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Rolls-Royce

Rolls-Royce plc
Annual Report 2001

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Rolls-Royce plc
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Company number
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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 53,000 Rolls-Royce gas turbines in service and these generate high-value services throughout their operational lives. Rolls-Royce is a technology leader, employing over 40,000 people and operating from more than 30 countries.

Group financial highlights

For the year ended December 31, 2001	2001	2000
Group turnover	**£6,328m**	£5,864m
Underlying profit before taxation	**£475m**	£436m
Order book	**£14.4bn**	£13.1bn
Return on capital employed	**19.3%**	17.9%
Equity shareholders' funds	**£2,068m**	£2,040m

Earnings per ordinary share:		
Underlying	**20.20p**	19.38p
Basic	**6.67p**	5.07p
Dividend per ordinary share	**8.18p**	8.00p

Chairman's statement

Sir Ralph Robins
Chairman

We have continued to strengthen our position in growth markets. All of our businesses made good progress in 2001 and the current adverse market conditions in civil aerospace will not affect its long-term value to the company.

In many respects 2001 was a record year. We exceeded £6 billion of sales for the first time and achieved a record order intake and a record year-end order book. We generated our highest level of underlying profit, achieved a positive cash flow and increased underlying earnings per share, in line with expectations.

The terrorist attacks on the World Trade Centre and the Pentagon altered the course of the year. In the short term, the repercussions will have a significant impact on our civil aerospace activities.

However, we have built a robust business through the pursuit of consistent strategies over many years. This enabled us to mitigate the financial impact of the attacks in 2001 and will enable us to maintain a sound balance sheet and remain profitable through the ensuing recession, after absorbing the costs of restructuring.

We made good progress in each of our businesses.

In civil aerospace we continued to win 30 per cent of engine orders placed and delivered a record number of engines. This success was achieved across our broad product range. The Trent 500's first flight took place on schedule in 2001 and the engine will enter service on the Airbus A340-500/600 during 2002. We launched the Trent 900 engine for the new Airbus A380 and secured three of its first four airline customers. In the aftermarket, new customers selected our Total Care packages, which offer comprehensive engine management services throughout the life of the product.

Our defence business performed well in 2001. It is a well-balanced business with a broad portfolio of mature programmes, as well as new production and development programmes. The EJ200 engine for Eurofighter Typhoon has commenced production and has continued to perform well during flight tests. We signed a US$1 billion contract covering design and development work on the innovative LiftFan™ and associated equipment that provides the short take-off and vertical landing capability for the Lockheed Martin Joint Strike Fighter (F-35) aircraft.

Our marine business made an increased contribution in 2001. Recovery of the commercial offshore market sector continued and we won a high share of the available business. In the naval sector we announced two powerplant support contracts, with a combined potential value of £800 million, for the Royal Navy's nuclear submarine programme. A new product application, the Marine Trent 30, is well suited to commercial and naval vessels requiring high powered propulsion.

The energy business continued to be affected by the cost of developing and introducing new products. We have made good progress with the introduction of new low-emission combustion systems for the industrial Trent and resumed marketing the product in the fourth quarter.

Our financial services businesses produced a robust performance, in the face of challenging market conditions.

As a result of the strength of our businesses we were able to report a record year-end order book of £14.4 billion, with a further £2.3 billion announced but not yet signed.

Importantly, we are continuing to invest in the development of new products and services across all our businesses. This investment addresses the whole product life-cycle from materials to the management of total care and future technologies such as fuel cells.

Our success is founded upon the talent and commitment of our people. I regret that the challenges we face in the wake of the terrorist attacks have caused us to announce significant job losses, particularly in our civil aerospace business. However, it is essential that we remain competitive in the short term, making the cost reductions that are necessary to withstand the downturn and to position the Group for long-term success. I thank all our employees for their contribution.

I congratulate Phil Ruffles, John Rivers, John Widdrington, Robert Somerville, Douglas Whitlam and Linda Reeve, all of whom received honours in the New Year and Birthday Honours Lists. I would especially like to congratulate Phil Ruffles and John Cheffins who were awarded the prestigious Francois-Xavier Bagnoud Aerospace Prize for the development of the Trent engine family. The US$250,000 prize will be used to further research into design and manufacture in universities.

I extend my thanks to Phil Ruffles on his retirement from the Board, after a long and distinguished career with Rolls-Royce and have much pleasure in welcoming to the Board, Mike Howse, who also succeeds Phil Ruffles as Director – Engineering and Technology.

In accordance with previous plans, I will retire within the next 12 months. The excellent performance of the company over the past year, assures me that I will be leaving behind a strong business with a bright future in the hands of a highly effective management team under Chief Executive John Rose's leadership.

Prospects
The short-term outlook for Rolls-Royce is consistent with the guidance we provided on October 19, 2001, with profitability in 2002 affected by the downturn in civil aerospace. Average net debt in 2002 is expected to be at a level similar to that in 2000.

Rolls-Royce operates in growth markets, in which we have established strong positions. We therefore believe that the current adverse market conditions in civil aerospace will not materially affect the long-term value of the business.

While engine deliveries will decline in 2002, the momentum in the civil aerospace business is positive. As the number of engines in service grows, the opportunity for sales of spare parts and aftermarket services increases. Our strategy ensures that we capture a large part of this opportunity.

The market for military aero engines is forecast to grow steadily. Our defence business has a strong position on many of the world's new programmes.

Our marine business has been strengthened by the acquisition of Vickers and is benefiting from new programmes in the naval market and a strong flow of orders in the commercial offshore market.

The performance of the energy business will improve as new products are introduced into service and development expenditure reduces. In particular, further orders for the industrial Trent are expected.

All our businesses provide a significant service and outsourcing opportunity, with some 53,000 Rolls-Royce gas turbines in service around the world.

The financial services businesses are now making a substantial contribution to profits. Over the long term these businesses are expected to grow in support of the company's core activities.

Our wide range of products, technical excellence, success in the market place, growing aftermarket activities and lower cost base position Rolls-Royce for growth.

Your Board has recommended a final dividend of 5.00p per share, making a total for the year of 8.18p, an increase of 2.3 per cent over 2001.

Ralph Robins

Sir Ralph Robins
Chairman
March 6, 2002

Rolls-Royce at a glance

Group
Sales: £6,328 million
Underlying profit before interest: £594 million

We have a record year-end order book and we continue to make progress in developing our services as well as investing in new products for the future.

We have built a strong business by growing organically and through successful, focused acquisitions aimed at broadening our product range and opening up new markets. This enabled us to deliver results in line with expectations, despite difficult market conditions in the civil aerospace sector.

Group strategy
Our long-term strategy for the Group continues to be built on the following foundations:

- Customer focused organisation
- Investing in products, capability and people
- Developing effective partnerships
- Building leading market positions
- Improving operating efficiency
- Leveraging competence in technology
- Capturing aftermarket and services opportunity.

Civil aerospace
Sales: £3,443 million
Underlying profit before interest: £347 million

Rolls-Royce has one of the broadest ranges of aero engines in the world. We have more than 500 airline customers and secure 30 per cent of the annual global business in commercial jet engines. We have successfully introduced seven new civil engine programmes since 1995, powering aircraft from the corporate sector to the largest wide-bodied airliners. This year we achieved record engine deliveries.

Highlights
- 30 per cent market share of commercial jet engines secured.
- 9,000 civil jet engines in service.
- Trent 900 launched for Airbus A380.
- Total Care service agreements in place for 30 per cent of fleet.

Defence
Sales: £1,400 million
Underlying profit before interest: £175 million

Rolls-Royce military aero engines are in service with 160 armed forces. We power many of the world's latest fighters, transports, multi-role aircraft, helicopters and unmanned aerial vehicles. In particular we have key roles in some of the major future defence programmes such as Eurofighter and F-35 Joint Strike Fighter (JSF).

Highlights
- US$1 billion development contract for F-35 JSF programme.
- First EJ200 production engines delivered for Eurofighter Typhoon.
- RTM322 helicopter engine gained five new customers.
- Technology agreement for future combat engines signed with Snecma.

Marine
Sales: £827 million
Underlying profit before interest: £73 million

Rolls-Royce is a global leader in marine propulsion, engineering and hydrodynamic expertise, with a broad product range and full systems integration capability. More than 2,000 commercial marine customers and over 50 navies use our propulsion systems and products.

Highlights

- Established as global leader in marine propulsion systems.
- Now supplying over 2,000 commercial and over 50 naval customers.
- Market leader in design of offshore support vessels.
- Long-term contracts signed with UK MoD for nuclear submarine fleet.

Energy
Sales: £608 million
Underlying loss before interest: £64 million

Rolls-Royce has supplied more than 5,000 units to customers in nearly 120 countries and is investing in new products and capabilities for the oil and gas industry and for distributed electricity generation. Our gas turbines are used for gas compression, oil pumping and power generation.

Highlights

- Now supplied over 5,000 power units in 120 countries.
- RB211 increasing sales in power generation sector.
- Technology agreement signed with ALSTOM.
- Industrial Trent now being marketed and sold.

Financial services
Sales: £50 million
Underlying profit before interest: £63 million

The Rolls-Royce financial services businesses continue to grow and we now aim to offer customers total packages from product sales, to financing, maintenance and after sales support. Our financial services comprise engine leasing, aircraft leasing and electrical power project development.

Highlights
Through a combination of subsidiaries and joint venture companies, we have:

- 243 engines on lease to 40 lessees in 22 countries
- 64 aircraft owned and a further 49 managed on behalf of third parties
- 12 power generation projects in operation.

Chief Executive's review

The tragic events of September 11, 2001 have cast a shadow over the year. They affected individuals, industries, institutions and countries in many ways and generated greater levels of economic uncertainty than have been experienced in recent years.

The most profound impact on our company will be experienced in the civil aerospace sector where our airline customers felt the consequences immediately. They saw reductions in travel on a scale unprecedented in the last 50 years, with predictable consequences for their operations and fleet planning. The suppliers to the industry will also be adversely affected until demand for air travel returns to normal levels and surplus capacity has been absorbed.

Over the past decade we have transformed our company by pursuing a consistent strategy. We have created a balanced business portfolio and a strong management team. We have built a robust business by growing organically and through focused and well-integrated acquisitions which have broadened our product range and opened up new markets.

John E V Rose
Chief Executive

A customer focused organisation

We have a robust business based on a strategic approach that builds on the common characteristics of power systems and an understanding of customers' service needs. We have excellent technology, products, services and people and are well positioned for further growth.

The acquisitions of the Allison Engine Company, Vickers, Cooper Energy Services' compressor business and National Airmotive and their successful integration into Rolls-Royce opened up new opportunities for our civil, defence, marine and energy businesses. In addition, we have enhanced our focus through the disposal of 40 non-core businesses over the past decade. The result is that the civil aerospace sector now accounts for 54 per cent of our Group sales. This balance has helped reduce some of the financial impact of September 11, allowing us to manage our business through the crisis and remain on course to deliver our strategic objectives.

In building a more robust business, we have also created a highly integrated and effective team of managers. In 1998 we implemented a new organisation to place greater focus on delivering our customers' requirements. Since then, three quarters of senior management positions within the company have been filled by new people, a third of them joining us from outside the company. The events of September 11 tested the quality of this management team and I am pleased to report that they successfully rose to that challenge.

On October 19, 2001, following a major review within the company, we set out the detailed planning assumptions underlying our expectations for the civil aerospace business in 2002. This work included an analysis of the impact which those assumptions would have on demand and capacity and the consequences for workload and employment at our facilities around the world.

These assumptions were based on a detailed review of our customer base and our areas of activity. Since October, we have continued to refine our understanding of the potential impact and made some further changes to our assumptions. Nevertheless, we expect our overall results for 2002 to be within the guidance we provided on October 19.

One of the consequences of the downturn in the civil aerospace market is a requirement for us to accelerate our cost reduction programme. We very much regret having to make people redundant and in doing so, we treat people with care and respect and provide outplacement support as they leave the company.

One result of the rapid response of all our businesses to these changed market conditions is that our financial results for 2001 are in line with expectations with underlying profit of £475 million (2000 £436 million) and average net debt of £990 million, a reduction of 25 per cent relative to 2000. We also achieved a record year-end order book of £14.4 billion (2000 £13.1 billion).

The Business Sector Presidents cover the activities within their areas of responsibility later in this report. However, it is worth highlighting here some of the changes we have made over the past decade which give us confidence for the future.

We have nearly doubled our turnover, more than doubled our firm order book and increased underlying profit before interest and tax from £125 million to £594 million.

