette participates in pension plans sponsored by Rolls-Royce North America Inc.

l other executive directors under their normal retirement age are members of the Group's UK pension schemes. These schemes are funded and approved nal salary pension schemes providing, at retirement, a pension of up to two thirds of final remuneration, subject to Inland Revenue limits.

he Company also operates the Rolls-Royce 1994 Senior Executive Retirement Scheme (SERS). The purpose of the SERS is to fund pension provision above the ensionable earnings cap which was imposed on approved pension schemes under the 1989 Finance Act. The scheme provides a lump sum payment on tirement in lieu of the additional pension which would have been provided under the approved schemes had the earnings cap not been introduced. embership of the scheme is restricted to executive directors and to a limited number of senior executives. The scheme is administered by three trustees, under the Chairmanship of Lord Moore of Lower Marsh, none of whom has a beneficial interest in the scheme. The members of the scheme include Mr P Heiden and Mr R T Turner. They joined the Group after the introduction of the earnings cap and their terms and conditions on joining the Group included a commitment to provide pension and life cover based on total salary, in line with other directors and senior executives. The committee believes that for these executive directors, a funded arrangement is in the best interests of shareholders and avoids the build up of unfunded liabilities for the future.

In 2002 the payments detailed on page 35 were made to Mr P Heiden and Mr R T Turner in connection with their participation in the SERS, enabling them to discharge the income tax liability incurred by them on the contributions made by the Company into the SERS.

During the year, the Company did not make any pension contributions in respect of Sir Ralph Robins, who reached normal retirement age in June 1994.

Details of the pension benefits, which accrued over the year in the Group's approved UK pension schemes, are given below[6].

	Increase in accrued pension during the year ended Dec 31, 2002 [1] £000pa		Total accrued pension entitlement at the year ended Dec 31, 2002 [2] £000pa	Transfer value of accrued pension as at Dec 31, 2002 [3] £000	Transfer value as at Dec 31, 2001 of accrued pension at that date [3] £000	Increase in transfer value over 2002 net of the member's own contributions [4] £000	
Sir John Rose	50	(46)	294	5,268	4,570	662	(784)
Mr J P Cheffins	63	(59)	255	4,483	3,693	768	(1,017)
Mr C H Green	17	(13)	241	4,232	4,351	(140)	(208)
Mr P Heiden	2	(2)	21	302	288	—	(14)
Dr M G J W Howse	49	(47)	169	2,919	2,088	815	(796)
Mr R T Turner	2	(2)	18	310	279	20	(18)

Details of the retirement benefits, which accrued over the year in the SERS and the plans sponsored by Rolls-Royce North America Inc., are given below.

	Increase in accrued retirement lump sum during the year ended Dec 31, 2002 [1] £000pa		Total accrued retirement lump sum entitlement at the year ended Dec 31, 2002 [7] £000pa	Transfer value of accrued retirement lump sum as at Dec 31, 2002 [8] £000	Transfer value as at Dec 31, 2001 of accrued retirement lump sum at that date [8] £000	Increase in transfer value over 2002 net of the member's own contributions [4] £000	
Mr J M Guyette [5,9]	111	(95)	1,201	840	671	169	(62)
Mr P Heiden	153	(134)	1,247	715	586	129	(77)
Mr R T Turner	91	(77)	913	862	746	116	(73)

[1] The figure in brackets is the increase in pension/retirement lump sum during the year ended December 31, 2002 but in this case excluding the effect of inflation.
[2] The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year.
[3] The transfer values stated represent liabilities of the Rolls-Royce sponsored pension schemes and not sums paid to the individuals. The transfer values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11. Actuarial Guidance Note GN11 covers individual transfer calculations and the above figures have been calculated using assumptions certified by the Actuaries as being consistent with GN11. These transfer values are calculated in accordance with the requirements of the Directors' Remuneration Report Regulations 2002. Under these regulations the transfer value of the pension accrued prior to the start of the year must be calculated taking account of the executive's age and market conditions at the end of 2001. The transfer value of the pension accrued to the end of December 31, 2002 must take account of the executive's age and market conditions on that date. Therefore, the difference between the transfer values calculated at the beginning and the end of the year is only partly attributable to the additional pension accrued during the year and is also partly attributable to differences in market conditions on the respective calculation dates and to the executive having aged by one year.
[4] The figure in brackets, which is consistent with the approach used in previous years in order to comply with the stock exchange listing requirements, is the transfer value of the increase in pension/retirement lump sum during the year ended December 31, 2002 excluding the effect of inflation, and net of the member's own contributions. The transfer value has been calculated taking account of market conditions and the executive's age on December 31, 2002.
[5] Benefits are translated at US\$1.50 = £1.00.
[6] Members of the schemes have the option to pay Additional Voluntary Contributions. Neither the contributions nor the resulting benefits are included in the above table.
[7] The lump sum entitlement shown is that which would be paid on retirement based on service to the end of the year.
[8] The transfer values have been calculated on the basis of actuarial advice.
[9] Mr J M Guyette is a member of two defined benefit plans in the USA, one qualified and one non-qualified. He is also a member of an unfunded non-qualified plan in the USA. He accrues a retirement lump sum benefit in all three plans. The aggregate value of the three plans is shown in the second table. In addition, Mr Guyette is a member of two 401(K) Savings Plans in the USA, one qualified and one non-qualified, to which his employer, Rolls-Royce North America Inc., contributes. During 2002 the employer's contributions amounted to £29,876.

Approval of the directors' remuneration report

The directors' remuneration report above was approved by the Board of directors on March 3, 2003

Carl G Symon
Chairman of the Remuneration Committee

roup profit and loss account
or the year ended December 31, 2002

	Notes	Continuing operations before exceptional items £m	Exceptional items[1] £m	Total 2002 £m	Total 2001 £m
rnover: Group and share of joint ventures		**6,072**	**—**	**6,072**	6,680
les to joint ventures		**948**	**—**	**948**	871
ss share of joint ventures' turnover		**(1,232)**	**—**	**(1,232)**	(1,223)
roup turnover	2	**5,788**	**—**	**5,788**	6,328
st of sales		**(4,846)**	**(69)**	**(4,915)**	(5,406)
ross profit		**942**	**(69)**	**873**	922
her operating income	3	**158**	**—**	**158**	239
ommercial, marketing and product support costs		**(285)**	**(2)**	**(287)**	(288)
eneral and administrative costs		**(275)**	**(4)**	**(279)**	(281)
esearch and development (net)*		**(297)**	**—**	**(297)**	(358)
roup operating profit		**243**	**(75)**	**168**	234
are of operating profit of joint ventures		**66**	**—**	**66**	82
ss on sale or termination of businesses	32	**(22)**	**—**	**(22)**	(11)
ofit on sale of fixed assets		**—**	**—**	**—**	6
ofit on ordinary activities before interest	2	**287**	**(75)**	**212**	311
t interest payable – Group	4	**(72)**	**—**	**(72)**	(77)
– joint ventures		**(35)**	**—**	**(35)**	(42)
ofit on ordinary activities before taxation	3	**180**	**(75)**	**105**	192
xation	5	**(73)**	**21**	**(52)**	(86)
ofit on ordinary activities after taxation		**107**	**(54)**	**53**	106
uity minority interests in subsidiary undertakings				**—**	—
ofit attributable to ordinary shareholders				**53**	106
ividends	6			**(133)**	(132)
ansferred from reserves	26			**(80)**	(26)
esearch and development (gross)				**(590)**	(636)
arnings per ordinary share:	7				
nderlying				**11.10p**	20.20p
asic				**3.29p**	6.67p
luted basic				**3.26p**	6.56p

Exceptional items are analysed in note 3. In 2001 exceptional items amounted to £230m.

s permitted by the Companies Act 1985, a separate profit and loss account for the Company has not been included in these financial statements.
f the Group profit attributable to ordinary shareholders, a profit of **£19m** (2001 £63m) has been dealt with in the profit and loss account of the Company.
ere have been no material acquisitions or material discontinued operations in 2002 or 2001.

Balance sheets
at December 31, 2002

	Notes	Group 2002 £m	Group 2001 £m	Company 2002 £m	Company 2001 £m
Fixed assets					
Intangible assets	9	**868**	823	**45**	34
Tangible assets	10	**1,876**	1,732	**964**	860
Investments – subsidiary undertakings	11	**—**	—	**1,487**	1,759
– joint ventures	12	**195**	204	**47**	51
share of gross assets		**1,160**	1,341		
share of gross liabilities		**(971)**	(1,144)		
goodwill		**6**	7		
– other	13	**71**	30	**49**	6
		3,010	2,789	**2,592**	2,710
Current assets					
Stocks	14	**1,158**	1,222	**667**	677
Debtors – amounts falling due within one year	15	**1,487**	1,640	**1,769**	1,331
– amounts falling due after one year	16	**926**	810	**478**	465
Short-term deposits and investments	17	**84**	301	**13**	203
Cash at bank and in hand		**634**	578	**319**	293
		4,289	4,551	**3,246**	2,969
Creditors – amounts falling due within one year					
Borrowings	18	**(275)**	(276)	**(31)**	(113)
Other creditors	19	**(2,727)**	(2,720)	**(2,593)**	(2,240)
Net current assets		**1,287**	1,555	**622**	616
Total assets less current liabilities		**4,297**	4,344	**3,214**	3,326
Creditors – amounts falling due after one year					
Borrowings	20	**(1,038)**	(1,104)	**(794)**	(693)
Other creditors	21	**(450)**	(288)	**(325)**	(364)
Provisions for liabilities and charges	22	**(772)**	(882)	**(176)**	(260)
		2,037	2,070	**1,919**	2,009
Capital and reserves					
Called-up share capital	25	**323**	320	**323**	320
Share premium account	26	**634**	636	**634**	636
Revaluation reserve	26	**100**	103	**93**	97
Other reserves	26	**195**	189	**167**	167
Profit and loss account	26	**783**	820	**702**	789
Equity shareholders' funds		**2,035**	2,068	**1,919**	2,009
Equity minority interests in subsidiary undertakings		**2**	2	**—**	—
		2,037	2,070	**1,919**	2,009

The financial statements on pages 40 to 73 were approved by the Board on March 3, 2003 and signed on its behalf by:
Euan Baird Chairman, **Andrew Shilston** Finance Director.