In creating a more balanced business we have also changed the mix of our sales. Services have grown from £1.0 billion in 1991 to £2.3 billion in 2001 and now account for approximately 40 per cent of total sales. Our service activities will continue to grow as a result of deliveries of new engines, the increasing maturity of our installed base, and the growth of our repair and overhaul activities. The high level of proprietary technology embedded in our products enables us to offer a growing range of value-added services.

Our civil aerospace market share for new engines has increased by 40 per cent over the last decade and we now consistently achieve 30 per cent of the world market. This increase has been driven by our investment in new and derivative civil engines and our resulting ability to power a wider range of aircraft. This broadening of our product range has resulted in our installed base more than doubling over the last decade to 9,000 jet engines and our annual rate of deliveries more than trebling to 1,362 in 2001. Although we now expect to deliver approximately 900 civil engines in 2002, a 40 per cent reduction on our internal forecast made before September 11, this will still represent 27 per cent of the commercial jet engine market.

Of the 9,000 engines we have in service, 5,500 engines were delivered over the past six years. Our young fleet of engines with their long operational life, provides a significant and growing opportunity for profitable service activity.

Since 1991, our focus on service has enabled us to more than double the share of the repair and overhaul market for our engines from less than 25 per cent to more than 55 per cent in 2001. Following the events of September 11, we expect civil aftermarket revenue in 2002 to be approximately the same as in 2001, before returning to growth in 2003, relative to 2002, as our installed base continues to mature.

Our defence sector revenues almost halved from £710 million to £380 million between 1990 and 1994, following the end of the Cold War and the 'Peace Dividend'. However, our focus on military markets has allowed us to rebuild our presence to the point where in 2001, revenues were £1.4 billion. Today we power many of the new generation of fighter, transport and multi-role aircraft, helicopters and unmanned aerial vehicles. These programmes provide a sound basis for growth. In common with all our businesses, there is a significant service opportunity and we expect to grow service revenues in the sector.

The acquisition of the Vickers marine business in 1999 and our continuing investment in new products are transforming the scope and scale of our marine business. We are now a world leader in the provision of marine power systems, providing a comprehensive range of products capable of managing all aspects of electrical and propulsive power. We supply over 2,000 naval and commercial marine customers in more than 200 countries. Our investment in new products will enable us to take full advantage of the increasing use of gas turbines for commercial shipping as well as the opportunities created by the re-equipment programmes being implemented by the world's navies. We have also been particularly successful in the offshore oil and gas marine market which is expected to remain buoyant as oil exploration continues at high levels.

Chief Executive's review
continued

In the energy sector we have invested in new products to ensure that we are able to benefit from the opportunities created by the deregulation of the global energy markets and the more widespread availability of gas as a fuel. We have increased our focus in this area by selling certain businesses which could not meet our market share and profitability objectives. While we serve this market up to 75MW, our recent technology transfer agreement with ALSTOM also demonstrates that we can benefit from the application of our technology to markets in which we do not choose to participate as a principal.

Our energy business has been affected by the larger than anticipated costs of lowering environmental emission levels for the industrial Trent. This work has been necessary in order to meet increasingly demanding international regulations. We suspended sales of the industrial Trent in 2000 but we have now re-commenced taking orders and the first deliveries of the new standard will take place in 2002.

Success in our chosen markets has been based on our continuing investment in new technology, where we have doubled our expenditure over the past five years. We have applied this investment to a number of new products and innovative services. Market access has been strengthened by the development of our financial services capability and the support of a strong global network of partners and suppliers.

Our most important asset is the quality of our people around the world. They have continued to demonstrate their ability and commitment in the way they have managed the consequences of September 11 and their success in innovating and adapting existing capabilities to access new market opportunities. The increasingly global nature of our business presents our people with varying and exciting opportunities to exercise their skills. It also means that we can recruit high calibre individuals for the future and continue to develop them through wide experience and participation in high-quality training programmes. The changes to our business structure, which we implemented in 1998, simplified and flattened the organisation to allow greater accountability and transparency and encouraged all our skilled people to contribute more effectively to the achievement of our objectives.

We place great emphasis on corporate social responsibility and we are continuing to develop our policy in this area, which we believe will contribute to the Group's competitiveness.

Care and concern for our people, the environment and the community has been a key feature of our approach for a number of years. Our commitment to improving environmental performance covers both our operations and our products. Travel, power generation and the transport of goods play an essential role in improving the quality of life for people all over the world. Rolls-Royce technology creates products designed to satisfy this growing demand whilst minimising their impact on the environment. Our strong performance in this area is reflected in the Business in the Environment (BiE) index of corporate environmental engagement, which in 2001, placed Rolls-Royce 26th out of the 184 companies surveyed.

In this challenging business climate, it is easy to forget the basis for our confidence which stems from the growing worldwide demand for clean and efficiently generated propulsive and electrical power.

We believe that we have both the depth of technology and the understanding of customers' requirements to create profitable long-term relationships in those parts of the market where the barriers to entry are highest. Our approach extends beyond the technology that we embed in our products. Wherever possible we seek to integrate our technical expertise throughout our customers' value chain, addressing the whole product life-cycle from materials to the management of Total Care service packages.

Our strategic approach builds on the common characteristics of power systems and our ability to adapt to customer requirements in the different market sectors. In doing so we maximise the transfer of capability and knowledge between our business sectors. We aim to 'invest once and use many times,' gaining maximum benefit from the investments we make and the innovations we achieve in technology, products, services and processes.

Over the past decade we have built a robust business, created a strong management team and won a world-leading market position based upon our unique technology. We have become adept at managing change and we have demonstrated this by the speed of our action following recent events. I am confident that we will be well positioned when we emerge from this difficult period.

Dr Mike Howse
Director – Engineering and Technology

Technology

Research and development is key to the success of the company. Last year we invested £636 million in total research and development and approved a record 215 patent applications for filing. Our aim is to maximise the benefit of this investment by creating technology and methods once but using them in many parts of our business.

In doing this we aim to address the whole product life-cycle, from applied research into materials and validation of design concepts, to the development of new products and the management of their operational lives through the development of our services capabilities. One example of this approach is our web-based predictive data management system, Aeromanager, which went live in 2001. This provides a whole range of facilities enabling a customer to have access to interactive technical data, predictive information based on engine health monitoring and an analysis of engine performance using artificial intelligence.

Advanced computational fluid dynamics tools, which have been developed through collaboration with a number of universities, have been applied within all business sectors. This capability has improved the Kamewa water jet impeller, enhanced the performance of the Trent 500 aero engine high and low-pressure turbine and increased the life and engine performance of the inlet particle separator of the RTM322 helicopter engine.

Technology has been acquired to enable us to produce efficient, reliable and durable low-emission combustors. This technology has been exploited in the design of the advanced cycle WR-21 marine engine, the low-emission Trent engine for power generation and the latest Trent 900 for the Airbus A380.

We continue to research new materials and manufacturing processes to enhance the performance and life of our engines. Coatings and surface treatments play an important part in reducing wear, lowering blade temperatures, increasing fatigue life and preventing oxidation and corrosion of various components in our products.

While common technologies and methods are routinely applied across our business sectors, further benefits are obtained by using components, sub-systems or engines for multiple applications. Thus, the core of the Trent 800 engine which powers the Boeing 777 has been used to produce a Trent engine for power generation and is now being adapted to produce the Marine Trent 30, for the commercial and naval marine market sectors.

Technology acquisition programmes have also started to produce the compressors, turbines and combustors which will be the building blocks for the next development of both the three-shaft Trent-style engines for larger aircraft and the two-shaft engines for small and business jet aircraft. The aim is to produce engines with improved performance, lower noise, reduced emissions and better cost of ownership.

The technology agreement, which we recently announced with ALSTOM allows us to benefit from our technology in markets where we do not offer our own products, thus increasing the returns from our original investment.

We will continue to pursue advances in technology and processes through investment in research and development using the exceptional and extensive skills within our own workforce and by collaboration with universities, partners and suppliers.

John Cheffins
President – Civil Aerospace

Civil aerospace
Growing services and improving business mix

In 2001 we secured a 30 per cent share of commercial jet engine orders placed, sustaining our cumulative share for the past six years at 30 per cent and clearly maintaining our second place ranking amongst the world's engine manufacturers. New engine production of 1,362 was the highest ever for the company, increasing our market share of commercial jet deliveries by value to 29 per cent.

Total commercial aircraft orders in 2001 decreased in quantity by 43 per cent to 1,119 and in value by 22 per cent to US$71.6 billion indicating that the market cycle had passed its peak prior to the impact of the terrorist attacks of September 11. We anticipate a further sharp downturn in both orders and deliveries in 2002; we expect to deliver around 900 engines, a 40 per cent reduction on our internal forecasts made before September 11.

Nevertheless this still represents 27 per cent of the commercial jet engine market. With our growing and relatively young installed base and our strengthening aftermarket service skills, the civil aerospace business is in a strong competitive position.

The Trent engine family made good progress in 2001. The latest family member, the Trent 900, was launched for the Airbus A380 with orders from Singapore Airlines (SIA), Virgin Atlantic and Qantas. The Trent 500 made its first flight powering the Airbus A340-600 and production deliveries commenced towards the end of 2001. The Trent 800 received a significant new order from SIA and the Trent 700 recorded four new airline customers. Five new risk and revenue sharing partners joined the Trent 900 programme during the year.

Investing in products, capabilities and people

Rolls-Royce is investing in new products and capabilities to develop further its growing aftermarket and services business. One example of this is Aeromanager, where the technology of the World Wide Web is providing new opportunities for innovative customer services. Aeromanager is a recent introduction from Rolls-Royce and uses the power of the web to provide an efficient and enhanced method of organising the management of engine fleets. Customers have access to secure, timely and accurate data.

The market for corporate aircraft was strong in 2001 and has been less impacted by September 11 than the airline market. We achieved a 32 per cent total value market share of engine deliveries and the BR710 engine was selected for Bombardier's new model, the Global 5000. The latest version of the Tay engine, the Mk 611-8C made a successful first test run in November.

Deliveries of AE 3007 and BR715 engines for regional jets were at record levels in 2001. The 1,000th AE 3007 engine was delivered, highlighting the success of this product in both regional airline and corporate aircraft sectors.

The September 11 effect was pronounced in the regional jet category but early indications are that it is recovering faster than other parts of the market, as regional jets are returned to service in preference to turboprops in this sector. Boeing announced in December that production of the B717 will continue at a sharply reduced rate.

International Aero Engines, the multi-national consortium in which Rolls-Royce is a major shareholder, had another successful year winning its highest ever percentage share of Airbus A320 family engine orders at 72 per cent.

We completed a successful implementation of the SAP system for Enterprise Resource Planning during the year. The improved level of control it has delivered was put to good use under the difficult circumstances following September 11 as we rescheduled our entire civil supply chain to effect a 40 per cent reduction in planned deliveries at very short notice.

Strong progress was also made with the development of aftermarket services. We now have over 9,000 jet engines in service and our broad services capability is increasing potential business. The proportion of the installed base which is covered by Total Care packages increased to just over 30 per cent during the year. To develop further our customer offering in this area, an initial group of 15 airlines went on-line with aeromanager.com, the Rolls-Royce e-business portal which provides a comprehensive range of aftermarket services. Construction was completed on the facilities for the most recent addition to our repair and overhaul global network, Singapore Aero Engine Services, which commenced operations early in 2002.

Colin Green
President – Defence Aerospace

Defence
Well positioned on new programmes

Our ability to offer a wide product range, our strong US position through Rolls-Royce Corporation (formerly known as Allison) and our unique technology, led to significant progress in the defence aerospace sector in 2001.

The highlight of the year was the receipt of a US$1 billion contract for the development of the short take-off and vertical landing (STOVL) system for the F-35 Joint Strike Fighter (JSF). Rolls-Royce is the only engine manufacturer with combat proven vertical lift technology and the F-35 is expected to be the largest defence aerospace programme in the world. The F136 alternate engine for the F-35 also secured its next phase contract. Rolls-Royce is teamed with General Electric and has a 40 per cent share of this important programme.

The first production EJ200 engine for the Eurofighter Typhoon was delivered during the year. We also signed a contract with the UK Ministry of Defence to provide aftermarket support for this programme.

Our strong position in the defence transport sector was extended with the certification of the AE 2100 on the Italian C-27J and the supply of AE 2100 and T800 engines for the innovative, Japanese US-1A Kai amphibious aircraft.

The first production Adour Mk 106 engines for upgraded Jaguar aircraft were supplied to BAE SYSTEMS and the first development Adour Mk 951 was delivered for the latest version of the Hawk trainer aircraft.