roup cash flow statement
or the year ended December 31, 2002

		2002 £m	2001 £m
et cash inflow from operating activities	A	**611**	418
vidends received from joint ventures		**12**	15
turns on investments and servicing of finance	B	**(84)**	(54)
xation paid		**(41)**	(24)
pital expenditure and financial investment	C	**(381)**	(179)
quisitions and disposals	D	**(20)**	79
uity dividends paid		**(109)**	(84)
sh (outflow)/inflow before use of liquid resources and financing		**(12)**	171
anagement of liquid resources	E	**217**	(162)
nancing	F	**(81)**	111
crease in cash		**124**	120

econciliation of net cash flow to movement in net funds	2002	2001
crease in cash	**124**	120
sh (inflow)/outflow from (decrease)/increase in liquid resources	**(217)**	162
sh outflow/(inflow) from decrease/(increase) in borrowings	**82**	(95)
ange in net funds resulting from cash flows	**(11)**	187
orrowings of businesses acquired	**(52)**	—
nance lease additions	**(32)**	—
ero-coupon bonds 2005/2007 (9.0% interest accretion)	**(5)**	(3)
change adjustments	**6**	5
ovement in net funds	**(94)**	189
et debt at January 1	**(501)**	(690)
et debt at December 31	**(595)**	(501)

nalysis of net debt	**At January 1, 2002 £m**	**Cash flow £m**	**Acquired businesses £m**	**Exchange adjustments £m**	**Other non-cash changes £m**	**At December 31, 2002 £m**
sh at bank and in hand	**578**	**82**	**—**	**(26)**	**—**	**634**
erdrafts	**(56)**	**42**	**—**	**1**	**—**	**(13)**
ort-term deposits and investments	**301**	**(217)**	**—**	**—**	**—**	**84**
her borrowings due within one year	**(198)**	**155**	**(10)**	**5**	**(200)**	**(248)**
orrowings due after one year	**(1,034)**	**(103)**	**(42)**	**23**	**195**	**(961)**
nance leases	**(92)**	**30**	**—**	**3**	**(32)**	**(91)**
	(501)	**(11)**	**(52)**	**6**	**(37)**	**(595)**

Group cash flow statement
for the year ended December 31, 2002 continued

	2002 £m	2001 £m
Reconciliation of operating profit to operating cash flows		
Operating profit	**168**	234
Amortisation of intangible assets (note 9)	**74**	57
Depreciation of tangible fixed assets (note 3)	**236**	198
(Decrease)/increase in provisions for liabilities and charges	**(125)**	180
Decrease/(increase) in stocks	**19**	(52)
Decrease/(increase) in debtors	**27**	(386)
Increase in creditors	**212**	187
A **Net cash inflow from operating activities**	**611**	418
Returns on investments and servicing of finance		
Interest received	**23**	25
Interest paid	**(101)**	(73)
Interest element of finance lease payments	**(6)**	(6)
B **Net cash outflow for returns on investments and servicing of finance**	**(84)**	(54)
Capital expenditure and financial investment		
Additions to unlisted investments	**(44)**	(1)
Additions to intangible assets	**(50)**	(25)
Purchases of tangible fixed assets	**(314)**	(211)
Disposals of tangible fixed assets	**27**	56
Other investments	**—**	2
C **Net cash outflow for capital expenditure and financial investment**	**(381)**	(179)
Acquisitions and disposals		
Acquisitions of businesses (note 31)	**(28)**	(1)
Disposals of businesses (note 32)	**14**	102
Investments in joint ventures	**(6)**	(24)
Loan repayments from joint ventures	**—**	2
D **Net cash (outflow)/inflow for acquisitions and disposals**	**(20)**	79
Management of liquid resources		
Decrease/(increase) in short-term deposits	**218**	(159)
Increase in government securities and corporate bonds	**(1)**	(3)
E **Net cash inflow/(outflow) from management of liquid resources**	**217**	(162)
Financing		
Borrowings due within one year – repayment of loans	**(201)**	(46)
– increase in loans	**46**	85
Borrowings due after one year – repayment of loans	**(48)**	(2)
– increase in loans	**151**	69
Capital element of finance lease payments	**(30)**	(11)
Net cash (outflow)/inflow from (decrease)/increase in borrowings	**(82)**	95
Issue of ordinary shares	**1**	16
F **Net cash (outflow)/inflow from financing**	**(81)**	111

roup statement of total recognised gains and losses
r the year ended December 31, 2002

	2002 £m	2001 £m
ofit attributable to the shareholders of Rolls-Royce plc	**53**	106
change adjustments on foreign currency net investments	**15**	(11)
tal recognised gains for the year	**68**	95

Group historical cost profits and losses
or the year ended December 31, 2002

	2002 £m	2001 £m
rofit on ordinary activities before taxation	**105**	192
ifference between the historical cost depreciation charge and the actual depreciation charge for the year calculated on the revalued amount	**3**	5
istorical cost profit on ordinary activities before taxation	**108**	197
istorical cost transfer from reserves	**(77)**	(21)

Reconciliations of movements in shareholders' funds
or the year ended December 31, 2002

	Group		Company	
	2002 £m	2001 £m	2002 £m	2001 £m
t January 1	**2,068**	2,040	**2,009**	2,020
otal recognised gains for the year	**68**	95	**19**	63
rdinary dividends (net of scrip dividend adjustments)	**(110)**	(90)	**(110)**	(90)
ew ordinary share capital issued (net of expenses)	**1**	16	**1**	16
oodwill transferred to the profit and loss account in respect of disposals of businesses	**8**	7	**—**	—
t December 31	**2,035**	2,068	**1,919**	2,009

1 Accounting policies

Basis of accounting
The financial statements have been prepared in accordance with applicable accounting standards on the historical cost basis, modified to include the revaluation of land and buildings.

Basis of consolidation
The Group financial statements include the financial statements of the Company and all of its subsidiary undertakings made up to December 31, together with the Group's share of the results up to December 31 of:

i) Joint ventures
A joint venture is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. The results of joint ventures are accounted for using the gross equity method of accounting.

ii) Joint arrangements that are not entities
The Group has certain contractual arrangements with other participants to engage in joint activities that do not create an entity carrying on a trade or business of its own. The Group includes its share of assets, liabilities and cash flows in such joint arrangements, measured in accordance with the terms of each arrangement, which is usually pro-rata to the Group's risk interest in the joint arrangement.

Any subsidiary undertakings, joint ventures and joint arrangements that are not entities, sold or acquired during the year are included up to, or from, the dates of change of control.

Some small adjustments have been made to comparative figures to put them on a consistent basis with the current year.

Purchased goodwill
Goodwill represents the excess of the fair value of the purchase consideration for shares in subsidiary undertakings and joint ventures over the fair value to the Group of the net assets acquired.

i) To December 31, 1997: Goodwill was written off to reserves in the year of acquisition. The profit or loss on the disposal of a business acquired before December 31, 1997 takes into account the attributable value of purchased goodwill relating to that business.

ii) From January 1, 1998: Goodwill has been recognised within fixed assets in the year in which it arises and amortised on a straight line basis over its useful economic life, up to a maximum of 20 years.

Turnover
Turnover, excluding value added tax and discounts, comprises sales to outside customers, and the Group's percentage interest in sales of joint ventures. Long-term contracts are included in turnover on the basis of the sales value of work performed during the year by reference to the total sales value and stage of completion of these contracts.

Risk and revenue sharing partnerships
From time to time the Group enters into arrangements with partners who, in return for a share in future programme turnover or profits, make cash or other payments in kind which are not expected to be refundable. Sums received are credited to other operating income and payments to partners are charged to cost of sales.

Research and development
The charge to the profit and loss account consists of research and development expenditure incurred in the year, excluding known recoverable costs on contracts, contributions to shared engineering programmes and application engineering. Application engineering expenditure, incurred in the adaptation of existing technology to new products, is capitalised and amortised over the programme life, up to a maximum of ten years, where both the technical and commercial risks are considered to be sufficiently low.

Foreign currencies
Assets and liabilities denominated in foreign currencies are translated into sterling at the rate ruling at the year end or, where applicable, at the estimated sterling equivalent, taking account of future foreign exchange and similar contracts. The trading results of overseas undertakings are translated at the average exchange rates for the year or, where applicable, at the estimated sterling equivalent, taking account of future foreign exchange and similar contracts. Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are taken to reserves. Other exchange differences, including those arising from currency conversions in the usual course of trading, are taken into account in determining profit on ordinary activities before taxation.

Treasury instruments
The accounting treatment of the key instruments used by the Group is as follows:

i) Gains or losses arising on forward exchange contracts are taken to the profit and loss account in the same period as the underlying transaction.

ii) Net interest arising on interest rate agreements is taken to the profit and loss account.

iii) Premiums paid or received on currency options are taken to the profit and loss account when the option expires or matures.

iv) Gains or losses arising on jet fuel swaps are taken to the profit and loss account in the same period as the underlying transaction.

If the underlying transaction to a hedge ceases to exist, the hedge is terminated and the profits and losses on termination are recognised in the profit and loss account immediately. If the hedge transaction is terminated, the profits and losses on termination are held in the balance sheet and amortised over the life of the original underlying transactions.

Post-retirement benefits
Contributions to Group defined benefit pension schemes are charged to the profit and loss account so as to spread the cost of pensions at a substantially level percentage of payroll costs over employees' service lives.

The cost of providing post-retirement benefits other than pensions is charged to the profit and loss account over the service lives of the relevant employees.

Certification costs
Costs incurred in respect of meeting regulatory certification requirements for new civil engine/aircraft combinations, including those paid to airframe manufacturers, are carried forward in intangible assets to the extent that they can be recovered out of future sales and are charged to the profit and loss account over the programme life, up to a maximum of ten years.

Interest
Interest payable is charged to the profit and loss account as incurred, except where the borrowing finances tangible fixed assets in the course of construction relating to power development projects. Such interest is capitalised until the asset is complete and income producing and is then written off by way of depreciation of the relevant asset.

Interest receivable is credited to the profit and loss account as earned.

Taxation
Provision for taxation is made at the current rate and for deferred taxation at the projected rate on all timing differences which have originated, but not reversed at the balance sheet date.

Scrip dividends
The amounts of dividends taken as shares instead of cash under the scrip dividend scheme have been added back to reserves. The nominal value of shares issued under the scheme has been funded out of the share premium account.

Accounting policies continued

ock, contract provisions and long-term contracts
ock and work in progress are valued at the lower of cost and net realisable value. Full ovision is made for any estimated losses to completion of contracts having regard to e overall substance of the arrangements including, if appropriate, related commitments d undertakings given by customers. Provided that the outcome of long-term contracts n be assessed with reasonable certainty, such contracts are valued at cost plus tributable profit earned to date.

ogress payments received, when greater than recorded turnover, are deducted from the lue of work in progress except to the extent that payments on account exceed the lue of work in progress on any contract where the excess is included in creditors. The nount by which recorded turnover of long-term contracts is in excess of payments on count is classified as 'amounts recoverable on contracts' and is separately disclosed ithin debtors.

ccounting for leases
As Lessee
Assets financed by leasing agreements which give rights approximating to ownership (finance leases) have been capitalised at amounts equal to the original cost of the assets to the lessors and depreciation provided on the basis of the Group depreciation policy. The capital elements of future obligations under finance leases are included as liabilities in the balance sheet and the current year's interest element, having been allocated to accounting periods to give a constant periodic rate of charge on the outstanding balance, is charged to the profit and loss account.

The annual payments under all other lease arrangements, known as operating leases, are charged to the profit and loss account on an accruals basis.

As Lessor
Amounts receivable under finance leases are included under debtors and represent the total amount outstanding under lease agreements less unearned income. Finance lease income, having been allocated to accounting periods to give a constant periodic rate of return on the net cash investment, is included in turnover.

Rentals receivable under operating leases are included in turnover on an accruals basis.

Tangible fixed assets and depreciation
Tangible fixed assets are stated at cost or valuation less accumulated depreciation and any provision for impairments in value.