Our helicopter engine programmes had an outstanding year. The Rolls-Royce Turbomeca RTM322 gained five new customers, having been selected by Denmark, Finland, Norway, Portugal and Sweden, confirming it as the customer's choice in open competition. Initial LHTEC CTS800 production engines were delivered and Thailand became a new customer for the T800-powered Super Lynx. Australia became the first export customer for the MTR390-powered Tiger.

The AE 3007-powered Global Hawk became the first unmanned aircraft to depart from one continent under its own power and land on another, and it also won the prestigious US Collier Trophy.

With customers in more than 160 armed forces around the world, aftermarket services are a key element of our business. During the year we further developed our position in the aftermarket through agreements with Aviall, Lockheed Martin and Standard Aero.

We also continued to build new partnerships designed to enhance our strategic position and secure future business. Rolls-Royce Snecma will conduct technology programmes for future combat aero engines supported by the UK and French governments. Air Tanker (in which Rolls-Royce has a 20 per cent share) is bidding to provide an innovative solution for the UK's Future Strategic Tanker Aircraft requirement.

Vickers Defence Systems made a larger contribution to defence profits, following a good performance in 2000. This was due to effective management of the Challenger 2 contract, enabling a one-off release of contingencies as the contract progressed towards completion. The company signed a £250 million contract with the UK Ministry of Defence for the supply of the next generation of engineer tanks for the British Army.

Developing effective partnerships

Rolls-Royce is working in close partnership with Lockheed Martin, Pratt and Whitney and General Electric to deliver high-technology solutions for vertical lift and propulsion for the F-35 (JSF) aircraft programme.

Building leading market positions

Rolls-Royce has built unrivalled expertise in short take-off and vertical landing (STOVL) technology. As a result of its leading position in this market the company will earn US$1 billion over ten years for development work on vertical lift components, including the LiftFan™ for the F-35 (JSF).

Saul Lanyado
President – Marine

Marine

Continuing strong order intake

The successful integration of the Vickers marine business has created a global leader in marine propulsion systems. During 2001 we built upon this by maintaining market leading positions in both the commercial and naval marine markets and focusing on being the leading provider of integrated power, propulsion and motion control solutions worldwide. More than 2,000 commercial marine customers and over 50 navies now use Rolls-Royce propulsion systems and products.

The strong offshore supply and service vessel market continued. We ended the year with £270 million of contracts to supply ship designs and integrated equipment for a record 71 vessels.

We are playing a significant role in the prestigious *Queen Mary 2* cruise liner project through the supply of Mermaid™ podded propulsion systems, Brown Brothers stabilisers and Rauma Brattvaag cable handling equipment. The *Queen Mary 2* will be the largest ocean liner built to date and is due to enter service in 2003.

Long-term contracts worth up to £760 million were signed with the UK Ministry of Defence to ensure the safety and power performance of the Royal Navy's nuclear submarine fleet. Rolls-Royce expertise throughout the propulsion system led to our selection for the design, supply and support of propulsors for the submarines *Astute*, *Ambush* and *Artful*.

Improving operational efficiency

Over the past two years the Rolls-Royce marine business has successfully integrated the Vickers marine business and has reorganised its manufacturing operations to improve productivity.

Leveraging competence in technology

Rolls-Royce expertise in computational fluid dynamics, developed for our aerospace business, is now being applied to our marine markets to enhance the performance of marine propulsion systems.

Contracts with a value in excess of £100 million were signed to supply 12 advanced cycle WR-21 marine gas turbines and Kamewa propulsion systems for the first six ships in the Royal Navy's new Type 45 class of air defence destroyers.

We continued to introduce market leading products, launching a new marine diesel engine, the Bergen C, which is already winning orders in the offshore market, and a new range of modular thrusters designed to offer a wide range of propulsion and positioning options.

Following the acquisition of the Hamburg-based specialist company, Intering, we are now able to offer our customers complete motion control solutions.

By applying our 'invest once and use many times' approach to technology we have adapted our aero-engine technology to create the marine Trent gas turbine. The marine Trent offers a market leading power-to-weight ratio and a high degree of operational flexibility to both commercial and naval customers.

Tom Curley
President – Energy

Energy
Introducing new products

In the energy sector, Rolls-Royce has supplied more than 5,000 units to customers in nearly 120 countries. We are an established supplier to the worldwide oil and gas markets, a growing equipment provider to the global power generation industry and a significant supplier of aftermarket services. We have achieved this position through a combination of organic growth, focused acquisitions and by developing strategic partnerships.

Our gas turbine products serve major energy markets in gas compression, oil pumping and power generation. Other Rolls-Royce energy products include centrifugal gas compressors, control systems, and innovative, customised service products such as Long-Term Service Agreements.

Investment in a range of new products for the power generation market has continued to affect the profitability of the energy business.

We have broadened our power generation product range through the development of the industrial Trent. Further development work, which includes completion of a standard of combustion system that can be retrofitted to existing power stations, is being undertaken. Recent successful testing of an alternative combustion system has resulted in the resumption of marketing of the industrial Trent. There is very significant potential for the Trent in power generation applications, despite short-term market weakness following the events of September 11, and the company has recommenced taking orders.

The industrial RB211, the highest output gas turbine in its class, is gaining increased global acceptance in the growing independent power generation sector. Shipments in 2001, to customers in Europe and South America, included the first upgraded 32.1MW units.

2001 was a very good year for our oil and gas business, which has developed into a global operation. Orders received in 2001 included industrial RB211 engines for installations in Algeria, Azerbaijan, Brazil, Indonesia, Malaysia, Pakistan and North America. The oil and gas market for 2002 looks equally encouraging.

Our customer service business provides aftermarket support in both the oil and gas and the power generation sectors. The growing number of Long-Term Service Agreements offer customers more reliable and profitable operations while opening up new opportunities for the company.

Capturing aftermarket and services opportunities

We continue to grow our aftermarket and services businesses across the whole of the Group. In our energy business we provide aftermarket support in both the oil and gas and the power generation sectors.

In the oil and gas sector, RB211 DLE (dry low emissions) technology gas turbines already operate successfully on power generation and land-based pipeline duties and are now being employed offshore. These gas turbines combine efficient power output with extremely low-emission levels.

Finance Director's review

Paul Heiden
Finance Director

Our performance in 2001 was robust in the face of difficult market conditions. We met expectations for earnings and net debt, strengthened the order book and continued to improve the return on invested capital.

Results for the year
Underlying profit before tax was £475 million*, up nine per cent over 2000.

Underlying earnings per share grew by four per cent, to 20.2p.

Group turnover increased by eight per cent to £6,328 million, as a result of growth in the civil aerospace, marine, energy and financial services sectors.

- Civil aerospace sales grew by nine per cent. This included growth in engine deliveries of 25 per cent.
- Defence turnover was almost level with 2000, with aerospace growth offset by declining sales in Vickers Defence Systems, which is nearing completion of the large Challenger 2 contract.
- Marine sales grew by ten per cent, reflecting the strength of the offshore support market sector.
- Energy sales increased by 28 per cent, reflecting our strong position in the oil and gas sector.
- Financial services turnover increased by 25 per cent, with most of the growth arising in engine leasing and power development businesses.

The company reinforced its position as a global business, with 82 per cent of sales to customers outside the UK.

Underlying trading margins, before risk and revenue sharing partner receipts and net research and development increased from 8.7 per cent to 9.9 per cent.

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

The net interest charge reduced from £123 million to £119 million. This reflected the lower level of average net debt during the year, partially offset by growth in the financial services businesses, the gross assets of which are primarily funded by debt.

Group interest was covered 6.6 times, based upon underlying profit before interest, excluding joint ventures.

As announced on October 19, 2001, the company expected to spend a total of £290 million to complete its ongoing rationalisation exercise and to reduce capacity to reflect the lower demand resulting from the events of September 11. Of the £290 million, £86 million was expensed during the year and a provision of £144 million was made to cover committed specific restructuring activities. The company expects the balance of £60 million, to be charged during 2002. The cash impact of the provision and of the further charges will be concentrated in the first half of 2002. These items are excluded from underlying earnings.

Restructuring costs of £25 million (2000 £45 million) were recorded within cost of sales and included in the calculation of underlying earnings.

The Group made an underlying profit before tax of £475 million (2000 £436 million). After charging exceptional and non-trading items, profit before tax was £192 million (2000 £166 million).

Net working capital, excluding long-term contracts, reduced as a percentage of sales, from eight per cent to six per cent.

A final dividend of 5.0p per share is proposed, making a total of 8.18p per share for the year, an increase of two per cent over 2000. The dividend is covered 2.4 times by underlying earnings and 0.8 times after exceptional and non-trading items.

The number of Group employees reduced by 1,500 during the year.

Order book
The order book was £14.4 billion (2000 £13.1 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 one year at a time. In such circumstances, even though there may be no engine choice available to the customer, only the contracted business is included in the order book.

Total Care packages for aftermarket services represented 16 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 £2.3 billion at the year end (2000 £1.4 billion).

Investments
The company has continued to invest in projects which create value.

Gross research and development investment amounted to £636 million (2000 £604 million). Net research and development was £358 million (2000 £371 million). The small reduction was largely attributable to the mix of products under development. Investment in training amounted to £26 million (2000 £27 million).

Capital expenditure, excluding investments in financial services businesses, was £161 million (2000 £186 million). Investment in financial services businesses was £60 million (2000 £67 million).

Partnerships
The development of effective partnerships has been 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 described in the table below. Substantially all of the debt of the joint ventures is secured on the assets of the respective companies and is non-recourse to Rolls-Royce. The recourse financing obligations total £51million and are included in contingent liabilities (see note 28).

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 and enabling it to increase market share by 40 per cent over a relatively short time period.

RRSP agreements are a standard form of cooperation in the civil aero-engine industry. They bring benefits to the engine maker and the partner. For the engine 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.

Finance Director's review
continued

The sharing of risk is fundamental to RRSPs. 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 2001 other operating income in respect of RRSPs amounted to £239 million (2000 £341 million). Payments to RRSPs, charged in cost of sales, amounted to £113 million (2000 £129 million).

Intangible assets
Since the implementation of FRS 10, from January 1, 1998, purchased goodwill has been recognised within intangible 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.

Costs incurred in respect of testing and meeting regulatory certification requirements for new civil engine/aircraft combinations are carried forward in intangible assets to the extent that they can be recovered out of future sales.

Similarly, costs incurred in the adaptation and testing of an existing aero engine for marine use have been carried forward in intangible assets. This application engineering expenditure is very low risk and there is a high degree of certainty that future sales will be achieved.

Cash
The Group cash flow statement is shown on pages 38 and 39 of the financial statements.

Net debt for the year reduced by £189 million, to £501 million (2000 £690 million). The company attaches greater significance to the average net debt level, which reduced, as planned, by some 25 per cent, from £1,323 million to £990 million.

The level of average net debt is expected to increase in 2002, to a level similar to that experienced in 2000. This reflects the impact of the events of September 11, which will lead to lower levels of profitability and higher rationalisation costs in 2002.

Net cash flow from operating activities was £418 million (2000 £479 million). Major uses of funds were capital expenditure and investments in financial services businesses.

Taxation
The overall tax charge on the profits before tax was £86 million (2000 £87 million), a rate of 45 per cent (2000 52 per cent). This relatively high overall Group tax rate is primarily due to the impact of goodwill charged against profits for which no tax relief is available. Goodwill charged against profits in 2000 was greater than in 2001 due to the disposal of the Materials Handling and Vickers Turbine Components businesses and this is the main reason for the year to year reduction in the overall tax rate.

The rate is 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.

During the year the company adopted FRS 19, a new accounting standard for deferred tax. Accordingly comparative figures have been restated. The effect of the new standard is to produce a Group tax rate which is generally higher than under the previous standard, but which is expected to be more stable going forward. There is no impact on cash flows.

The tax charge on underlying profits was £154 million (2000 £134 million), a rate of 32 per cent (2000 31 per cent).

Acquisitions and disposals
The bulk of Vickers Turbine Components was sold in December 2000. Cash relating to this disposal, of £76 million, was received in 2001.

Accounting policies
In 2001, FRS 18 (Accounting Policies) and FRS 19 (Deferred Tax) have been implemented. FRS 18 has had no significant impact. The impact of adopting FRS 19 has been noted in the taxation section.

The Group is required to adopt FRS 17 (Post Retirement Benefits) fully in 2003. For 2001 accounts certain disclosures are required including the value of pension scheme assets and liabilities using the new rules specified by FRS 17. Under this standard a snapshot is taken of pension fund assets and liabilities at a specific point in time. Thus, movements in equity markets and discount rates are expected to create volatility in the calculation of scheme assets and liabilities.

On this basis, at December 31, 2001, and after taking account of deferred taxation, for the UK schemes, there was a net shortfall of assets over respective liabilities amounting to £284 million. This deficit represents six per cent of assets under management and has been assessed at a point in time when equity markets are depressed and discount rates are low, both of which have a material impact on the net surplus/deficit of the schemes. For example, a 15 per cent improvement in equity markets or a one per cent increase in discount rates would have the effect of eliminating this deficit.

There is no impact on funding requirements for 2002. The Group's funding requirements for the schemes are derived from tri-annual actuarial valuations, the next of which is due in 2003. Any adjustment to the current contribution rate will depend upon the predicted performance of the pension fund assets and liabilities at that point.

The shortfall on overseas schemes amounted to £113 million, which is covered by existing provisions on the balance sheet.

Aftermarket services
The company has been successful in selling Total Care 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. Following the market success of Total Care packages, amounts recoverable on these contracts grew to £268 million during the year. These are included in debtors and shown in notes 15 and 16.

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.

An external assessment of the risk management system was carried out during 2001. It concluded that the Rolls-Royce risk management process exceeds the Turnbull compliance requirements.

Treasury management
The Group uses various financial instruments in order to manage the exposures that arise in its business operations as a result of movements in financial markets. The Group does not trade in financial instruments for profit generation. All treasury activities are focused on the management of risk. There have been no significant changes in the Group's policies in the last year.

The main 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 policy is that it is exposed only to those counterparties that have a long-term credit rating of A3/A- or better.

Foreign exchange
The Group is exposed to movements in exchange rates for both foreign currency transactions and the translation of net assets and profit and loss accounts of foreign subsidiaries.

The Group does not hedge the translation effect of exchange rate movements on the profit and loss account or balance sheet as it regards its interest in overseas subsidiary companies as long-term investments.

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

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

The permitted range of the amount of cover taken is determined by the written policies set by the Board, based on known and forecast income levels. The forward cover is managed within the parameters of these policies in order to achieve the Group's objectives, having regard to the Group's view of long-term exchange rates. Forward cover extends for periods of up to eight years and is in the form of standard foreign exchange contracts and instruments on which the exchange rates achieved may be dependent on future interest rates. The Group also writes currency options against a portion of the unhedged dollar income at a rate which is consistent with the Group's long-term target rate. The premium received from the sale of the options is included in the Group's achieved rate. Total US dollar cover approximated to five years' net US dollar income at December 31, 2001 (2000 four years).

The consequence of this policy has been to maintain a relatively stable long-term foreign exchange rate. Note 24, financial instruments, includes the impact of revaluing forward currency contracts at market values on December 31, 2001, showing a reduction in value of £550 million. This figure, which will fluctuate over time, does not represent an actual loss. The Group has entered into these forward contracts as part of the hedging policy, described above, in order to mitigate the impact of volatile exchange rates.

Finance Director's review
continued

Interest rate risk
The Group uses fixed rate bonds and floating rate debt as funding sources. To the extent that interest rate risk exists, a combination of interest rate swaps and caps are used 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 Chairman, Chief Executive, and Finance Director. The Group operates a sophisticated risk-pricing model to assess risk and exposure. Costs 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. 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 Group's gross contingent liability has been stated for the first time. The 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 2001 provisions against customer financing exposures were increased from £35 million to £82 million (see note 22).

The Group's contingent liabilities are 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 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 gross contingent liability increased to £857 million (2000 £766 million), of which £78 million (2000 £101 million) relates to sales financing support provided to joint ventures.

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 following the events of September 11, 2001.

After taking account of the underlying security, the Group's net contingent liability increased to £206 million (2000 £184 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 current and future values already reflect the current depressed market. Application of this stress test results in a net contingent liability of £283 million (2000 £347 million).

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

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

The Group has a portfolio of projects at different stages of their life-cycles. Discounted cash flow analysis of the remaining life of projects is performed on a regular basis.

During the year Rolls-Royce shares fell by 16 per cent from 198.25p to 166.5p per share, compared to a 14 per cent fall for the aerospace and defence sector and a 16 per cent fall for the FTSE 100.

The company's shares ranged in price from 121p in October to 250p in June.

The number of shares in issue at the end of the year was 1,601 million, an increase of 32 million of which 10 million related to share options and 22 million related to scrip dividends.

The average number of shares in issue was 1,589 million (2000 1,558 million). Underlying earnings per share were 20.20p, an increase of 4.2 per cent over 2000. The proposed final dividend per share will result in a total payment of 8.18p per share, an increase of 2.3 per cent over 2000.

Financial Services
Robust performance

Rolls-Royce aims to provide its customers with a complete service, from the financing of initial product sales 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).

Rolls-Royce & Partners Finance (RRPF), established in 1989 is a 50:50 joint venture with GATX Capital and is the world's largest engine leasing specialist with 243 engines on lease to 40 lessees in 22 countries. Last year, RRPF diversified its asset base to include the A501, Avon, RB211 and Trent industrial engines. Utilisation of the fleet of lease engines remains high after September 11, with 98 per cent of engines on lease at the year end.

Pembroke, also a 50:50 joint venture with GATX Capital, had a fleet at the year end of 64 owned aircraft and a further 49 aircraft managed on behalf of third parties. It worked closely with its airline customers in the critical weeks following September 11 and as a result no aircraft leased by Pembroke has been returned.

In the energy market, Rolls-Royce Power Ventures continued to develop its portfolio of projects. It ended the year with 12 power generation projects in operation, three in construction, and four in the late stages of commissioning.

Board of directors
at March 6, 2002

Sir Ralph Robins BSc, FREng
Chairman
Appointed to the Board in 1982. He joined Rolls-Royce in 1955, became Managing Director in 1984, Chief Executive in 1991, and was appointed Chairman in 1992. He is non-executive Chairman of Cable & Wireless plc and a non-executive director of Schroders plc and Standard Chartered plc. He is a Fellow of the Royal Academy of Engineering and Chairman of the Defence Industries Council. Age 69.

John E V Rose MA
Chief Executive
Appointed to the Board in 1992. He joined Rolls-Royce in 1984 and was Managing Director – Aerospace Group from 1995 to 1996 when he was appointed Chief Executive. He is a Fellow of the Royal Aeronautical Society and a Council Member of The Prince's Trust as Chairman of the Prince's Trust Business. Age 49.

Lord Moore of Lower Marsh PC, BSc
Non-executive Deputy Chairman and Senior Independent non-executive director
Appointed to the Board in 1994 and appointed Deputy Chairman in 1996. He is a non-executive director of Monitor Company Inc., Marvin & Palmer Inc., and Private Client Bank AG and he is a former President of the Energy Saving Trust. Age 64.

Peter J Byrom BSc, FCA
Non-executive director
Appointed to the Board in 1997. He was a director of N M Rothschild & Sons Limited from 1977 to 1996. He is Chairman of Domino Printing Sciences plc and of Molins PLC, and a non-executive director of Wilson Bowden plc. He is a Fellow of the Royal Aeronautical Society. Age 57.

John P Cheffins BSc, Ing
Chief Operating Officer and
President – Civil Aerospace
Appointed to the Board in 2001. He joined Rolls-Royce in 1967, became President and Chief Executive Officer of Rolls-Royce Industries Canada Inc. in 1991, Director, Civil Engine Business in 1993, President – Civil Aerospace in 1998 and Chief Operating Officer in 2001. He is a Fellow of the Royal Aeronautical Society and a member of the Institution of Electrical Engineers. Age 54.

Colin H Green BSc, FREng
President – Defence Aerospace
Appointed to the Board in 1996. He joined Rolls-Royce in 1968, became Director – Military Engines in 1989, Executive Vice President – Business Operations Allison Engine Company, Inc. in 1995, Managing Director – Aerospace Group in 1996, Director – Operations in 1998 and was appointed President – Defence Aerospace in 2001. He is a non-executive director of BAA plc. He is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers. He is also a Council Member of the Society of British Aerospace Companies and Chairman of the UK Council for Electronic Business. Age 53.

James M Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Appointed to the Board in 1998. He became President and Chief Executive Officer of Rolls-Royce North America Inc., in October 1997. Until 1994 he was Executive Vice President, Marketing and Planning of United Airlines. He serves on the United States National Research Council Aeronautics and Space Engineering Board and he is a director of the Private Bank and Trust Company of Chicago, Illinois. Age 56.

Paul Heiden BSc, ARCS, ACA
Finance Director
Appointed to the Board in 1997. He joined Rolls-Royce in 1992 from Hanson plc as Finance Director – Aerospace Group. He was appointed Director – Industrial Businesses in 1997 and Finance Director in October 1999. He is a non-executive director of Bunzl plc. Age 45.

Dr Michael G J W Howse OBE, FREng, 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, a past 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 59.

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 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 67.

Carl G Symon BSc, MSc
Non-executive director
Appointed to the Board in 1999. He was previously Chairman and CEO, 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 currently Managing Director, Global Business Development and Alliances, Diamond Cluster International Inc. and Chairman of Riversoft plc, Worldmark International Ltd and Metapack Ltd. He is a non-executive director of BT Group plc and a Member of the Advisory Board of Cross Atlantic Partners. Age 55.

Richard T Turner OBE, BA
Group Marketing Director
Appointed to the Board in 1992. He joined Rolls-Royce in 1991 having previously been with the Company from 1965 to 1988. He is a Fellow of the Royal Aeronautical Society, a member of the Board of British Trade International and several other government advisory committees. He is a non-executive director of Corus Group plc and Senior plc. Age 59.

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 1998 to 2002. He is currently a non-executive director of Hakluyt & Co Ltd, Hon President of the Community Foundation Network (UK) and Chairman of Governors of Sherborne School. Age 63.

Charles Blundell MA
Company Secretary
He joined Rolls-Royce in 1993 and was appointed Company Secretary in 1995. Age 50.

Membership of principal Board committees:
Audit committee – P J Byrom (Chairman), Lord Moore of Lower Marsh and Sir Robin Nicholson.
Remuneration committee – All non-executive directors (C G Symon, Chairman).
Nominations committee – Sir Ralph Robins (Chairman), J E V 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, 2001.

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 7, 2002, this will make a total dividend of 8.18p a share for the year. Subject to approval of the recommended final dividend by shareholders, the total cost of dividends for 2001 is £132 million. If approved, the Company will pay the final dividend on July 1, 2002 to shareholders registered on April 26, 2002.

Directors
Directors who held office during 2001 are listed on page 24, with the exception of Mr P C Ruffles who retired from the Board with effect from October 18, 2001. Mr J P Cheffins was appointed a director of the Company with effect from January 1, 2001 and in accordance with the Company's Articles of Association was re-elected to the Board by shareholders at the 2001 Annual General Meeting. Dr M G J W Howse was appointed a director of the Company on October 18, 2001.

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 directors retiring at this year's Annual General Meeting are Mr P J Byrom, Mr J M Guyette, Mr J E V Rose and Sir John Weston. As a newly appointed director, Dr M G J W Howse will also retire at the Annual General Meeting in 2002. They all offer themselves for re-election.

Corporate governance
The Group is committed to the highest standards of corporate governance. This report (and, where appropriate, the Remuneration report) describes how it applies the principles and complies with the provisions of the Combined Code.

Compliance
The Board confirms that in 2001, the Company complied with all the provisions of the Combined Code.

The Board
The Board comprises a chairman, a chief executive, six 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 Mr J E V Rose – Chief Executive. Its other members are:
Mr J P Cheffins, Chief Operating Officer and President – Civil Aerospace
Mr 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 P Heiden, Finance Director
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
Mr J R Rivers, Director – Human Resources
Mr R T Turner, Group Marketing Director.

Board committees
The Board has delegated certain powers and duties to Board committees, all of which operate within defined terms of reference.

The *nominations committee* makes recommendations to the Board on the appointment of executive and non-executive directors. The committee is chaired by Sir Ralph Robins and its other members are Mr P J Byrom, Lord Moore of Lower Marsh, Sir Robin Nicholson, Mr J E V Rose, Mr C G Symon and Sir John Weston.

The *remuneration committee's* membership and principal terms of reference are set out in the Remuneration report on pages 30 to 35.

The *audit committee* meets regularly with the external auditors, reviews the Group's annual and interim financial statements and also ensures that appropriate accounting policies and compliance procedures are in place. As part of this process, it regularly reviews the accounting treatment of the Group's financial arrangements. The committee is chaired by Mr P J Byrom and its other members are Lord Moore of Lower Marsh and Sir Robin Nicholson.

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 Mr J E V Rose and its other members are Mr J P Cheffins, Mr C H Green, Mr J M Guyette, Mr P Heiden and Dr M G J W Howse.

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 setting health, safety and environment (HS&E) policy and objectives. Further information on its work in this important area is set out in the Group's environmental report.