Depreciation is provided on the following basis:

i) Land and buildings
Depreciation is provided on the original cost of purchases since 1996 and on the valuation of properties adopted at December 31, 1996 and is calculated on the straight line basis at rates sufficient to reduce them to their estimated residual value. Estimated lives, as advised by the Group's professional valuers, are:
a) Freehold buildings – five to 45 years (average 24 years).
b) Leasehold land and buildings – lower of valuers' estimates or period of lease.

No depreciation is provided in respect of freehold land.

ii) Plant and equipment
Depreciation is provided on the original cost of plant and equipment and is calculated on a straight line basis at rates sufficient to reduce them to their estimated residual value. Estimated lives are in the range five to 25 years (average 16 years).

iii) Aircraft and engines
Depreciation is provided on the original cost of aircraft and engines and is calculated on a straight line basis at rates sufficient to reduce them to their estimated residual value. Estimated lives are in the range five to 20 years (average 18 years).

iv) In course of construction
No depreciation is provided on assets in the course of construction.

2 Segmental analysis

	Group turnover 2002 £m	Group turnover 2001 £m	Profit before interest 2002 £m	Profit before interest 2001 £m	Net assets[1] 2002 £m	Net assets[1] 2001 £m
Analysis by business:						
Civil aerospace	**2,739**	3,443	**87**	198	**1,219**	1,124
Defence	**1,376**	1,400	**161**	132	**25**	179
Marine	**984**	827	**54**	37	**550**	513
Energy	**639**	608	**(70)**	(118)	**348**	381
Financial services[2]	**50**	50	**(20)**	62	**490**	374
	5,788	6,328	**212**	311	**2,632**	2,571
Geographical analysis by origin:						
United Kingdom	**3,395**	3,760	**52**	137	**1,170**	1,275
Other	**2,393**	2,568	**160**	174	**1,462**	1,296
	5,788	6,328	**212**	311	**2,632**	2,571
Geographical analysis by destination:						
United Kingdom	**892**	1,118				
Rest of Europe	**893**	797				
USA	**1,966**	2,328				
Canada	**134**	267				
Asia	**1,018**	1,081				
Africa	**145**	69				
Australasia	**115**	151				
Other	**625**	517				
	5,788	6,328				
Exports from United Kingdom	**2,486**	2,629				
Sales to overseas subsidiaries	**(179)**	(328)				
Sales by overseas subsidiaries	**2,572**	2,896				
Sales by overseas joint arrangements	**17**	13				
Total overseas	**4,896**	5,210				

[1] Net assets exclude net debt of **£595m** (2001 net debt of £501m).
[2] The turnover of financial services businesses including share of joint ventures is **£122m** (2001 £149m).

The analysis of underlying profit before interest, the profit and loss account exceptional items and the reconciliation to underlying profit before taxation are as follows:

	2002 Underlying profit before interest £m	2002 Exceptional items £m	2002 Other non-trading items £m	2002 Profit before interest £m	2001 Underlying profit before interest £m	2001 Exceptional items £m	2001 Other non-trading items £m	2001 Profit before interest £m
Civil aerospace	**150**	**(51)**	**(12)**	**87**	347	(136)	(13)	198
Defence	**183**	**(11)**	**(11)**	**161**	175	(38)	(5)	132
Marine	**82**	**(1)**	**(27)**	**54**	73	(15)	(21)	37
Energy	**(41)**	**(10)**	**(19)**	**(70)**	(64)	(41)	(13)	(118)
Financial services	**(12)**	**(2)**	**(6)**	**(20)**	63	—	(1)	62
	362	**(75)**[1]	**(75)**[2]	**212**	594	(230)[1]	(53)[2]	311
Interest	**(107)**				(119)			
Underlying profit before taxation	**255**				475			

[1] Rationalisation costs see note 3.
[2] Comprising amortisation of goodwill **£52m** (2001 £45m), loss on sale of businesses **£22m** (2001 £11m) and loss on sale of fixed assets **£1m** (2001 profit of £3m).

Profit on ordinary activities before taxation

	2002 £m	2001 £m
ter crediting		
sk and revenue sharing partnerships – receipts (credited to other operating income)	**158**	239
– payments (charged to cost of sales)	**(139)**	(113)
et impact of risk and revenue sharing partnerships	**19**	126
perating lease rentals receivable	**34**	36
fter charging		
ceptional items – rationalisation costs [1]	**75**	230
mortisation of goodwill	**52**	45
mortisation of certification costs	**22**	12
epreciation of owned tangible fixed assets [2]	**212**	192
epreciation of tangible fixed assets held under finance leases [2]	**24**	6
perating lease rentals payable – hire of plant and equipment	**60**	54
– hire of other assets	**21**	21

uditors' fees were as follows during the year:
Audit 2002 – Group **£3.2m** (2001 £3.0m) including Company **£0.7m** (2001 £0.6m)
Other 2002 – United Kingdom **£0.8m** (2001 £1.1m)
– Rest of World **£0.8m** (2001 £0.9m)

Rationalisation costs relate to termination of employment, site decommissioning and relocation and related disruption to operations, including accelerated depreciation of plant and machinery. At December 31, 2002 **£52m** (2001 £144m) was included in provisions (see note 22).
Including appropriate amounts charged to stocks.

Net interest payable – Group

	2002 £m	2001 £m
terest payable on:		
Bank loans and overdrafts	**(26)**	(45)
Other borrowings	**(62)**	(52)
Finance leases	**(6)**	(6)
terest capitalised	**—**	2
	(94)	(101)
terest receivable	**22**	24
	(72)	(77)

5 Taxation

Current tax	UK 2002 £m	UK 2001 £m	Overseas 2002 £m	Overseas 2001 £m	Total 2002 £m	Total 2001 £m
Current tax charge/(credit) for the period	**(16)**	6	**54**	46	**38**	52
Less double tax relief	**(1)**	(4)	**—**	—	**(1)**	(4)
	(17)	2	**54**	46	**37**	48
Joint ventures	**5**	6	**4**	3	**9**	9
	(12)	8	**58**	49	**46**	57
Deferred tax						
Deferred tax charge/(credit) for the period	**22**	16	**(10)**	13	**12**	29
Adjustments in respect of prior periods	**(7)**	—	**1**	—	**(6)**	—
	3	24	**49**	62	**52**	86

Tax reconciliation [1]	2002	2001
Profit on ordinary activities before taxation	**105**	192
Nominal tax charge at UK corporation tax rate **30%** (2001 30%)	**32**	58
Goodwill not deductible for tax purposes	**19**	16
Unrelieved overseas losses	**8**	12
Fixed asset timing differences	**3**	24
Other timing differences	**(15)**	(53)
UK R&D tax credit	**(6)**	—
Other items	**5**	—
	46	57

[1] For the purpose of this reconciliation the tax on the profits of joint ventures has been assumed to be entirely current.

Analysis of taxation charge:	2002	2001
Trading activities	**76**	154
Non underlying items (note 7)	**(24)**	(68)
	52	86

6 Dividends – ordinary shares

	2002 £m	2001 £m
Interim **3.18p** (2001 3.18p) per share	**51**	51
Final proposed **5.00p** (2001 5.00p) per share	**82**	81
	133	132

Earnings per ordinary share

sic earnings per ordinary share are calculated by dividing the profit attributable to ordinary shareholders of **£53m** (2001 £106m) by **1,612 million** (2001 1,589 million) ordinary ares, being the average number of ordinary shares in issue during the year, excluding own shares held under trust (note 13) which have been treated as if they had been cancelled.

nderlying earnings per ordinary share have been calculated as follows:

	2002 Pence	**2002** £m	2001 Pence	2001 £m
ofit attributable to ordinary shareholders	**3.29**	**53**	6.67	106
clude:				
Exceptional rationalisation costs	**4.65**	**75**	14.47	230
Loss/(profit) on sale of fixed assets (excluding lease engines and aircraft sold by financial services companies)	**0.06**	**1**	(0.19)	(3)
Amortisation of goodwill	**3.23**	**52**	2.83	45
Net loss on sale of businesses	**1.36**	**22**	0.69	11
Related tax effect	**(1.49)**	**(24)**	(4.27)	(68)
nderlying earnings per ordinary share	**11.10**	**179**	20.20	321

luted basic earnings per ordinary share are calculated by dividing the profit attributable to ordinary shareholders of **£53m** (2001 £106m) by **1,624 million** (2001 1,616 million) dinary shares, being **1,612 million** (2001 1,589 million) as above adjusted by the bonus element of existing share options of **12 million** (2001 27 million).

Employee information

	2002 Number	2001 Number
verage weekly number of Group employees during the year		
nited Kingdom	**23,900**	27,300
verseas	**15,300**	16,000
	39,200	43,300
vil aerospace	**21,800**	24,300
efence	**6,000**	7,200
arine	**6,500**	6,600
nergy	**4,800**	5,100
nancial services	**100**	100
	39,200	43,300
	£m	£m
roup employment costs [1]		
ages and salaries	**1,313**	1,430
ocial security costs	**108**	128
ensions and other post-retirement benefits (note 30)	**83**	89
	1,504	1,647

Directors' remuneration is shown on page 35.

9 Intangible fixed assets

	Group				Company
	Goodwill £m	Certification costs £m	Application engineering £m	Total £m	Certification costs £m
Cost					
At January 1, 2002	**861**	**111**	**20**	**992**	**111**
Exchange adjustments	**68**	**—**	**—**	**68**	**—**
Additions	**12**	**33**	**17**	**62**	**33**
Disposals	**(4)**	**—**	**—**	**(4)**	**—**
At December 31, 2002	**937**	**144**	**37**	**1,118**	**144**
Accumulated amortisation					
At January 1, 2002	**92**	**77**	**—**	**169**	**77**
Exchange adjustments	**8**	**—**	**—**	**8**	**—**
Provided during the year	**52**	**22**	**—**	**74**	**22**
Disposals	**(1)**	**—**	**—**	**(1)**	**—**
At December 31, 2002	**151**	**99**	**—**	**250**	**99**
Net book value at December 31, 2002	**786**	**45**	**37**	**868**	**45**
Net book value at December 31, 2001	769	34	20	823	34

Tangible fixed assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
roup					
ost or valuation:					
At January 1, 2002	**474**	**1,758**	**173**	**195**	**2,600**
Exchange adjustments	**3**	**(21)**	**(15)**	**(9)**	**(42)**
Additions at cost	**10**	**107**	**126**	**101**	**344**
On acquisitions of businesses	**7**	**87**	**—**	**—**	**94**
On disposals of businesses	**(6)**	**(7)**	**—**	**—**	**(13)**
Reclassifications	**24**	**52**	**—**	**(76)**	**—**
Disposals/write-offs	**(1)**	**(65)**	**(5)**	**(13)**	**(84)**
At December 31, 2002	**511**	**1,911**	**279**	**198**	**2,899**
cumulated depreciation:					
At January 1, 2002	**60**	**753**	**55**	**—**	**868**
Exchange adjustments	**1**	**(13)**	**(5)**	**—**	**(17)**
Provided during year [1]	**16**	**193**	**27**	**—**	**236**
On disposals of businesses	**—**	**(1)**	**—**	**—**	**(1)**
Disposals/write-offs	**—**	**(58)**	**(5)**	**—**	**(63)**
At December 31, 2002	**77**	**874**	**72**	**—**	**1,023**
et book value at December 31, 2002	**434**	**1,037**	**207**	**198**	**1,876**
et book value at December 31, 2001	414	1,005	118	195	1,732
mpany					
ost or valuation:					
At January 1, 2002	**284**	**1,065**	**—**	**54**	**1,403**
Additions at cost	**2**	**78**	**93**	**45**	**218**
Reclassifications	**3**	**33**	**—**	**(36)**	**—**
Disposals/write-offs	**(17)**	**(51)**	**—**	**(2)**	**(70)**
At December 31, 2002	**272**	**1,125**	**93**	**61**	**1,551**
cumulated depreciation:					
At January 1, 2002	**46**	**497**	**—**	**—**	**543**
Provided during year	**11**	**86**	**—**	**—**	**97**
Disposals/write-offs	**(3)**	**(50)**	**—**	**—**	**(53)**
At December 31, 2002	**54**	**533**	**—**	**—**	**587**
et book value at December 31, 2002	**218**	**592**	**93**	**61**	**964**
et book value at December 31, 2001	238	568	—	54	860

Includes impairment charges as follows:
Aircraft and engines – £17m relating to the write-down of aircraft to values provided by independent aircraft appraisers.
Plant and equipment – £30m relating to the write-down of certain Rolls-Royce Power Ventures' industrial Trent power projects to their recoverable amount based on value in use, using a pre-tax discount rate of 10%.

10 Tangible fixed assets continued

	Group		Company	
Tangible fixed assets include:	**2002 £m**	2001 £m	**2002 £m**	2001 £m
Net book value of finance leased assets	**115**	113	**52**	27
Assets held for use in operating leases:				
Cost	**259**	153	**93**	—
Depreciation	**(59)**	(44)	**—**	—
Net book value	**200**	109	**93**	—
Non-depreciable land	**79**	80	**58**	58
Land and buildings at cost or valuation comprise:				
Cost	**285**	248	**80**	83
Valuation at December 31, 1985	**1**	1	**—**	—
Valuation at December 31, 1996 [1]	**225**	225	**192**	201
	511	474	**272**	284
Land and buildings at net book value comprise:				
Freehold	**404**	383	**211**	230
Long leasehold	**17**	19	**7**	8
Short leasehold	**13**	12	**—**	—
	434	414	**218**	238
On a historical cost basis the net book value of land and buildings would have been as follows:				
Cost	**495**	458	**254**	266
Depreciation	**(161)**	(147)	**(129)**	(125)
	334	311	**125**	141
Capitalised interest included in net book value of assets in course of construction	**2**	5	**—**	—
Capital expenditure commitments – contracted but not provided for	**68**	96	**28**	30

The Group has followed the transitional provisions of FRS 15 'Tangible fixed assets', to retain the book value of land and buildings, certain of which were revalued in 1996 (see [1] below).

[1] Group properties were revalued at December 31, 1996 as follows:

i) Specialised properties, including certain of the Group's major manufacturing sites, were revalued on a depreciated replacement cost basis.
ii) Non-specialised properties were revalued by reference to their existing use value.
iii) Properties surplus to the Group's requirements were revalued on an open market value basis.

In the United Kingdom the revaluation was carried out by Gerald Eve, Chartered Surveyors, Fuller Peiser, Chartered Surveyors and Storey Sons & Parker, Chartered Surveyors, in accordance with the appraisal and valuation manual of the Royal Institution of Chartered Surveyors. Overseas properties were valued principally by independent local valuers.

Investments – subsidiary undertakings

	Shares £m	Loans £m	Total £m
mpany			
st:			
At January 1, 2002	**1,472**	**287**	**1,759**
Additions/(repayments)	**15**	**(287)**	**(272)**
At December 31, 2002	**1,487**	**—**	**1,487**

e principal subsidiary undertakings are listed on pages 70 and 71.

2 Investments – joint ventures

	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m
roup				
January 1, 2002	**142**	**47**	**15**	**204** [1]
change adjustments	**(5)**	**(2)**	**(1)**	**(8)**
dditions	**5**	**1**	**—**	**6**
sposals and repayments	**(16)**	**8**	**(9)**	**(17)**
are of retained profit	**—**	**10**	**—**	**10**
December 31, 2002	**126**	**64**	**5**	**195** [1]
ompany				
January 1, 2002	**47**	**—**	**4**	**51**
dditions	**2**	**—**	**—**	**2**
sposals and repayments	**(2)**	**—**	**(4)**	**(6)**
December 31, 2002	**47**	**—**	**—**	**47**

e principal joint ventures are listed on pages 72 and 73.

nvestments in joint ventures are represented by:

	2002 £m	2001 £m
are of aggregate assets:		
Fixed	**710**	856
Current	**450**	485
are of aggregate liabilities: [2]		
Due within one year	**(391)**	(431)
Due after one year	**(580)**	(713)
odwill	**6**	7
	195	204
Includes borrowings of	**(616)**	(781)

13 Investments – other

	Unlisted investments at cost £m	Own shares held under trust[1] £m	Total £m
Group			
At January 1, 2002	**24**	**6**	**30**
Net additions	**44**	**—**	**44**
Amortisation and utilisation	**—**	**(3)**	**(3)**
At December 31, 2002	**68**	**3**	**71**
Company			
At January 1, 2002	**—**	**6**	**6**
Net additions	**46**	**—**	**46**
Amortisation and utilisation	**—**	**(3)**	**(3)**
At December 31, 2002	**46**	**3**	**49**

[1] Ordinary shares in the Company are held in two trusts:

i) As part of the long-term incentive plan (LTIP), the Rolls-Royce 1999 executive share option plan and other employee share schemes (see Directors' remuneration report on pages 31 to 39).
The shares held by this independently managed trust were purchased on the open market:

		£m
March 26, 1999	114,466 at £2.54 per share	0.3
June 30, 1999	1,475,000 at £2.73 per share	4.0

At December 31, 2002, these shares had a market value of £1.7m. In accordance with UITF 17 'Employee share schemes', the Company is required to amortise the cost of likely awards over each separate performance measurement period and to include this charge as part of the cost of 'wages and salaries'. The UITF is a committee of the Accounting Standards Board.

ii) In respect of a Qualifying Employee Share Trust (QUEST), which provides employees with shares under Inland Revenue approved Save As You Earn (SAYE) share schemes. As permitted by UITF 17, no amortisation charge has been made. At December 31, 2002, a total of 401,283 of these shares had still not been allocated to option holders, their market value being £0.4m. These outstanding allocations are expected to occur in 2003.

Both trusts have waived dividends and voting rights, and their costs of administration have been charged to the Company's profit and loss account.

14 Stocks

	Group		Company	
	2002 £m	2001 £m	2002 £m	2001 £m
Raw materials	**187**	218	**29**	52
Work in progress	**385**	334	**136**	76
Long-term contracts work in progress	**105**	96	**70**	47
Finished goods	**755**	815	**509**	583
Payments on account	**27**	35	**46**	30
	1,459	1,498	**790**	788
Progress payments received against:				
Long-term contracts work in progress	**(122)**	(27)	**(37)**	—
Other stocks[1]	**(179)**	(249)	**(86)**	(111)
	1,158	1,222	**667**	677
[1] Includes payments received from joint ventures	**(18)**	(23)	**(18)**	(23)

Debtors – amounts falling due within one year

	Group		Company	
	2002 £m	2001 £m	**2002 £m**	2001 £m
ade debtors	**941**	991	**415**	382
nounts recoverable on contracts	**61**	74	**16**	7
nounts owed by – subsidiary undertakings	**—**	—	**1,010**	621
– joint ventures	**172**	195	**155**	156
rporate taxation	**2**	5	**—**	—
eferred tax assets (note 23)	**21**	15	**—**	—
her debtors	**115**	182	**43**	39
epayments and accrued income	**175**	178	**130**	126
	1,487	1,640	**1,769**	1,331

5 Debtors – amounts falling due after one year

	Group		Company	
	2002 £m	2001 £m	**2002 £m**	2001 £m
ade debtors	**41**	48	**40**	47
nounts recoverable on contracts	**450**	274	**343**	245
nounts owed by – subsidiary undertakings	**—**	—	**10**	10
– joint ventures	**43**	68	**24**	54
eferred tax assets (note 23)	**84**	82	**—**	—
her debtors	**56**	40	**5**	—
epayments and accrued income	**48**	117	**47**	102
epaid pension contributions	**204**	181	**9**	7
	926	810	**478**	465

7 Short-term deposits and investments

	Group		Company	
	2002 £m	2001 £m	**2002 £m**	2001 £m
nort-term deposits	**44**	262	**13**	203
vestments – government securities and corporate bonds	**40**	39	**—**	—
	84	301	**13**	203

3 Borrowings – amounts falling due within one year

	Group		Company	
	2002 £m	2001 £m	**2002 £m**	2001 £m
verdrafts	**13**	56	**25**	—
ank loans	**44**	187	**—**	99
ther loans	**4**	11	**—**	—
bligations under finance leases	**14**	22	**6**	14
/8% Notes 2003 [1]	**200**	—	**—**	—
	275	276	**31**	113

The Group has borrowed US $300m through a subsidiary, Rolls-Royce Capital Inc., in order to provide a loan for general Group purposes. This has been translated into sterling after taking account of future contracts. The loan is guaranteed by the Company. These notes are the subject of interest swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest in consideration for amounts payable by the Group at variable rates of interest.

19 Other creditors – amounts falling due within one year

	Group 2002 £m	Group 2001 £m	Company 2002 £m	Company 2001 £m
Payments received on account [1]	**263**	234	**172**	92
Trade creditors	**475**	587	**228**	269
Amounts owed to – subsidiary undertakings	**—**	—	**905**	644
– joint ventures	**105**	161	**98**	158
Corporate taxation	**198**	211	**81**	100
Other taxation and social security	**51**	60	**27**	23
Other creditors	**600**	631	**485**	460
Accruals and deferred income	**902**	704	**464**	362
Interim dividend since paid	**51**	51	**51**	51
Final proposed dividend	**82**	81	**82**	81
	2,727	2,720	**2,593**	2,240
[1] Includes payments received from joint ventures	**60**	44	**60**	44

20 Borrowings – amounts falling due after one year

	Group 2002 £m	Group 2001 £m	Company 2002 £m	Company 2001 £m
Unsecured				
Bank loans	**213**	87	**80**	—
7 1/8% Notes 2003 [1]	**—**	200	**—**	—
4 1/2% Notes 2005 [2]	**177**	177	**177**	177
6 3/8% Notes 2007 [2]	**310**	310	**310**	310
7 3/8% Notes 2016	**200**	200	**200**	200
Other loan 2009 (interest rate nil)	**4**	4	**—**	—
Secured				
Bank loans	**14**	13	**—**	—
Obligations under finance leases payable: [3]				
Between one and two years	**7**	10	**7**	2
Between two and five years	**70**	50	**20**	3
After five years	**—**	10	**—**	1
Zero-coupon bonds 2005/2007 (including 9.0% interest accretion) [4]	**43**	43	**—**	—
	1,038	1,104	**794**	693
Repayable				
Between one and two years – by instalments	**92**	10	**87**	2
– otherwise	**59**	201	**—**	—
Between two and five years – by instalments	**121**	84	**20**	3
– otherwise	**546**	247	**487**	177
After five years – by instalments	**20**	19	**—**	1
– otherwise	**200**	543	**200**	510
	1,038	1,104	**794**	693

[1] See note 18.
[2] The Company has borrowed 756m in order to provide a loan for general Group purposes. These notes are the subject of currency swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable by the Company at variable rates of interest and at fixed exchange rates.
[3] Obligations under finance leases are secured by related leased assets.
[4] Secured on aircraft financed by joint arrangements. Repayment of the zero-coupon bonds is also guaranteed by the Company.