The *nuclear propulsion assurance committee* is responsible for the HS&E aspects of the Company's nuclear facilities. It is chaired by Sir Ralph Robins and its members are Mr P Heiden, Dr M G J W Howse, Sir Robin Nicholson and Mr J E V Rose.

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 R T Turner. 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 2001.

Communication with shareholders
The Company attaches considerable importance to the effectiveness of its communication with shareholders. It publishes a concise 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 web site 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 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.

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

There is an ongoing process to identify, assess and manage risk including those risks affecting the Company's reputation. 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 risk process has recently been updated to include explicitly the risks associated with corporate social responsibility issues.

The Board has reviewed the process and has confirmed 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 on this page.

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 problem escalation 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 completely external and largely unpredictable events such as terrorist activity or war. All risks, irrespective of source, are actioned 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 2001, the communication and understanding of risk has been enhanced throughout the organisation, including the ongoing development of plans to address the identified risks. Management have extended their continuous and comprehensive risk reviews, at individual businesses, to include all key projects, programmes and business change plans.

All the processes operated by the Company are subjected to continuous improvement activity. However, particular attention has been paid to four key processes:
- Planning the business
- Resourcing the business
- Defining customer solutions
- Fulfilling customer orders.

Steps have been taken to strengthen risk management in each of these areas with the objective of mitigating those risks that threaten the delivery of business objectives.

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 reporting and compliance with law and regulation. 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 audit functions of health, safety and environment, quality, engineering and business assurance. These functions operate to work programmes agreed by the appropriate Board member.

In particular, the business assurance function, which works closely with the external auditors, undertakes a financial and operational audit programme agreed by the audit committee and 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.

Corporate Social Responsibility
The Group attaches considerable importance to Corporate Social Responsibility (CSR). CSR is a key issue central to the Group's relationship with its shareholders, customers, employees and the communities in which it operates. Progress in this area will deliver a competitive advantage and will contribute to the Group's long-term success.

During 2001, the Board considered an initial review of the Group's position on CSR. It concluded that the Group had well developed policies and information on health, safety and environment, charitable donations, community involvement, employment policies and employee learning and development. Details of these policies are set out on pages 27 to 29. The Board has commissioned further work on other aspects of CSR and the Company will report on progress made in this area in the 2002 Annual Report.

Recognising the importance of CSR, the Board has also reviewed the procedures which exist within the Group for managing risks associated with CSR. The Board sees it as important that significant risks with a potential impact on shareholder value are promptly drawn to its attention, with proposals for mitigating action. As is described on page 26, the Company 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.

Health, safety and environment (HS&E)
The Group's HS&E policy is founded on our core values of reliability, integrity and innovation.

The Group's HS&E management system standard and guideline, developed in line with the requirements of ISO 14001 and OHSAS 18001, was issued in 2000. It provides a common template across the Group and good progress has been made in implementing it during the year. It is based on effective risk management and requires the visible leadership and commitment of management at all levels and the active participation of all employees and contractors. It is underpinned by the principle that HS&E is a line management responsibility. To help managers undertake their role effectively, they are advised and supported by HS&E professionals.

An integrated HS&E audit programme is supporting implementation of the management system. In 2001, the HS&E audit programme covered a number of facilities in the UK, North America, Norway, Sweden and Poland.

Businesses are making good progress against Group targets set in 1999 for the reduction of lost-time injuries, noise-induced hearing loss, health surveillance, greenhouse gases, solvent use and recycling. Effort continues to be made to reduce the amount of waste generated from operations and to increase the proportion of such waste that is either recovered or recycled. Further challenging reduction targets in all of these areas have recently been agreed.

The HS&E committee (see page 26) is responsible for developing HS&E policy and objectives and for reviewing the effectiveness of the HS&E management system.

Health and safety management
The level of lost-time injuries remains low compared to other companies in the engineering sector. It is with great regret, however, that we report a fatal accident involving an employee at a recently acquired facility in Poland. The accident occurred when a load, being lifted by a fork-lift truck, fell and struck an employee. A full investigation has been undertaken and corrective measures have been put in place at the facility.

The Group continues with its commitment to provide appropriate facilities and expertise in occupational health worldwide. The business benefits of promoting and maintaining occupational health are summarised in the Group's 'Occupational Health Strategy, Policy and Management Guidelines' issued in September 2001.

Management training featured significantly in 2001 with the launch of an 'Occupational Health for People Managers' course. This promotes a better understanding of absence management, health promotion, health surveillance, disability and the requirements for fitness to work. In addition, around 50 per cent of the management population have attended stress awareness training and a new on-line stress risk assessment questionnaire is helping employees to identify relevant issues.

Continuing improvements in information technology systems will enable relevant absence data to be recorded. The resulting bank of knowledge will facilitate the early identification of health risks associated with specific jobs.

Report of the directors
continued

The health promotion programme in 2001 also included campaigns on cardiovascular and stroke awareness. During European Health and Safety week in October, a variety of preventative programmes were held relating to musculo-skeletal disorders and work related injuries.

The most significant occupational health risks remain those associated with noise and vibration, although the incidence of noise-induced hearing loss and vibration related disease has shown a steady reduction over recent years.

Environment
The Environmental Advisory Board (EAB) chaired by Sir Robin Nicholson, includes external members who are respected authorities in their fields. The role of the EAB is to review and make recommendations on the environmental aspects of the activities of Rolls-Royce.

A second edition of the external environment report *'Powering a better world'* was published in 2001 and is available on the Rolls-Royce website. The report provides detailed information on the health, safety and environmental performance of the Group's operations for 1999 and 2000. It also contains environmental information relating to products and discloses the progress made towards meeting the Group's challenging environmental targets.

All the Rolls-Royce core businesses operate an environmental management system certified to the international standard ISO 14001. In addition, it is Company policy that any newly acquired business should achieve ISO 14001 certification within two years of acquisition. Implementation programmes are currently underway in the UK, the Nordic countries, Poland and North America. Over the last year, two additional facilities in North America have achieved certification. Management systems at the business unit level provide effective and robust controls for any significant environmental aspects and are also used by businesses to reduce their overall environmental impact as part of their commitment to continual improvement.

Rolls-Royce was placed 26th out of the 184 companies taking part in the Business in the Environment (BiE) index of corporate environmental engagement. This score reflects a sustained improvement over the five years that the survey has been carried out.

In December 2001, Rolls-Royce Corporation (Indianapolis, USA), along with partners Granger Energy and the South Side Landfill, received the 'Industry Ally' of the Year Award from the Federal Environmental Protection Agency. This award recognised the accomplishment of implementing a landfill gas project, which has resulted in reduced greenhouse gas emissions equivalent to some 250,000 tons of CO_2 per annum.

The Group's nuclear facilities, involved in the design and manufacture of submarine power plant for the Royal Navy, continue to operate under strict control. The Nuclear Propulsion Assurance Committee, a sub-committee of the Board, is responsible for monitoring HS&E at these facilities (see page 26).

In October 2000, applications were submitted to the UK Environment Agency, requesting updated discharge authorisations for solid, liquid and gaseous discharges from two licensed nuclear sites in Derby. The proposed discharge limits were either the same as existing levels or represented reductions. Some limits were proposed where none had existed before. The review by the Environment Agency includes a consultation process, involving statutory consultees, such as the Nuclear Installations Inspectorate and local authorities, and non-statutory bodies, such as the Health Authorities, and the general public. This rigorous process was followed throughout 2001 and is likely to be completed in 2002.

A site in Derbyshire is used for the disposal of low-level radioactive waste from the Rolls-Royce nuclear sites in Derby.

Employment policies
The number of Group employees at the end of the year was 42,200 (2000 43,700). In 2001, 176 graduate trainees and 73 modern apprentices were recruited. In addition, there have been 220 undergraduate students in the Company for training periods of between two and 12 months.

The Group's employment policies and practices support its overall business objectives by motivating and developing employees to be responsive to the needs of the business and its customers.

The Group operates an equal opportunities policy. The Group's policy is to provide, wherever possible, employment opportunities and training for disabled people, to care for employees who become disabled and to make the best possible use of their skills and potential.

A particularly strong emphasis has been placed on effective employee communications and there are various forms of employee communication programmes across the Group, each adapted to the particular needs of individual businesses.

The Group consults with employees and their elected representatives on a wide range of topics relating to its overall business objectives. Management and employee representatives hold regular meetings at every location to discuss opportunities and issues of common interest.

Employee learning and development
It is one of the Company's fundamental values that achieving business success and promoting individual development go hand in hand. This requires us to invest in training, education and development programmes that improve individual and corporate capability. The Company is actively working to create an organisational climate that ensures effective business learning and continuous professional development for individuals.

The Company has in place a business and professional development framework which ensures that individuals and the Company can both anticipate and respond to changing technical, market or customer requirements. Last year the Company invested £26 million in the training and education of its workforce.

During the year the Company received corporate recognition as an Investor in People. This means that the Company as a whole has successfully secured external accreditation for all its UK businesses, an important step forward achieved by only a limited number of companies.

Charitable donations
The Group pursues an active policy with respect to charitable donations, which it sees as playing an important role in the Group's involvement in the community.

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 2001, the Company made charitable donations in the UK amounting to £381,000. This included support for the work of the Derbyshire Community Foundation, The Prince's Trust and the Royal Air Force Benevolent Fund.

The Company also financed the administration and operation of a Payroll Giving Scheme for its UK employees which enabled £365,000 of employee donations to be paid directly to the charities of their choice. In 2001, the Company received a Payroll Giving Champions Award for the successul launch of this scheme.

Elsewhere, the Group made charitable donations amounting to £568,000 in those countries in which it has significant presence. In North America, this included support for the work of the September 11th Disaster Relief Fund and Habitat for Humanity and in Germany, the Children's Festivity of the Federal President of Germany.

A list of the principal donations made in 2001 is available on written request to the Company Secretary.

Community involvement
The Company has a long and proud history of community involvement. As part of our commitment to being a good corporate citizen, Rolls-Royce seeks to assist the communities in which its businesses operate and its employees live and work. The Company also encourages its employees to play a full role in the community.

Our community investment activities support our values of reliability, integrity and innovation. We are involved in a wide range of initiatives across the fields of education, the arts, the environment and social and economic regeneration.

In addition to our local charitable donations activity, we also positively encourage our employees to take up opportunities for development within local community based projects. Support in-kind is given to local initiatives.

Payment to suppliers
The Company is guided by the Supply Chain Relationships in Aerospace (SCRIA) initiative. It seeks the best possible terms from suppliers and when entering into binding purchasing contracts, gives consideration to quality, delivery, price and the terms of payment. In the event of disputes, efforts are made to resolve them quickly.

The Company had the equivalent of 55 days purchases outstanding at December 31, 2001, based on the average daily amount invoiced by suppliers during 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 6, 2002:

	% of issued share capital
BMW AG	**9.89**
Franklin Resources, Inc.	**12.08**

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 6, 2002

Remuneration report

Rolls-Royce operates in a highly competitive, international market. Its business is complex, technologically advanced and has long time horizons. The improvement in performance to which the Group is committed depends crucially on the individual contributions made by the executive team and by employees at all levels. It is for this reason that the Board strongly believes that an effective remuneration strategy will continue to play a crucial part in the future success of the Group by providing keen incentives and creating a close identity of interest with shareholders.

This report also describes how the principles identified by the Combined Code in relation to executive directors' remuneration are applied by the Company.

The remuneration committee
In line with the requirements of the Combined Code, the remuneration committee (the committee), meets regularly and has responsibility for making recommendations to the Board on the Group's general policy towards executive remuneration. The committee 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. Its members are Mr P J Byrom, Lord Moore of Lower Marsh, Sir Robin Nicholson, Mr C G Symon and Sir John Weston. Sir Robin Nicholson served as chairman of the committee until May 24, 2001 when he was succeeded by Mr C G Symon.

The Chairman of the Company, Sir Ralph Robins, and the Chief Executive, Mr J E V Rose, attend meetings by invitation but are not present during any discussion of their own emoluments.

During 2001, the committee appointed Andersen, a consultancy with extensive experience of executive remuneration, to provide it with independent advice through a senior partner. The committee may also call for information and advice from other advisors inside and outside the company as it sees fit.

Compliance
The Board confirms that the Company has complied throughout the year with the provisions of the Combined Code relating to directors' remuneration.

The framework of remuneration
The Board has adopted, on the recommendation of the committee, a remuneration policy reflecting the following broad principles:

i) The remuneration of executive directors and other senior executives should directly 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 encourage a close identity of interest between senior management and shareholders.

Within this framework of remuneration, the committee keeps under regular review the competitiveness of the Group's remuneration structure. The policy takes into account pay and employment conditions elsewhere in the Group.

The main components of remuneration
The emoluments of executive directors and senior executives currently comprise the following elements: a base salary, an annual performance related award, long-term incentive arrangements, pension contributions and other benefits.

Base salary
The committee believes that base salaries should generally be determined with reference to the median-level of the relevant marketplace and that performance-related plans should provide the opportunity of increasing total earnings to upper quartile earnings if performance justifies it.

Incentives and rewards linked to annual performance
Executive directors and senior executives participate in an annual performance related award plan. This enables a maximum performance award of up to 60 per cent of salary to be paid to executive directors and a small number of senior executives for the achievement of pre-determined targets based on a combination of underlying earnings per share (EPS) and cash. There is a reducing scale of maximum percentages for other senior executives. The targets are set by the committee based upon the Group's annual operating plans. Such payments do not form part of pensionable earnings.

One third of any awards made are paid in Rolls-Royce shares which are held in trust for two years, with release normally being conditional on the individual remaining in the Group's employment until the end of the period. The required shares are purchased on the open market. This arrangement provides a strong link between performance and remuneration and helps to promote a culture of share ownership amongst the Group's senior management.

The committee continues to keep the proportion of shares and the deferred period for those shares under review relative to market practice and the objective of promoting share ownership among the Group's senior management.

Long-term incentives
The committee is aware that market practice for long-term incentives is subject to change. It therefore continues to review market practice and to develop plans which are appropriate to the nature of the business and which will encourage improved performance to the benefit of shareholders.

Executive share options were re-introduced in 1999. Since then, no new grants have been made under the Company's long-term incentive plan (LTIP). The last grant under the LTIP came to the end of its three year performance period at the end of December 2001 and no award was made.

Depending on performance, executives are eligible to receive options on an annual basis. The normal practice is to grant options in March, following the announcement of the Company's annual results. Options are granted at the mid-market price on the day before the day of issue and normally have to be held for a minimum of three years before they are capable of exercise. They expire after ten years. In line with the committee's view that an increasing proportion of remuneration should be performance-related, the exercise of options is subject to a performance condition that the Group's growth in EPS must exceed the UK retail price index by three per cent per annum, over a three-year period. Options were granted on this basis on March 26, 2001 (see pages 34 and 35).

In the course of 2001, the committee reviewed the adequacy of the Company's long-term incentives. It 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 approved by shareholders in 1999. 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 the Company made a special award of options to key executives in March 2001, including the executive directors (see pages 34 and 35). The number of options granted, multiplied by the option price, was the equivalent in each case to four times the executive director's salary at the time of grant. These options were granted under the rules of the Rolls-Royce1999 Executive Share Option Plan but the committee decided to introduce a number of additional requirements to strengthen the incentive effect of the grant. First, the options will only vest if the recipients have built up a significant personal shareholding in Rolls-Royce. In the case of the executive directors and selected senior executives, the shareholding requirement is the equivalent in value to one-half of their annual salary at the time of the grant. This holding will have to be achieved by the third anniversary of the date of the grant. There were also annual targets and a failure to achieve any of these will result in the options lapsing in their entirety. Secondly, the Company performance criterion has been strengthened significantly for these options so that the growth in EPS will have to exceed six per cent year on year in absolute terms as well as exceeding the increase in the UK retail price index by three per cent per annum over a rolling three year period. These requirements will be very demanding particularly in adverse trading conditions, given the requirement that increases will be measured from the year 2000 or the base year of the rolling three year period in question, which ever has the more stringent test.

All employee incentives
The committee believes that share-based schemes, described in more detail on page 59 make a significant contribution to the close involvement and interest of all employees in the Group's performance. The Company introduced an approved profit sharing share scheme for UK employees in 1999.

UK employees will be able to take shares equivalent to one week's pay as part of the Company component of any bonus paid for 2002. These shares will be delivered as 'Free Shares' under a government approved Share Incentive Plan (SIP). The Company will also enable UK employees to make regular purchases of shares from pre-tax income under the SIP. All such shares will be free of income tax if they are retained for five years.

The Company operates a SAYE Sharesave plan which is available to all its employees and those of wholly owned subsidiaries worldwide. Employees agree to save money over the life of a savings contract, which has a linked share option exercisable on contract maturity. An invitation to participate in the plan was made in September 2001 to employees in 35 countries and applications were received from 46.1 per cent of those eligible. Based on these applications 55 million options and Stock Appreciation Rights were granted on October 31, 2001. It is intended that new issue shares will be used to satisfy options on exercise.

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

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

The Company also operates the Rolls-Royce 1994 Senior Executive Retirement Scheme (SERS). The purpose of the SERS is to fund pension provision above the pensionable earnings cap which was imposed on approved pension schemes under the 1989 Finance Act. The scheme provides a lump sum payment on retirement in lieu of the additional pension which would have been provided under the approved schemes had the earnings cap not been introduced. Membership 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.

The Company does not make any pension contributions in respect of Sir Ralph Robins, who reached normal retirement age in June 1994.

In recent years the cost of providing pensions through approved schemes has increased, as actuaries have projected longer life expectancy and lower investment returns. Recognising that the same factors would increase the SERS lump sum necessary to equate to the pension it was intended to replace, the Company has reviewed the level of the SERS lump sum to be provided in respect of each year of service for all SERS participants, including Mr P Heiden and Mr R T Turner. This review resulted in an adjustment to the lump sums already accrued in respect of prior service and an increase to the lump sum which will be accrued for each year of future service. The one off adjustment in respect of past service is included in the additional retirement lump sum earned in excess of inflation during the year.

During the year, special bonus payments were made to Mr P Heiden and Mr R T Turner to cover the income tax liability incurred by them on the contribution payments made by the Company into the SERS. These payments amounted to £69,719 (2000 £29,415) in the case of Mr P Heiden and £65,991 (2000 £41,018) in the case of Mr R T Turner.

Remuneration report
continued

Details of the pension benefits, which accrued over the year in the Group's approved UK pension schemes, are given below[1,4].

	Additional pension earned in excess of inflation during year ended Dec 31, 2001 £000 per annum	Transfer value[2] of additional pension earned in excess of inflation during year ended Dec 31, 2001 £000	Total accrued pension entitlement at the year ended Dec 31, 2001 £000 per annum
Mr J E V Rose	23	398	244
Mr J P Cheffins	44	824	192
Mr C H Green	7	111	224
Mr P Heiden	2	15	19
Dr M G J W Howse	7	126	120
Mr R T Turner	2	17	16

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[5].

	Additional retirement lump sum earned in excess of inflation during year ended Dec 31, 2001 £000	Transfer value[6] of additional retirement lump sum earned in excess of inflation during year ended Dec 31, 2001 £000	Total accrued retirement lump sum entitlement at the year ended Dec 31, 2001 £000
Mr J M Guyette[3,7]	203	121	1,090
Mr P Heiden	626	335	1,094
Mr R T Turner	323	293	822

Notes

[1] The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year.
[2] The transfer value stated represents liabilities of the Rolls-Royce sponsored pension schemes and not sums paid to the individuals. The transfer value has been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11, less the director's contributions. 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.
[3] Benefits are translated at US$1.50 = £1.00.
[4] 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.
[5] The lump sum entitlement shown is that which would be paid on retirement based on service to the end of the year.
[6] The transfer values have been calculated on the basis of actuarial advice.
[7] 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 2001 the employer's contributions amounted to £21,645.

Terms and conditions

Service contracts

Sir Ralph Robins has a one-year rolling contract, which provides for 12 months' notice in event of termination by the Company. He works for the Company at the equivalent rate of three days a week.

Mr J M Guyette has a contract 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.

In the light of the Combined Code, the committee has reviewed its previous policy of offering UK executive directors two-year rolling contracts. It concluded that new appointees to the Board would be 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 twelve months after that initial period.

Mr J E V Rose, Mr C H Green, Mr P Heiden, and Mr R T Turner have two-year rolling contracts which provide for 24 months notice in the event of termination of employment by the Company. These contracts were entered into before the change in the policy described above.

The non-executive directors do not have service contracts.

Compensation and mitigation

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, years of service and the director's obligation to mitigate his own loss.

Non-executive directors

The fees paid to non-executive directors are determined by the Board who are informed by independent market surveys. 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.

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.

Non-executive directors do not participate in any of the Company's share schemes, performance pay arrangements or pension schemes.

Individual directors' emoluments

The individual directors' emoluments are analysed as follows:

	Basic salaries £000	Board and committee fees £000	Taxable benefits £000	Annual performance related award scheme (APRA) Deferred shares £000	Cash £000	Total APRA £000[1]	2001 Aggregate emoluments excluding pensions contributions[2] £000	2000 Aggregate emoluments excluding pensions contributions £000
Sir Ralph Robins [3]	384	—	24	80	160	240	648	457
Mr J E V Rose	573	—	19	120	240	360	952	689
Mr J P Cheffins [4]	361	—	15	75	150	225	601	—
Mr C H Green	351	—	24	35	70	105	480	413
Mr J M Guyette [5]	388	—	40	80	160	240	668	481
Mr P Heiden	369	—	16	75	150	225	610	419
Dr M G J W Howse [6]	59	—	3	40	80	120	182	—
Mr P C Ruffles [7]	246	—	11	55	109	164	421	391
Mr R T Turner	269	—	18	56	112	168	455	326
Mr P J Byrom	—	37	—	—	—	—	37	37
Lord Moore of Lower Marsh	—	45	—	—	—	—	45	45
Sir Robin Nicholson	—	42	—	—	—	—	42	39
Mr C G Symon	—	32	—	—	—	—	32	30
Sir John Weston	—	30	—	—	—	—	30	30
	3,000	186	170	616	1,231	1,847	5,203	3,357

[1] One-third of the award was paid in Rolls-Royce shares (see page 30). In addition, the directors undertook to use an amount at least equal to a further one-third of the total award after tax to purchase shares in the Company.
[2] Details of the directors' pensions are set out on pages 31 and 32.
[3] 40% of Sir Ralph Robins' taxable benefits for 2001 was reimbursed by Cable & Wireless plc, in respect of his position as non-executive Chairman of that Company.
[4] Mr J P Cheffins was appointed to the Board with effect from January 1, 2001.
[5] Mr J M Guyette was paid in US dollars translated at $1.50 = £1.
[6] Dr M G J W Howse was appointed to the Board with effect from October 18, 2001.
[7] Mr P C Ruffles retired as a director with effect from October 18, 2001.

Directors' share interests

The directors, including their immediate families, at December 31, 2001, had the following beneficial interests in the ordinary shares of the Company as shown in the following tables:

Holdings of ordinary shares	January 1, 2001[1]	December 31, 2001
Sir Ralph Robins	99,611	103,607
Mr J E V Rose	117,290	153,824
Mr J P Cheffins	3,000	66,000
Mr C H Green	100,267	104,632
Mr J M Guyette	29,826	79,466
Mr P Heiden	31,739	42,739
Dr M G J W Howse	2,282	18,446
Mr R T Turner	22,349	39,249
Mr P J Byrom	31,129	31,887
Lord Moore of Lower Marsh	22,672	38,620
Sir Robin Nicholson	17,036	17,036
Mr C G Symon	2,500	5,500
Sir John Weston	2,120	3,208

[1] Or date of appointment if later.

Sir Ralph Robins, Mr C H Green, Mr J M Guyette, Mr P J Byrom, Lord Moore of Lower Marsh, Sir John Weston and Mr C G Symon took 2,505; 2,513; 1,814; 732; 882; 74 and 125 shares respectively instead of cash dividends in January 2002. Otherwise there has been no change in the directors' interests between December 31, 2001 and March 6, 2002.

Remuneration report
continued

Directors' share interests continued

Shares held in trust	Shares held in trust under the annual performance related award scheme[2]		Shares held in trust under the profit sharing share scheme[3]	
	January 1, 2001[1]	December 31, 2001	January 1, 2001	December 31, 2001
Sir Ralph Robins	17,113	30,907	2,743	6,076
Mr J E V Rose	25,402	45,906	3,576	7,332
Mr J P Cheffins	15,883	33,824	1,797	4,274
Mr C H Green	16,043	27,786	2,572	5,409
Mr J M Guyette	17,431	31,858	—	—
Mr P Heiden	15,241	27,916	2,443	5,505
Dr M G J W Howse	18,179	18,179	2,414	2,414
Mr R T Turner	12,567	22,260	2,015	4,357

[1] Or date of appointment if later.
[2] Under the annual performance related award scheme, shares vest after two years (see page 30).
[3] Under the profit sharing share scheme, shares vest after three years.