Other creditors – amounts falling due after one year

	Group 2002 £m	Group 2001 £m	Company 2002 £m	Company 2001 £m
yments received on account [1]	**175**	109	**175**	109
nounts owed to – subsidiary undertakings	**—**	—	**5**	198
– joint ventures	**20**	24	**—**	—
rporate taxation	**2**	—	**—**	—
her creditors	**78**	43	**73**	32
cruals and deferred income	**175**	112	**72**	25
	450	288	**325**	364
ncludes payments received from joint ventures	**35**	26	**35**	26

2 Provisions for liabilities and charges

	At January 1, 2002 £m	Exchange adjustments £m	Acquisition/ disposal of businesses £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At December 31, 2002 £m
roup							
ost-employment, pensions and other post-retirement benefits	157	(14)	—	—	29	(14)	158
eferred taxation	149	2	9	(8)	27	—	179
arranty/guarantees	197	2	(6)	(12)	70	(69)	182
ontract loss	88	1	—	(4)	35	(36)	84
ustomer financing	82	—	—	—	31	(49)	64
surance	21	—	—	—	3	(1)	23
estructuring and rationalisation	150	—	—	(4)	16	(108)	54
ther	38	(1)	—	(5)	18	(22)	28
	882	(10)	3	(33)	229	(299)	772
ompany							
eferred taxation	69	—	—	(3)	—	—	66
arranty/guarantees	37	—	—	(3)	14	(5)	43
ontract loss	3	—	—	—	1	(2)	2
ustomer financing	30	—	—	—	15	(7)	38
estructuring and rationalisation	114	—	—	—	1	(88)	27
ther	7	—	—	—	—	(7)	—
	260	—	—	(6)	31	(109)	176

ost-employment, pensions and other post-retirement provisions are long term in nature and the timing of their utilisation is uncertain.
arranty provisions primarily relate to products sold and generally cover a period of up to three years.
ovisions for contract loss and restructuring are generally expected to be utilised within one year.
ustomer financing provisions cover guarantees provided for asset values and/or financing as described in note 28. Timing of utilisation is uncertain.
surance provisions relate to the Group's captive insurance business with timing of utilisation being uncertain.
ther provisions comprise a number of liabilities with varying expected utilisation rates.

23 Deferred taxation

	Group £m	Company £m
At January 1, 2002	**(52)**	**(69)**
Amount charged to profit and loss account	**(6)**	**3**
On acquisitions of businesses	**(9)**	**—**
Exchange movements	**(6)**	**—**
Transfers	**(1)**	**—**
At December 31, 2002	**(74)**	**(66)**

There are other deferred tax assets totalling **£35m** (2001 £27m) that have not been recognised on the basis that their future economic benefit is uncertain.

The undistributed profits of overseas subsidiary undertakings and joint ventures may be liable to overseas taxes and/or United Kingdom tax (after allowing for double tax relief) if remitted as dividends to the UK. No deferred tax has been provided as there are currently no commitments to pay such dividends.

The analysis of the deferred tax position is as follows:

	Group		Company	
	2002 £m	2001 £m	**2002 £m**	2001 £m
Fixed asset timing differences	**(130)**	(110)	**(109)**	(112)
Other timing differences	**—**	4	**6**	8
Advance corporation tax	**56**	54	**37**	35
	(74)	(52)	**(66)**	(69)

Included in:				
Provisions	**(179)**	(149)	**(66)**	(69)
Debtors	**105**	97	**—**	—
	(74)	(52)	**(66)**	(69)

The above figures exclude taxation payable on capital gains which might arise from the sale of fixed assets at the values at which they are stated in the Group's balance sheet.

Financial instruments

tails of the Group's policies on the use of financial instruments are given in the Finance Director's review on pages 18 to 23 and in the accounting policies on pages 45 to 46. e following disclosures provide additional information regarding the effect of these instruments on the financial assets and liabilities of the Group, excluding short-term debtors d creditors where permitted by FRS 13.

nding and interest rates

	Sterling £m	**US Dollar £m**	**Euro £m**	**Other £m**	**2002 Total £m**
ancial assets					
Cash at bank and in hand [1]	**180**	**292**	**83**	**79**	**634**
Short-term deposits [2]	**15**	**3**	**—**	**26**	**44**
Government securities and corporate bonds [3]	**39**	**1**	**—**	**—**	**40**
Unlisted fixed asset investments [4]	**46**	**12**	**2**	**8**	**68**
Debtors – amounts falling due after one year [4]	**65**	**39**	**—**	**20**	**124**
	345	**347**	**85**	**133**	**910**
ancial liabilities [5]					
Floating-rate borrowings [6]	**(96)**	**(53)**	**(9)**	**(1)**	**(159)**
Fixed-rate borrowings	**(833)**	**(151)**	**—**	**(166)**	**(1,150)**
Borrowings on which no interest is paid [7]	**—**	**—**	**—**	**(4)**	**(4)**
Other creditors – amounts falling due after one year [4]	**(1)**	**(85)**	**—**	**(2)**	**(88)**
Provisions [4]	**—**	**—**	**—**	**—**	**—**
	(930)	**(289)**	**(9)**	**(173)**	**(1,401)**

	Sterling £m	US Dollar £m	Euro £m	Other £m	2001 Total £m
ancial assets					
Cash at bank and in hand [1]	39	419	55	65	578
Short-term deposits [2]	223	28	—	11	262
Government securities and corporate bonds [3]	38	1	—	—	39
Unlisted fixed asset investments [4]	—	13	1	10	24
Debtors – amounts falling due after one year [4]	86	10	17	20	133
	386	471	73	106	1,036
ancial liabilities [5]					
Floating-rate borrowings [6]	(164)	(87)	(10)	(183)	(444)
Fixed-rate borrowings	(820)	(83)	—	(29)	(932)
Borrowings on which no interest is paid [7]	—	—	—	(4)	(4)
Other creditors – amounts falling due after one year [4]	(37)	(27)	—	(3)	(67)
Provisions [4]	—	(6)	—	—	(6)
	(1,021)	(203)	(10)	(219)	(1,453)

otes
Cash at bank and in hand comprises bank balances and deposits placed on money markets overnight.
Short-term deposits are deposits placed on money markets for periods ranging from two nights up to one month.
Interest on the securities and bonds are at fixed rates. The weighted average interest rate on the sterling securities is 5.1% (2001 6.4%) and the weighted average interest rate on the US Dollar securities is 5.0% (2001 5.0%). The weighted average time for these securities is 2.3 years (2001 2.6 years).
These amounts do not incur or accrue interest.
Financial liabilities are stated after taking into account the various interest rate and currency swaps entered into by the Group.
Floating-rate financial liabilities comprise bank borrowings bearing interest at rates fixed in advance for periods ranging from one to six months based on the applicable LIBOR rate.
The weighted average period for borrowings on which no interest is paid is seven years (2001 eight years).

24 Financial instruments continued

The analysis of fixed-rate borrowings is as follows:

	2002 Total £m	2002 Weighted average interest rate at which fixed %	2002 Weighted average period for which rate is fixed Months	2001 Total £m	2001 Weighted average interest rate at which fixed %	2001 Weighted average period for which rate is fixed Months
Currency						
Sterling	**833**	**7.3**	**14**	820	6.4	15
US Dollar	**151**	**7.0**	**56**	83	7.1	47
Other	**166**	**5.2**	**32**	29	5.4	60

The maturity profile of the Group's financial liabilities is as follows:

	2002 £m	2001 £m
In one year or less, or on demand	**275**	276
In more than one year but not more than two years	**194**	250
In more than two years but not more than five years	**712**	365
In more than five years	**220**	562
	1,401	1,453

Borrowing facilities
The Group has various borrowing facilities available to it. The undrawn committed facilities available at December 31, 2002 were as follows:

	2002 £m	2001 £m
Expiring within one year	**64**	399
Expiring in one to two years	**500**	75
Expiring thereafter	**825**	500
	1,389	974

Exchange risk management
The table below shows the Group's currency exposures at December 31, 2002 on currency transactions that give rise to the net currency gains and losses recognised in the profit and loss account. Such exposures comprise the net monetary assets and liabilities of the Group at December 31, 2002 that are not denominated in the functional currency of the operating company involved. The exposures are stated after taking into account the effects of currency swaps and forward foreign exchange contracts.

	2002 Net foreign currency monetary assets/(liabilities)				2001 Net foreign currency monetary assets/(liabilities)			
Functional currency of Group operation	Sterling £m	US Dollar £m	Euro £m	Other £m	Sterling £m	US Dollar £m	Euro £m	Other £m
Sterling	**—**	**(3)**	**(1)**	**2**	—	(1)	—	1
US Dollar	**1**	**—**	**—**	**(1)**	—	—	—	—
Euro	**1**	**1**	**—**	**—**	—	—	—	1
Other	**2**	**1**	**—**	**—**	2	1	3	(1

Financial instruments continued

ir values of financial assets and financial liabilities

e estimated fair value of the Group's financial instruments are summarised below:

	2002 Book value £m	2002 Fair value £m	2001 Book value £m	2001 Fair value £m
listed fixed asset investments	**68**	**68**	24	24
sh at bank and in hand	**634**	**634**	578	578
ort-term deposits and investments	**84**	**87**	301	301
ort-term debt	**(275)**	**(281)**	(276)	(274)
ng-term debt	**(1,038)**	**(1,170)**	(1,104)	(1,133)
her creditors – amounts falling due after one year	**(88)**	**(85)**	(67)	(64)
btors – amounts falling due after one year	**124**	**119**	133	127
ovisions	**—**	**—**	(6)	(6)
rivatives used to hedge the interest, currency and commodity exposure of the business:				
Jet fuel swaps	**—**	**2**	—	(6)
Interest rate swaps	**(24)**	**(58)**	(40)	(97)
Currency options	**—**	**(1)**	—	(3)
Forward foreign currency contracts	**—**	**151**	(4)	(550)
Forward purchase of shares to meet share option commitments	**—**	**(59)**	—	(21)

here available, market values have been used to determine current values. Where market values are not available, fair values have been calculated by discounting expected ture cash flows at prevailing interest and exchange rates.

ash at bank and in hand, short-term deposits and short-term borrowings:
The book value approximates to fair value either due to the short-term maturity of the instruments or because the interest rate of investments is reset after periods not greater than six months.

erivatives:
The fair value of derivatives is the estimated amount, based on current market rates, which the Group would expect to pay or receive were it to terminate the derivatives at the balance sheet date.

edges of future transactions

s described in the Finance Director's review on pages 18 to 23 the Group's policy is to hedge the following exposures:
Interest rate risk – using interest swaps
Currency exposures on future forecast sales – using forward foreign currency contracts, currency swaps and currency options
Commodity price risk – using jet fuel swaps
ains and losses on instruments used for hedging are dealt with as outlined in the accounting policies on pages 44 and 45.

nrecognised gains and losses on instruments used for hedging, and the movements therein, are as follows:

	2002 Gains £m	2002 (Losses) £m	2002 Total net gains/(losses) £m	2001 Gains £m	2001 (Losses) £m	2001 Total net gains/(losses) £m
nrecognised gains and losses on hedges at January 1, 2002	**78**	**(711)**	**(633)**	96	(389)	(293)
ains and losses arising in previous year that were recognised in 2002	**(46)**	**209**	**163**	(44)	90	46
ains and losses arising in previous year that were not recognised in 2002	**32**	**(502)**	**(470)**	52	(299)	(247)
ains and losses arising in 2002 that were not recognised in 2002	**358**	**171**	**529**	26	(412)	(386)
nrecognised gains and losses on hedges at December 31, 2002 of which:	**390**	**(331)**	**59**	78	(711)	(633)
Gains and losses expected to be recognised in 2002	**163**	**(143)**	**20**	33	(227)	(194)
Gains and losses expected to be recognised thereafter	**227**	**(188)**	**39**	45	(484)	(439)

25 Share capital

Authorised	Non-equity special share of £1	Equity ordinary shares of 20p each	Nominal value £m
At January 1 and December 31, 2002	1	2,000,000,000	400
Issued and fully paid			
At January 1, 2002	1	1,601,143,713	320
Exercise of share options	—	659,267	—
In lieu of paying dividends in cash	—	15,193,090	3
At December 31, 2002	1	1,616,996,070	323

Certain special rights, set out in the Company's Articles of Association, attach to the special rights redeemable preference share (special share) issued to HM Government. Subject to the provisions of the Companies Act 1985, the special share may be redeemed by the Treasury Solicitor at par at any time. The special share confers no rights to dividends or to vote at general meetings but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

At December 31, 2002, the following ordinary shares were subject to options:

	Date of grant	Number	Exercise price	Exercisable dates
Executive share option scheme	1995	1,342,250	176p	2003-2005
	1996	75,600	238p	2003-2006
Executive share option plan	1999	1,252,095	269p	2003-2009
	1999	254,896	216p	2003-2009
	2000	6,467,373	194p	2003-2010
	2000	1,955,501	194p	2003-2010
	2000	36,808	163p	2003-2010
	2000	171,015	163p	2003-2010
	2000	11,731	170p	2003-2010
	2001	1,067,561	216p	2004-2011
	2001	10,142,944	216p	2004-2011
	2001	17,171,364	216p	2004-2011
	2001	41,283	218p	2004-2011
	2001	326,581	218p	2004-2011
	2002	15,360,077	188p	2005-2012
	2002	707,119	188p	2005-2012
	2002	581,312	216p	2005-2012
Sharesave schemes	1995	3,278,704	150p	2003
	1997	8,747,945	205p	2003/2005
	*1998	130,465	107p	2004
	1999	8,632,782	194p	2003/2005/2007
	2001	40,739,085	108p	2005/2007/2009

Under the terms of the executive share option scheme and the executive share option plan, options granted to 529 directors and senior executives were outstanding at December 31, 2002.

Under the terms of the sharesave schemes, the Board may grant options to purchase ordinary shares in the Company each year to those employees who enter into an Inland Revenue approved Save As You Earn (SAYE) contract for a period of either three, five or seven years.

Employees in 28 countries participate in sharesave schemes through arrangements broadly comparable to the UK scheme.

*Relates to options granted under the Vickers plc sharesave schemes which, following the acquisition of Vickers plc, were exchanged in accordance with Inland Revenue Rules for options over Rolls-Royce plc ordinary shares.

Reserves

	Non-distributable Share premium £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m
oup				
January 1, 2002	**636**	**103**	**189**	**820**
change adjustments	—	—	—	**15**
rip dividend adjustment	—	—	—	**23**
dinary shares issued relating to scrip dividend	**(3)**	—	—	—
ite-back of purchased goodwill relating to disposals	—	—	**8**	—
ising on share issues (net of expenses)	**1**	—	—	—
ansfers between reserves	—	**(3)**	**(2)**	**5**
tained loss for the year	—	—	—	**(80)**
December 31, 2002	**634**	**100**	**195**	**783**
mpany				
January 1, 2002	**636**	**97**	**167**	**789**
rip dividend adjustment	—	—	—	**23**
dinary shares relating to scrip dividend	**(3)**	—	—	—
ising on share issues (net of expenses)	**1**	—	—	—
ansfers between reserves	—	**(4)**	—	**4**
tained loss for the year	—	—	—	**(114)**
December 31, 2002	**634**	**93**	**167**	**702**

e cumulative amount of goodwill, arising on the acquisition of undertakings still in the Group at December 31, 2002, written off against other reserves amounts **£372m** (2001 £380m). The continuance of this basis, in respect of pre-1998 acquisitions, is permitted under the transitional arrangements of FRS 10.

Operating lease annual commitments

	Group 2002 £m	2001 £m	Company 2002 £m	2001 £m
ases of land and buildings which expire:				
Within one year	**2**	2	—	—
Between one and five years	**5**	6	**2**	2
After five years	**6**	6	**4**	3
ther leases which expire:				
Within one year	**1**	2	—	—
Between one and five years	**11**	12	**5**	6
After five years	**52**	52	—	—

28 Contingent liabilities

In connection with the sale of its products, on some occasions the Group and Company enter into individually and collectively significant long-term contingent obligations. These can involve, inter alia, guaranteeing financing for customers, guaranteeing a proportion of the values of both engine and airframe, entering into leasing transactions, commitments to purchase aircraft and in certain circumstances could involve the Group and Company assuming certain of its customers' entitlements and related borrowing or cash flow obligations until the value of the security can be realised.

At the date these accounts are approved, the directors regard the possibility that there will be any significant loss arising from these contingencies, which cover a number of customers over a long period of time, as remote. In determining this, and the values above, the directors have taken account of advice, principally from Airclaims Limited, professional aircraft appraisers, who base their calculations on a current and future fair market value basis assuming an arms-length transaction between a willing seller and a willing buyer.

At December 31, 2002, the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions amounted to **£1,093m** (2001 £857m), of which **£35m** (2001 £78m) related to sales finance support to joint ventures. Taking into account the net realisable value of the relevant security, the net contingent liabilities in respect of financing arrangements on all delivered aircraft amounted to **£186m** (2001 £206m). Sensitivity calculations are complex, but, for example, if the value of the relevant security was reduced by 20%, a net contingent liability of approximately **£251m** (2001 £283m) would result. There are also net contingent liabilities in respect of undelivered aircraft but it is not considered practicable to estimate these as deliveries can be many years in the future and the related financing will only be put in place at the appropriate time.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Company and some of its subsidiary undertakings have, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Group is no longer fully insured against known and potential claims from employees who worked for certain of the Group's UK based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group or Company.

In addition to the guarantees referred to in note 20 and above at December 31, 2002, there were other Company guarantees in respect of financial obligations of subsidiary undertakings **£125m** (2001 £156m), and in respect of joint ventures **£17m** (2001 £51m).

29 Related party transactions

Joint ventures
In the course of normal operations, the Group has contracted on an arms-length basis with joint ventures. The aggregated transactions which are considered to be material and which have not been disclosed elsewhere in the financial statements are summarised below:

	2002 £m	2001 £m
Other income	**20**	16
Purchases of goods and services from joint ventures	**(482)**	(333)

Post-retirement benefits

nsions

e Group's pension schemes are mainly of the defined benefit type and the assets of the schemes are held in separate trustee administered funds.

e pension cost relating to the UK schemes is assessed in accordance with SSAP 24 'Accounting for Pension Costs', based on the advice of independent qualified actuaries using the ojected unit method. The latest actuarial valuations of the principal schemes were as at March 31, 2001 (for the Vickers Group Pension Scheme), April 5, 2001 (for the Rolls-Royce oup Pension Scheme), and March 31, 2000 (for The Rolls-Royce Pension Fund). The principal assumptions used were that in the long term the average returns on investments ould be between 2.0% and 2.25% per annum higher than the average increase in pay and between 3.5% and 4.0% per annum higher than the average increase in pensions. Assets ere valued on a market related basis.

e pension cost relating to overseas schemes is calculated in accordance with local best practice and regulations.

e total pension cost for the Group was **£64m** (2001 £72m) of which **£21m** (2001 £17m) relates to overseas schemes.

e aggregate of the market values of the UK schemes at the dates of the latest actuarial valuations was £4,933m. The actuarial value of the assets of the principal schemes presented respectively 100% (for The Rolls-Royce Pension Fund), 129% (for the Vickers Group Pension Scheme) and 126% (for the Rolls-Royce Group Pension Scheme) of the lue of the projected accrued liabilities.

e difference between the value of the assets and the value of the projected accrued liabilities (after allowing for expected future increases in earnings and discretionary pension creases) is being amortised over periods of between 8.5 and 13 years, being the average expected remaining service lives of the pensionable employees.

epayments of **£204m** (2001 £181m) are included in debtors and accruals of **£30m** (2001 £33m) are included in provisions for liabilities and charges, being the differences between e accumulated amounts paid into the pension funds and the accumulated pension costs.

ost-retirement benefits other than pensions

the USA, and to a lesser extent in some other countries, the Group's employment practices include the provision of healthcare and life insurance benefits for retired employees. the USA, 330 retired employees currently benefit from these provisions and it is estimated that 4,900 current employees will be eligible on retirement.

e cost of post-retirement benefits other than pensions for the Group was **£19m** (2001 £17m). Provisions for the benefit obligations at December 31, 2002 amounted **£120m** (2001 £118m) and are included in provisions for liabilities and charges. There were no plan assets at either December 31, 2002 or December 31, 2001. The future costs benefits are assessed in accordance with the advice of independent qualified actuaries and are based on a weighted average discount rate of 6.75% and a weighted average sumed healthcare costs trend rate of 10.0% grading down to 5.0% over eight years.

30 Post-retirement benefits continued

FRS 17 disclosures
The full implementation of FRS17 'Retirement Benefits' has been deferred, however certain disclosures are required which are included below.

The valuations with respect to UK schemes have been based on the most recent actuarial valuation (as noted above) and updated by the scheme actuary to December 31, 2002 taking account of the requirements of FRS 17. For the material overseas defined benefit schemes the last formal actuarial valuations have been updated to December 31, 2002 by a qualified actuary taking account of the requirements of FRS 17.

The principal actuarial assumptions were as follows:

	2002		2001	
	UK schemes %	**Overseas schemes %[1]**	UK schemes %	Overseas schemes %[1]
Rate of increase in salaries	**3.8**	**2.9**	4.0	4.3
Rate of increase of pensions in payment and deferment	**2.3**	**0.4**	2.5	0.4
Discount rate	**5.5**	**6.6**	6.0	7.0
Inflation assumption	**2.3**	**2.9**	2.5	3.0

[1] Weighted average percentage.