In addition to their individual interests in shares, each of the executive directors is, for Companies Act purposes, regarded as interested in all the 3,200,199 shares held by the discretionary trust linked to the share based incentive schemes, the 401,283 shares held by the qualifying employee share trust and the 3,247,233 shares held by the trust linked to the Inland Revenue Approved Profit Sharing Share Scheme. These shares are held for the purpose of satisfying awards granted under the executive share option scheme, the annual performance related award scheme, sharesave schemes and the profit sharing share scheme.

Share options	January 1, 2001	Granted in 2001	Cancelled in 2001	Exercised in 2001	December 31, 2001	Exercise price	Market price at date exercised	Aggregate gains 2001 £000	Aggregate gains 2000 £000	Exercisable dates
Sir Ralph Robins	164,737				164,737	194p				2003-2010
	7,438		7,438		—	—				—
	499		499		—	—				—
		171,297			171,297	216p				2004-2011
		685,186			685,186[1]	216p				2004-2011
		4,398			4,398[2]	108p				2005
	172,674	860,881	7,937		1,025,618	212p[3]			239	
Mr J E V Rose	116,750				116,750	176p				2002-2005
	7,438		7,438		—	—				—
	947		947		—	—				—
	283,141				283,141	194p				2003-2010
		254,630			254,630	216p				2004-2011
		1,018,519			1,018,519[1]	216p				2004-2011
		7,662			7,662[2]	108p				2007
	408,276	1,280,811	8,385		1,680,702	209p[3]				
Mr J P Cheffins	72,250				72,250	176p				2002-2005
	15,444				15,444	194p				2003-2010
	118,405				118,405	194p				2003-2010
	5,060		5,060		—	—				—
	3,479		3,479		—	—				—
		173,612			173,612	216p				2004-2011
		694,445			694,445[1]	216p				2004-2011
		4,398			4,398[2]	108p				2005
	214,638	872,455	8,539		1,078,554	210p[3]				
Mr C H Green	67,250				67,250	176p				2002-2005
	4,756				4,756[2]	205p				2003
	4,053				4,053[2]	194p				2007
	154,441				154,441	194p				2003-2010
		162,038			162,038	216p				2004-2011
		648,149			648,149[1]	216p				2004-2011
		551			551[2]	108p				2007
	230,500	810,738			1,041,238	210p[3]			8	

Directors' share interests continued

Share options	January 1, 2001	Granted in 2001	Cancelled in 2001	Exercised in 2001	December 31, 2001	Exercise price	Market price at date exercised	Aggregate gains 2001 £000	Aggregate gains 2000 £000	Exercisable dates
Mr J M Guyette	114,581				114,581	269p				2002-2009
	2,721				2,721[2]	194p				2002
	167,799				167,799	194p				2003-2010
		179,161			179,161	216p				2004-2011
		716,641			716,641[1]	216p				2004-2011
		4,398			4,398[2]	108p				2005
	285,101	900,200			1,185,301	218p[3]				
Mr P Heiden	66,750				66,750	176p				2002-2005
	7,438		7,438		—	—				—
	499		499		—	—				—
	162,163				162,163	194p				2003-2010
		173,612			173,612	216p				2004-2011
		694,445			694,445[1]	216p				2004-2011
		7,662			7,662[2]	108p				2007
	236,850	875,719	7,937		1,104,632	210p[3]				
Dr M G J W Howse	41,250				41,250	176p				2002-2005
	15,444				15,444	194p				2003-2010
	48,392				48,392	194p				2003-2010
	3,395				3,395[2]	194p				2003
		69,445			69,445	216p				2004-2011
		138,889			138,889[1]	216p				2004-2011
		1,407			1,407[2]	108p				2005
	108,481	209,741			318,222	206p[3]				
Mr R T Turner	105,750				105,750	176p				2002-2005
	6,900			6,900	—	150p	231p	6		—
	1,697				1,697[2]	194p				2003
	120,979				120,979	194p				2003-2010
		120,371			120,371	216p				2004-2011
		481,482			481,482[1]	216p				2004-2011
		2,920			2,920[2]	108p				2005
	235,326	604,773		6,900	833,199	207p[3]		6		

[1] Supplementary options, see page 31.
[2] Sharesave schemes.
[3] Weighted average exercise price of December 31, 2001 balance.

All of the outstanding options awarded under the executive share option scheme were granted at the market value on the date of issue and no discount was applied.
The closing market price of the Company's ordinary shares ranged between 121p and 250p during 2001 and was 166.5p on December 31, 2001.

To assist executives in purchasing shares to fulfil their ownership requirement (as described on page 31), they were given a once only opportunity to join a plan through which regular fixed salary deductions would be held in a savings account and used to purchase shares at a price of £2.16 at the end of a three year period. Shares would have to be purchased at this price regardless of the prevailing market price at the time.

The interests of executive directors in the number of shares with the value of savings accrued to the end of 2001 are detailed below:

	Shares December 31, 2001
Mr P Heiden	3,277

Group profit and loss account

for the year ended December 31, 2001

	Notes	Continuing operations before exceptional items £m	Exceptional items[1] £m	Total 2001 £m	Restated Total 2000 £m
Turnover: Group and share of joint ventures		**6,680**	**—**	**6,680**	5,955
Sales to joint ventures		**871**	**—**	**871**	893
Less share of joint ventures' turnover		**(1,223)**	**—**	**(1,223)**	(984)
Group turnover	2	**6,328**	**—**	**6,328**	5,864
Cost of sales		**(5,193)**	**(213)**	**(5,406)**	(5,005)[1]
Gross profit		**1,135**	**(213)**	**922**	859
Other operating income	3	**239**	**—**	**239**	341
Commercial, marketing and product support costs		**(283)**	**(5)**	**(288)**	(268)
General and administrative costs		**(269)**	**(12)**	**(281)**	(271)
Research and development (net)*		**(358)**	**—**	**(358)**	(371)
Group operating profit		**464**	**(230)**	**234**	290
Share of operating profit of joint ventures		**82**	**—**	**82**	76
Loss on sale or termination of businesses	31	**(11)**	**—**	**(11)**	(78)[1]
Profit on sale of fixed assets		**6**	**—**	**6**	1
Profit on ordinary activities before interest	2	**541**	**(230)**	**311**	289
Net interest payable – Group	4	**(77)**	**—**	**(77)**	(85)
– joint ventures		**(42)**	**—**	**(42)**	(38)
Profit on ordinary activities before taxation	3	**422**	**(230)**	**192**	166
Taxation	5	**(155)**	**69**	**(86)**	(87)
Profit on ordinary activities after taxation		**267**	**(161)**	**106**	79
Equity minority interests in subsidiary undertakings				**—**	—
Profit attributable to ordinary shareholders				**106**	79
Dividends	6			**(132)**	(126)
Transferred from reserves	26			**(26)**	(47)
*Research and development (gross)				**(636)**	(604)
Earnings per ordinary share:	7				
Underlying				**20.20p**	19.38p
Basic				**6.67p**	5.07p
Diluted basic				**6.56p**	5.04p

[1] Exceptional items are analysed in note 3. In 2000 exceptional items included in cost of sales and loss on sale of businesses were £145m and £73m respectively.

As permitted by the Companies Act 1985, a separate profit and loss account for the Company has not been included in these financial statements.
Of the Group profit attributable to ordinary shareholders, a profit of **£63m** (2000 restated £184m) has been dealt with in the profit and loss account of the Company.

There have been no material acquisitions or material discontinued operations in 2001 or 2000.

Profit and loss account and balance sheet 2000 comparatives have been restated to reflect FRS 19 'Deferred Tax' (see note 1).

Balance sheets
at December 31, 2001

	Notes	Group 2001 £m	Group Restated 2000 £m	Company 2001 £m	Company Restated 2000 £m
Fixed assets					
Intangible assets	9	**823**	877	**34**	41
Tangible assets	10	**1,732**	1,772	**860**	875
Investments – subsidiary undertakings	11	**—**	—	**1,759**	1,887
– joint ventures	12	**204**	174	**51**	51
share of gross assets		**1,341**	1,117		
share of gross liabilities		**(1,144)**	(943)		
goodwill		**7**	—		
– other	13	**30**	33	**6**	10
		2,789	2,856	**2,710**	2,864
Current assets					
Stocks	14	**1,222**	1,179	**677**	561
Debtors – amounts falling due within one year	15	**1,640**	1,591	**1,331**	1,334
– amounts falling due after one year	16	**810**	590	**465**	273
Short-term deposits and investments	17	**301**	142	**203**	—
Cash at bank and in hand		**578**	498	**293**	337
		4,551	4,000	**2,969**	2,505
Creditors – amounts falling due within one year					
Borrowings	18	**(276)**	(272)	**(113)**	(26)
Other creditors	19	**(2,720)**	(2,559)	**(2,240)**	(2,111)
Net current assets		**1,555**	1,169	**616**	368
Total assets less current liabilities		**4,344**	4,025	**3,326**	3,232
Creditors – amounts falling due after one year					
Borrowings	20	**(1,104)**	(1,058)	**(693)**	(707)
Other creditors	21	**(288)**	(206)	**(364)**	(329)
Provisions for liabilities and charges	22	**(882)**	(720)	**(260)**	(176)
		2,070	2,041	**2,009**	2,020
Capital and reserves					
Called-up share capital	25	**320**	314	**320**	314
Share premium account	26	**636**	623	**636**	623
Revaluation reserve	26	**103**	108	**97**	101
Other reserves	26	**189**	182	**167**	167
Profit and loss account	26	**820**	813	**789**	815
Equity shareholders' funds		**2,068**	2,040	**2,009**	2,020
Equity minority interests in subsidiary undertakings		**2**	1	**—**	—
		2,070	2,041	**2,009**	2,020

The financial statements on pages 36 to 68 were approved by the Board on March 6, 2002 and signed on its behalf by:
Sir Ralph Robins Chairman, **P Heiden** Finance Director.

PHeide Ralph Robins

Group cash flow statement
for the year ended December 31, 2001

		2001 £m	2000 £m
Net cash inflow from operating activities	A	**418**	479
Dividends received from joint ventures		**15**	13
Returns on investments and servicing of finance	B	**(54)**	(76)
Taxation paid		**(24)**	(25)
Capital expenditure and financial investment	C	**(179)**	(253)
Acquisitions and disposals	D	**79**	(53)
Equity dividends paid		**(84)**	(74)
Cash inflow before use of liquid resources and financing		**171**	11
Management of liquid resources	E	**(162)**	324
Financing	F	**111**	(360)
Increase/(decrease) in cash		**120**	(25)

Reconciliation of net cash flow to movement in net funds		
Increase/(decrease) in cash	**120**	(25)
Cash outflow/(inflow) from increase/(decrease) in liquid resources	**162**	(324)
Cash (inflow)/outflow from (increase)/decrease in borrowings	**(95)**	370
Change in net funds resulting from cash flows	**187**	21
Zero-coupon bonds 2005/2007 (9.0% interest accretion)	**(3)**	(3)
Exchange adjustments	**5**	(14)
Movement in net funds	**189**	4
Net debt at January 1	**(690)**	(694)
Net debt at December 31	**(501)**	(690)

Analysis of net debt	At January 1, 2001 £m	Cash flow £m	Exchange adjustments £m	Other non-cash changes £m	At December 31, 2001 £m
Cash at bank and in hand	**498**	**72**	**8**	**—**	**578**
Overdrafts	**(103)**	**48**	**(1)**	**—**	**(56)**
Short-term deposits and investments	**142**	**162**	**(3)**	**—**	**301**
Other borrowings due within one year	**(160)**	**(39)**	**1**	**—**	**(198)**
Borrowings due after one year	**(965)**	**(67)**	**1**	**(3)**	**(1,034)**
Finance leases	**(102)**	**11**	**(1)**	**—**	**(92)**
	(690)	**187**	**5**	**(3)**	**(501)**