The assets in the principal schemes and the expected rates of return at December 31, 2002 were as follows:

	2002 Group				**2002 Company**	
	UK schemes		**Overseas schemes**			
	Expected long-term rate of return %	**Market value £m**	**Expected long-term rate of return %**	**Market value £m**	**Expected long-term rate of return %**	**Market value £m**
Equities	**8.0**	**2,524**	**9.4**	**63**	**8.0**	**1,794**
Sovereign debt	**4.4**	**644**	**—**	**—**	**4.4**	**404**
Corporate bonds	**5.0**	**492**	**6.5**	**45**	**5.0**	**371**
Other	**5.9**	**144**	**6.5**	**9**	**6.2**	**125**
Total market value of assets	**—**	**3,804**	**—**	**117**	**—**	**2,694**
Present value of scheme liabilities	**—**	**(5,400)**	**—**	**(360)**	**—**	**(4,127)**
Deficit in the schemes	**—**	**(1,596)**	**—**	**(243)[2]**	**—**	**(1,433)**
Related deferred tax asset	**—**	**479**	**—**	**85**	**—**	**430**
Net pension liability	**—**	**(1,117)**	**—**	**(158)**	**—**	**(1,003)**

	2001 Group				2001 Company	
	UK schemes		Overseas schemes			
	Expected long-term rate of return %	Market value £m	Expected long-term rate of return %	Market value £m	Expected long-term rate of return %	Market value £m
Equities	8.4	3,118	10.0	70	8.5	2,170
Sovereign debt	5.0	665	—	—	5.0	390
Corporate bonds	6.0	496	7.0	49	6.0	379
Other	7.2	301	7.2	11	7.5	277
Total market value of assets	—	4,580	—	130	—	3,216
Present value of scheme liabilities	—	(4,986)	—	(304)	—	(3,782
Deficit in the schemes	—	(406)	—	(174)[2]	—	(566
Related deferred tax asset	—	122	—	61	—	170
Net pension liability	—	(284)	—	(113)	—	(396

[2] Provisions of **£158m** (2001 £157m) exist for overseas post-employment benefits and pensions (see note 22).

Post-retirement benefits continued

nounts charged to profit and loss account

	Group UK schemes £m	Group Overseas schemes £m	Company £m
erating profit			
Current service charge	**73**	**19**	**61**
iance income			
Expected return on pension scheme assets	**(344)**	**(11)**	**(244)**
Interest on pension scheme liabilities	**294**	**22**	**224**
	(50)	**11**	**(20)**
tal charge	**23**	**30**	**41**

ovement in scheme deficits during the year

	Group UK schemes £m	Group Overseas schemes £m	Company £m
January 1, 2002	**(406)**	**(174)**	**(566)**
change adjustments	**—**	**17**	**—**
rrent service cost	**(73)**	**(19)**	**(61)**
ontributions	**67**	**21**	**67**
iance income	**50**	**(11)**	**20**
tuarial loss	**(1,234)**	**(77)**	**(893)**
December 31, 2002	**(1,596)**	**(243)**	**(1,433)**

story of experience gains and losses and amount recognised in statement of total recognised gains and losses

	Group UK schemes £m	Group Overseas schemes £m	Company £m
fference between the expected and actual return on scheme assets			
Amount	**(950)**	**(28)**	**(656)**
Percentage of scheme costs	**(25%)**	**(24%)**	**(24%)**
perience gains and losses on scheme liabilities			
Amount	**110**	**(26)**	**100**
Percentage of the present value of scheme liabilities	**2%**	**(7%)**	**2%**
ect of changes in assumptions underlying the present value of scheme liabilities			
Amount	**(394)**	**(23)**	**(337)**
Percentage of the present value of scheme liabilities	**(7%)**	**(7%)**	**(8%)**
change adjustments	**—**	**17**	**—**
tal amount recognised in the statement of total recognised gains and losses			
Amount	**(1,234)**	**(60)**	**(893)**
Percentage of the present value of scheme liabilities	**(23%)**	**(17%)**	**(22%)**

et assets

he above net pensions liabilities had been recognised in the financial statements, the net assets and profit and loss reserve would be as follows:

	Group 2002 £m	Group 2001 £m	Company 2002 £m	Company 2001 £m
et assets per balance sheet	**2,037**	2,070	**1,919**	2,009
et pension liability	**(1,275)**	(397)	**(1,003)**	(396)
ension prepayment [1]	**(143)**	(127)	**(6)**	(5)
ovisions for pensions and other post retirement benefits [2]	**101**	102	**—**	—
tal FRS 17 pension adjustment	**(1,317)**	(422)	**(1,009)**	(401)
et assets under FRS 17	**720**	1,648	**910**	1,608

Pension prepayment currently recorded: Group **£204m** (2001 £181m) less related deferred tax liability of **£61m** (2001 £54m); Company **£9m** (2001 £7m) less related deferred tax liability of **£3m** (2001 £2m).
Provisions currently recorded **£158m** (2001 £157m) less related deferred tax asset of **£57m** (2001 £55m).

30 Post-retirement benefits continued

Profit and loss reserve

	Group 2002 £m	Group 2001 £m	Company 2002 £m	Company 2001 £m
Profit and loss reserve	**783**	820	**702**	789
Total FRS 17 pension adjustment	**(1,317)**	(422)	**(1,009)**	(401)
Profit and loss reserve under FRS 17	**(534)**	398	**(307)**	388

31 Acquisition of businesses

During the year the Group acquired interests in a number of small businesses as summarised below:

	Total £m
Tangible fixed assets	**94**
Stocks	**4**
Debtors	**12**
Creditors	**(15)**
Provisions for liabilities and charges	**(9)**
Net assets	**86**
Less borrowings on acquired businesses	**(52)**
	34
Goodwill arising	**6**
	40
Less transfer from joint ventures	**(20)**
	20
Deferred consideration from previous years	**8**
Net cash outflow per cash flow statement	**28**

32 Disposal or termination of businesses

During the year the Group disposed of its interests in Vickers Defence Systems and in a number of other small businesses, as summarised below:

	Vickers Defence Systems £m	Other businesses £m	Total £m
Tangible fixed assets	**12**	**—**	**12**
Stocks	**7**	**4**	**11**
Debtors	**18**	**—**	**18**
Creditors	**(23)**	**—**	**(23)**
Provisions for liabilities and charges	**(6)**	**—**	**(6)**
Net assets	**8**	**4**	**12**
Related goodwill	**3**	**8**	**11**
Loss on sale or termination of businesses	**(10)**	**(12)**	**(22)**
Disposal proceeds less costs	**1**	**—**	**1**
Net payments deferred at December 31, 2002	**12**	**(3)**	**9**
Accrued costs	**—**	**4**	**4**
Net cash inflow per cash flow statement	**13**	**1**	**14**

incipal subsidiary undertakings
December 31, 2002

orporated within the UK

il aerospace	
ls E.L. Turbofans Limited	FJ44 engine support services/holding company
ls-Royce Total Care Services Limited	Aftermarket support services
arine systems	
ls-Royce Marine Power Operations Limited	Nuclear submarine propulsion systems
kers Engineering plc [1]	Marine systems/holding company
ergy	
ls-Royce Fuel Cell Systems Limited	Development of fuel cell systems
ancial services and corporate	
l Overseas Holdings Limited [2]	Holding company
ls-Royce Aircraft Management Limited	Sales finance and other financial services
ls-Royce Capital Limited [3]	Sales finance and other financial services
ls-Royce International Limited	International support and commercial information services
ls-Royce Leasing Limited	Engine leasing
ls-Royce Overseas Holdings Limited	Holding company
ls-Royce Overseas Investments Limited [4]	Holding company
ls-Royce Power Engineering plc	Power generation and marine systems
ls-Royce Power Ventures Limited	Provision of project development capabilities
kers plc	Holding company

he interest is held by Vickers plc.
he interest is held by Rolls-Royce Power Engineering plc.
his subsidiary acts as an agent of Rolls-Royce plc.
he interest is held by Rolls-Royce (Ireland).

e above companies operate principally in the UK and the effective Group interest is 100%.

Principal subsidiary undertakings
at December 31, 2002 continued

Incorporated overseas

Civil aerospace		
Brazil	Rolls-Royce Brasil Limitada	Repair and overhaul
France	Rolls-Royce Technical Support SARL [1]	Project support
Germany	Rolls-Royce Deutschland Ltd & Co KG [2]	BR700 series engine development and manufacture
Italy	Europea Microfusioni Aerospaziali SPA	Manufacture of castings
USA	Rolls-Royce Corporation [3]	Design, development and manufacture of gas turbine engines
USA	Rolls-Royce Engine Services – Oakland Inc. [4]	Repair and overhaul
USA	Rolls-Royce Gear Systems Inc. [4]	Design and manufacture of accessory gearbox systems
Marine systems		
Finland	Rolls-Royce OY AB [5]	Manufacture of winches and propeller systems
Norway	Rolls-Royce Marine AS [5]	Design and manufacture of ship equipment
Norway	Ulstein Holding AS [6]	Holding company
Sweden	Kamewa Holding AB [5]	Holding company
Sweden	Rolls-Royce AB [7]	Manufacture of propeller systems
USA	Rolls-Royce Commercial Marine Inc. [4]	Aftermarket support services
USA	Rolls-Royce Naval Marine Inc. [4]	Design and manufacture of ship propellers
USA	Syncrolift Inc. [4]	Shiplift systems
Energy		
Canada	Rolls-Royce Canada Limited [8]	Industrial gas turbines and aero engine sales, service and overhaul
Canada	Rolls-Royce Holdings Canada Inc.	Holding company
India	Rolls-Royce Energy Systems India Private Limited [1]	Project management and customer support
Singapore	Rolls-Royce Pte Limited [1]	Engine and turbine compression systems, spares
USA	Rolls-Royce Energy Systems Inc. [4]	Turbine generator packages
Financial services and corporate		
Eire	Rolls-Royce (Ireland) [1]	Holding company
Guernsey	Nightingale Insurance Limited [1]	Insurance services
USA	Rolls-Royce North America (USA) Holdings Co. [9]	Holding company
USA	Rolls-Royce North America Holdings Inc. [10]	Holding company
USA	Rolls-Royce Capital Inc. [11]	Financial services

[1] The interests are held by Rolls-Royce Overseas Holdings Limited.
[2] The interest is held as follows: 49.5% Rolls-Royce Erste Beteiligungs GmbH, 50.5% Rolls-Royce Zweite Beteiligungs GmbH.
[3] The interest is held by Rolls-Royce Asset Management Inc.
[4] The interests are held by Rolls-Royce North America Ventures I Inc.
[5] The interests are held by Vickers International Limited.
[6] The interest is held by Rolls-Royce Marine AS.
[7] The interest is held by Kamewa Holding AB.
[8] The interest is held by Rolls-Royce Holdings Canada Inc.
[9] The interest is held by Rolls-Royce Overseas Investments Limited.
[10] The interest is held by Rolls-Royce North America (USA) Holdings Co.
[11] The interest is held by Rolls-Royce North America Ventures II Inc.

With the exception of Rolls-Royce (Ireland), which operates in the UK, the above companies operate principally in the country of their incorporation. The effective Group interest is 100%, other than Europea Microfusioni Aerospaziali SPA which is 51%.

A list of all subsidiary undertakings will be included in the Company's annual return to Companies House.

ncipal joint ventures
December 31, 2002

orporated within the UK

	Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
vil aerospace			
T Limited rbine blade repair services	A Ordinary B Ordinary	— 100	49.5
rbine Surface Technologies Limited rbine surface coatings	A Ordinary B Ordinary	— 100	50
efence			
tanker Holdings Limited lding company	Ordinary	20	20
lls-Royce Snecma Limited (UK & France) gine collaboration	A Shares B Shares	— 100	50
lls-Royce Turbomeca Limited (UK & France) our and RTM322 engines collaboration	A Shares B Shares	— 100	50
rbo-Union Limited (UK, Germany & Italy) 199 engine collaboration	Ordinary A Shares	40 37.5	40
ergy			
lls Wood Group (Repair and Overhauls) Limited pair and overhaul	A Ordinary B Ordinary	100 —	50
nancial services and corporate			
pha Partners Leasing Limited gine leasing	A Ordinary B Ordinary	100 —	50

corporated overseas

		Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
vil aerospace				
ina	Xian XR Aero Components Co Limited Manufacturing facility for aero-engine parts	Ordinary	49	49
ong Kong	Hong Kong Aero Engine Services Limited [1] Repair and overhaul	Ordinary	45	45
ael	TechJet Aerofoils Limited [1] Manufacture of compressor aerofoils	A Ordinary B Ordinary	50 50	50
udi Arabia	Middle East Propulsion Company Limited [2] Repair and overhaul	Ordinary	16.7	16.7
ngapore	International Engine Component Overhaul Pte Limited [1] Repair and overhaul	Common	50	50
ngapore	Singapore Aero Engine Services Private Limited [1] (effective interest 39%) Repair and overhaul	Ordinary	30	30
ain	Industria de Turbo Propulsores SA Manufacture and maintenance of aero engines	Ordinary	46.9	46.9
vitzerland	IAE International Aero Engines AG (UK, Germany, Japan & USA) V2500 series engine collaboration	A Shares B Shares C Shares D shares	100 — — —	32.5
SA	Data Systems & Solutions, LLC [3] Advanced controls and predictive data management	N/A	50:50 Partnership	
SA	Texas Aero Engine Services, LLC [4] Repair and overhaul	N/A	50:50 Partnership	
SA	Williams-Rolls Inc. [5] (UK & North America) FJ44 engine collaboration	Common	15	15

Principal joint ventures
at December 31, 2002 continued

Incorporated overseas continued

		Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Defence				
Germany	EPI Europrop International GmbH (Germany) A400M engine collaboration	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) EJ200 engine collaboration	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) MTR390 engine collaboration	Ordinary	33.3	33.3
Financial services and corporate				
Isle of Man	Pembroke Group Limited [6] (Eire) Aircraft leasing	Ordinary	50	50
USA	Alpha Leasing (US) LLC [7] Engine leasing	N/A	50:50 Partnership	
USA	Alpha Leasing (US) (No. 2) LLC [7] Engine leasing	N/A	50:50 Partnership	
USA	Exostar LLC [8] B2B exchange	N/A	17.6	Partnership
USA	Rolls-Royce & Partners Finance (US) LLC [7] Engine leasing	N/A	50:50 Partnership	

Unincorporated overseas

Civil aerospace

USA — Light Helicopter Turbine Engine Company (LHTEC)
Rolls-Royce Corporation has a 50% interest in this unincorporated partnership which was formed to jointly develop and market the T800 engine.

[1] The interests are held by Rolls-Royce Overseas Holdings Limited.
[2] The interest is held by Middle East Equity Partners Limited.
[3] The partner is Rolls-Royce Control Systems Holdings Co.
[4] The partner is Rolls-Royce Engine Services Holdings Co.
[5] The interest is held by Rolls E.L. Turbofans Limited.
[6] The interest is held by Larten Limited.
[7] The partner is Rolls-Royce Finance Holdings Co.
[8] The partner is Rolls-Royce Investment Co.

The countries of principal operations are stated in brackets after the name of the company.

Joint arrangements that are not entities
at December 31, 2002

		Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Jersey	RS Leasing Limited [1] Aircraft leasing	A Ordinary B Ordinary	100 —	50

[1] The interest is held by Rolls-Royce Leasing Limited.

rectors' responsibilities
r the financial statements

mpany law requires the directors to prepare financial statements for each financial year ich give a true and fair view of the state of affairs of the Company and of the Group d of the profit or loss for that period.

preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company and the Group will continue in business.

e directors are responsible for keeping proper accounting records which disclose with asonable accuracy at any time the financial position of the Company and to enable em to ensure that the financial statements comply with the Companies Act 1985. They ve general responsibility for taking such steps as are reasonably open to them to feguard the assets of the Group and to prevent and detect fraud and other egularities.

Report of the independent auditors
to the members of Rolls-Royce plc

We have audited the financial statements on pages 40 to 73. We have also audited the information in the directors' remuneration report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors
The directors are responsible for preparing the annual report and the directors' remuneration report. As described on this page, this includes responsibility for preparing the financial statements in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of the Financial Services Authority, and by our profession's ethical guidance.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the group is not disclosed.

We review whether the statement on page 25 reflects the Company's compliance with the seven provisions of the Combined Code specified for our review by the Listing Rules, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the annual report, including the corporate governance statement and the unaudited part of the directors' remuneration report, and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

Basis of audit opinion
We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the directors' remuneration report to be audited.

Opinion
In our opinion the financial statements give a true and fair view of the state of affairs of the Company and the Group as at December 31, 2002 and of the profit of the Group for the year then ended; and the financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants, Registered Auditor
London
March 3, 2003

Group five year review
for the years ended December 31

Profit and loss account	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
Group turnover [1]	**5,788**	6,328	5,864	4,634	4,471
Operating profit before exceptional items and net research and development	**540**	822	806	713	626
Operating exceptional items	**(75)**	(230)	(145)	—	—
Research and development (net)*	**(297)**	(358)	(371)	(337)	(310)
Group operating profit [2]	**168**	234	290	376	316
Share of operating profit of joint ventures	**66**	82	76	31	17
Non-operating exceptional items	**(22)**	(5)	(77)	6	9
Net interest payable	**(107)**	(119)	(123)	(53)	(17)
Profit on ordinary activities before interest	**105**	192	166	360	325
Taxation	**(52)**	(86)	(87)	(123)	(76)
Profit on ordinary activities after taxation	**53**	106	79	237	249
Equity minority interests in subsidiary undertakings	**—**	—	—	(2)	(2)
Profit attributable to ordinary shareholders	**53**	106	79	235	247
Dividends	**(133)**	(132)	(126)	(112)	(99)
Transferred (from)/to reserves	**(80)**	(26)	(47)	123	148
*Research and development (gross)	**(590)**	(636)	(604)	(626)	(668)
[1] **Group turnover**					
Continuing operations	**5,788**	6,328	5,864	4,634	4,301
Discontinued operations	**—**	—	—	—	170
[2] **Group operating profit/(loss)**					
Continuing operations	**168**	234	290	376	326
Discontinued operations	**—**	—	—	—	(10)
Earnings per ordinary share:					
Underlying	**11.10p**	20.20p	19.38p	16.47p	16.18p
Basic	**3.29p**	6.67p	5.07p	15.60p	16.51p
Dividends per ordinary share	**8.18p**	8.18p	8.00p	7.25p	6.55p

Balance sheet	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
Fixed assets	**3,010**	2,789	2,856	2,839	1,406
Current assets	**4,289**	4,551	4,000	3,974	3,408
	7,299	7,340	6,856	6,813	4,814
Liabilities and provisions	**(5,262)**	(5,270)	(4,815)	(4,833)	(3,070)
	2,037	2,070	2,041	1,980	1,744
Share capital	**323**	320	314	309	301
Reserves	**1,712**	1,748	1,726	1,658	1,431
Equity shareholders' funds	**2,035**	2,068	2,040	1,967	1,732
Minority interests in subsidiary undertakings	**2**	2	1	13	12
	2,037	2,070	2,041	1,980	1,744

Cash flow	2002 £m	2001 £m	2000 £m	1999 £m	1998 £m
Cash inflow from operating activities	**611**	418	479	359	309
Interest, dividends and taxation	**(222)**	(147)	(162)	(152)	(98)
Capital expenditure and financial investment	**(381)**	(179)	(253)	(199)	(333)
Acquisitions and disposals	**(20)**	79	(53)	(666)	87
	(12)	171	11	(658)	(35)
Cash flow from financing	**(81)**	111	(360)	622	113
(Decrease)/increase in cash and liquid resources	**(93)**	282	(349)	(36)	78

ancial calendar

lividend date for final dividend	April 23, 2003
culation period for scrip dividend	April 23-29, 2003
lifying (record) date for final dividend	April 25, 2003
date for new scrip dividend instructions	May 19, 2003
ual General Meeting, The Queen Elizabeth II Conference Centre, ad Sanctuary, London SW1,	11am May 29, 2003
ment of final/scrip dividend	July 7, 2003
ss advertisement of 2003 interim results*	August 1, 2003
dividend date for interim dividend	October 15, 2003
culation period for scrip dividend	October 15-21, 2003
alifying (record) date for interim dividend	October 17, 2003
t date for new scrip dividend instructions	November 14, 2003
ancial year end	December 31, 2003
ment of interim/scrip dividend	January 5, 2004
ss advertisement of 2003 preliminary results*	February, 2004
03 Annual Report published	March, 2004

ote: Preliminary and interim results are notified by press advertisements only.

e new holding company timetable is included in the circular to shareholders expected be dated April 11, 2003.

alysis of ordinary shareholders at December 31, 2002

nber of shares	Number of holdings	% of total holdings	% of total shares
150	119,263	37.06	0.94
– 500	155,370	48.27	2.48
– 10,000	45,157	14.03	5.07
001 – 100,000	1,457	0.45	2.49
,001 – 1,000,000	463	0.14	9.25
00,001 and over	166	0.05	79.77
	321,876	100.00	100.00

Shareholder enquiries

If you would prefer to receive new shares instead of cash dividends, please ask the Registrar for a Scrip Dividend Mandate. If you have any queries on the following:

i) Transfer of shares
ii) Change of name or address
iii) Lost share certificates
iv) Lost or out of date dividend cheques
v) Death of a registered holder of shares
vi) Any other query relating to Rolls-Royce plc shares

please write or telephone the Registrar at the following address:

Computershare Investor Services PLC
P O Box 82
The Pavilions
Bridgwater Road
Bristol, BS99 7NH
Helpline: 0870 702 0111

The Company operates a free-of-charge service for consolidating the individual shareholdings of immediate members of a family. Please ask the Registrar for details if you are interested.

Low cost share dealing

Details of special low cost dealing services in the Company's shares may be obtained from Hoare Govett Limited (telephone 020 7678 8000) and from NatWest Stockbrokers Limited (020 7895 5029). Both are members of the Securities and Futures Authority and NatWest Stockbrokers is a member of the London Stock Exchange.

You can obtain the current market price of the Company's shares by viewing teletext or similar services.

Internet

The annual report, Company announcements and other information are available on the Company website www.rolls-royce.com.

Designed by williams and phoa
Typeset by Charnwood Technic Art Limited
Printed by St Ives Burrups Limited