	2001 £m	2000 £m
Reconciliation of operating profit to operating cash flows		
Operating profit	**234**	290
Amortisation of intangible assets (note 9)	**57**	60
Depreciation of tangible fixed assets (note 3)	**198**	178
Profit on disposals of tangible fixed assets and investments	**—**	(3)
Increase in provisions for liabilities and charges	**180**	49
(Increase)/decrease in stocks	**(52)**	62
Increase in debtors	**(386)**	(374)
Increase in creditors	**187**	217
A **Net cash inflow from operating activities**	**418**	479
Returns on investments and servicing of finance		
Interest received	**25**	26
Interest paid	**(73)**	(96)
Interest element of finance lease payments	**(6)**	(6)
B **Net cash outflow for returns on investments and servicing of finance**	**(54)**	(76)
Capital expenditure and financial investment		
Additions to unlisted investments	**(1)**	(2)
Additions to intangible assets	**(25)**	(10)
Purchases of tangible fixed assets	**(211)**	(292)
Disposals of tangible fixed assets	**56**	51
Other investments	**2**	—
C **Net cash outflow for capital expenditure and financial investment**	**(179)**	(253)
Acquisitions and disposals		
Acquisitions of businesses	**(1)**	(45)
Disposals of businesses (note 31)	**102**	(5)
Investments in joint ventures	**(24)**	(13)
Loan repayments from joint ventures	**2**	10
D **Net cash inflow/(outflow) for acquisitions and disposals**	**79**	(53)
Management of liquid resources		
(Increase)/decrease in short-term deposits	**(159)**	327
Increase in government securities and corporate bonds	**(3)**	(3)
E **Net cash (outflow)/inflow from management of liquid resources**	**(162)**	324
Financing		
Borrowings due within one year – repayment of loans	**(46)**	(147)
– increase in loans	**85**	—
Borrowings due after one year – repayment of loans	**(2)**	(725)
– increase in loans	**69**	510
Capital element of finance lease payments	**(11)**	(8)
Net cash inflow/(outflow) from increase/(decrease) in borrowings	**95**	(370)
Issue of ordinary shares	**16**	10
F **Net cash inflow/(outflow) from financing**	**111**	(360)

Group statement of total recognised gains and losses
for the year ended December 31, 2001

	2001 £m	Restated 2000 £m
Profit attributable to the shareholders of Rolls-Royce plc	**106**	79
Exchange adjustments on foreign currency net investments	**(11)**	30
Total recognised gains for the year	**95**	109
Prior year adjustment (see Accounting policies page 41)	**(23)**	
Total recognised gains recognised since last annual report	**72**	

Group historical cost profits and losses
for the year ended December 31, 2001

	2001 £m	Restated 2000 £m
Profit on ordinary activities before taxation	**192**	166
Difference between the historical cost depreciation charge and the actual depreciation charge for the year calculated on the revalued amount	**5**	4
Historical cost profit on ordinary activities before taxation	**197**	170
Historical cost transfer from reserves	**(21)**	(43)

Reconciliations of movements in shareholders' funds
for the year ended December 31, 2001

	Group		Company	
	2001 £m	Restated 2000 £m	2001 £m	Restated 2000 £m
At January 1 (as previously reported)	**2,063**	—	**2,129**	—
Prior year adjustment (see Accounting policies page 41)	**(23)**	—	**(109)**	—
At January 1	**2,040**	1,967	**2,020**	1,915
Total recognised gains for the year	**95**	109	**63**	184
FRS 19 adjustment relating to goodwill (note 9)	**—**	2	**—**	—
Ordinary dividends (net of scrip dividend adjustments)	**(90)**	(89)	**(90)**	(89)
New ordinary share capital issued (net of expenses)	**16**	10	**16**	10
Goodwill transferred to the profit and loss account in respect of disposals of businesses	**7**	41	**—**	—
At December 31	**2,068**	2,040	**2,009**	2,020

Notes to the financial statements

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.

The Group has adopted FRS 19 'Deferred Tax', whereby provision for deferred tax is made on all timing differences which have originated, but not reversed at the balance sheet date. This has resulted in a net prior year adjustment of £11m for deferred tax as at December 31, 2000 (see note 23), and an increase in the taxation charge reported in the year ended December 31, 2000 of £4m. Additionally there has been an adjustment to goodwill of £12m (see note 9). The impact of the change in accounting policy for the year ended December 31, 2001 is to reduce reported profit after taxation by £22m. Comparative figures for December 31, 2000 have been restated as follows:

	Loss for the period after dividends £m	Shareholders' funds £m
As previously reported	(43)	2,063
Implementation of FRS 19	(4)	(23)
As restated	(47)	2,040

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.

Notes to the financial statements
continued

1 Accounting policies continued

Post-retirement benefits
Contributions to Group 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.

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

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

Accounting for leases
i) 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.

ii) 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.

Depreciation
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 2001 £m	Group turnover 2000 £m	Profit before interest 2001 £m	Profit before interest 2000 £m	Net assets[1] 2001 £m	Net assets[1] Restated 2000 £m
Analysis by business:						
Civil aerospace	**3,443**	3,150	**198**	312	**1,124**	1,116
Defence	**1,400**	1,403	**132**	151	**179**	261
Marine	**827**	751	**37**	38	**513**	582
Energy	**608**	476	**(118)**	(191)	**381**	449
Financial services[2]	**50**	40	**62**	55	**374**	346
Materials handling[3]	**—**	44	**—**	(76)	**—**	(23)
	6,328	5,864	**311**	289	**2,571**	2,731
Geographical analysis by origin:						
United Kingdom	**3,760**	3,730	**137**	201	**1,275**	1,433
Other	**2,568**	2,134	**174**	88	**1,296**	1,298
	6,328	5,864	**311**	289	**2,571**	2,731
Geographical analysis by destination:						
United Kingdom	**1,118**	1,056				
Rest of Europe	**797**	855				
USA	**2,328**	2,148				
Canada	**267**	259				
Asia	**1,081**	953				
Africa	**69**	67				
Australasia	**151**	149				
Other	**517**	377				
	6,328	5,864				
Exports from United Kingdom	**2,629**	2,692				
Sales to overseas subsidiaries	**(328)**	(262)				
Sales by overseas subsidiaries	**2,896**	2,365				
Sales by overseas joint arrangements	**13**	13				
Total overseas	**5,210**	4,808				

[1] Net assets exclude net debt of **£501m** (2000 net debt of £690m).
[2] The turnover of financial services businesses including share of joint ventures is **£149m** (2000 £115m).
[3] Materials handling was disposed of during 2000.

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:

	2001 Underlying profit before interest £m	2001 Exceptional items £m	2001 Other non-trading items £m	2001 Profit before interest £m	2000 Underlying profit before interest £m	2000 Exceptional items £m	2000 Other non-trading items £m	2000 Profit before interest £m
Civil aerospace	**347**	**(136)**	**(13)**	**198**	332	(9)	(11)	312
Defence	**175**	**(38)**	**(5)**	**132**	154	—	(3)	151
Marine	**73**	**(15)**	**(21)**	**37**	67	(3)	(26)	38
Energy	**(64)**	**(41)**	**(13)**	**(118)**	(48)	(133)	(10)	(191)
Financial services	**63**	**—**	**(1)**	**62**	56	—	(1)	55
Materials handling	**—**	**—**	**—**	**—**	(2)	(73)	(1)	(76)
	594	**(230)**[1]	**(53)**[2]	**311**	559	(218)[1]	(52)[2]	289
Interest	**(119)**				(123)			
Underlying profit before taxation	**475**				436			

[1] See note 3.
[2] Comprising amortisation of goodwill **£45m** (2000 £46m) and loss on sale of businesses **£11m** (2000 £5m) less profit on sale of fixed assets **£3m** (2000 loss of £1m).

Notes to the financial statements
continued

3 Profit on ordinary activities before taxation

	2001 £m	2000 £m
After crediting		
Risk and revenue sharing partnerships – receipts (credited to other operating income)	**239**	341
– payments (charged to cost of sales)	**(113)**	(129)
Net impact of risk and revenue sharing partnerships	**126**	212
Operating lease rentals receivable	**36**	28
After charging		
Exceptional items – rationalisation costs [1]	**230**	9
– restructuring costs in respect of acquired businesses	**—**	16
– industrial Trent provision [2]	**—**	120
– closure/termination of materials handling	—	73
	230	218
Amortisation of goodwill	**45**	46
Amortisation of certification costs	**12**	14
Depreciation of owned tangible fixed assets [3]	**192**	172
Depreciation of tangible fixed assets held under finance leases [3]	**6**	6
Operating lease rentals payable – hire of plant and equipment	**54**	39
– hire of other assets	**21**	8

Auditors' fees were as follows during the year:

Audit 2001 – Group **£3.0m** (2000 £2.9m) including Company **£0.6m** (2000 £0.6m)

Other 2001 – United Kingdom **£1.1m** (2000 £1.1m)

– Rest of World **£0.9m** (2000 £0.9m)

[1] 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, 2001 £144m was included in provisions (see note 22).

[2] Provision in respect of the industrial Trent covering both contractual obligations and write-down of assets.

[3] Including appropriate amounts charged to stocks.

4 Net interest payable – Group

	2001 £m	2000 £m
Interest payable on:		
Bank loans and overdrafts	**(45)**	(52)
Other borrowings	**(52)**	(55)
Finance leases	**(6)**	(6)
Interest capitalised	**2**	1
	(101)	(112)
Interest receivable	**24**	27
	(77)	(85)

5 Taxation

Tax charge	2001 £m	Restated 2000 £m
United Kingdom corporation tax at **30%** (2000 30%)	**6**	58
Less double tax relief	**(4)**	—
	2	58
Overseas current tax	**46**	36
Joint ventures	**9**	8
	57	102
United Kingdom deferred tax	**16**	4
Overseas deferred tax	**13**	(19)
	86	87

Tax reconciliation [1]		
Profit on ordinary activities before taxation	**192**	166
Nominal tax charge at UK corporation tax rate **30%** (2000 30%)	**58**	50
Goodwill not deductible for tax purposes	**16**	31
Unrelieved overseas losses	**12**	16
Fixed asset timing differences	**24**	(9)
Other timing differences	**(53)**	24
Other items	**—**	(10)
	57	102

[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:		
Trading activities	**154**	134
Non underlying items (note 7)	**(68)**	(47)
	86	87

6 Dividends – ordinary shares

	2001 £m	2000 £m
Interim **3.18p** (2000 3.00p) per share	**51**	47
Final proposed **5.00p** (2000 5.00p) per share	**81**	79
	132	126

Notes to the financial statements
continued

7 Earnings per ordinary share

Basic earnings per ordinary share are calculated by dividing the profit attributable to ordinary shareholders of **£106m** (2000 £79m) by **1,589 million** (2000 1,558 million) ordinary shares, 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.

Underlying earnings per ordinary share have been calculated as follows:

	2001 Pence	2001 £m	Restated 2000 Pence	Restated 2000 £m
Profit attributable to ordinary shareholders	**6.67**	**106**	5.07	79
Exclude:				
Exceptional rationalisation costs	**14.47**	**230**	0.58	9
Restructuring of acquired businesses	**—**	**—**	1.03	16
(Profit)/loss on sale of fixed assets (excluding lease engines and aircraft sold by financial services companies)	**(0.19)**	**(3)**	0.06	1
Amortisation of goodwill	**2.83**	**45**	2.95	46
Net loss on sale of businesses – materials handling	**—**	**—**	4.69	73
– other	**0.69**	**11**	0.32	5
Energy provision	**—**	**—**	7.70	120
Related tax effect	**(4.27)**	**(68)**	(3.02)	(47)
Underlying earnings per ordinary share	**20.20**	**321**	19.38	302

Diluted basic earnings per ordinary share are calculated by dividing the profit attributable to ordinary shareholders of **£106m** (2000 £79m) by **1,616 million** (2000 1,566 million) ordinary shares, being **1,589 million** (2000 1,558 million) as above adjusted by the bonus element of existing share options of **27 million** (2000 8 million).

8 Employee information

	2001 Number	2000 Number
Average weekly number of Group employees during the year		
United Kingdom	**27,300**	30,200
Overseas	**16,000**	16,400
	43,300	46,600
Civil aerospace	**24,300**	26,100
Defence	**7,200**	7,700
Marine	**6,600**	6,500
Energy	**5,100**	5,600
Financial services	**100**	100
Materials handling	**—**	600
	43,300	46,600

	£m	£m
Group employment costs		
Wages and salaries	**1,430**	1,388
Social security costs	**128**	128
Pensions and other post-retirement benefits (note 30)	**89**	84
	1,647	1,600

9 Intangible fixed assets

	Group				Company
	Goodwill £m	Certification costs £m	Application engineering [1] £m	Total £m	Certification costs £m
Cost					
At January 1, 2001 (as previously reported)	**898**	**106**	—	**1,004**	**106**
Prior year adjustment [2]	**(12)**	—	—	**(12)**	—
At January 1, 2001 as restated	**886**	**106**	—	**992**	**106**
Exchange adjustments	**(15)**	—	—	**(15)**	—
Additions	**1**	**5**	**20**	**26**	**5**
Disposals	**(11)**	—	—	**(11)**	—
At December 31, 2001	**861**	**111**	**20**	**992**	**111**
Accumulated amortisation					
At January 1, 2001	**50**	**65**	—	**115**	**65**
Exchange adjustments	**(2)**	—	—	**(2)**	—
Provided during the year	**45**	**12**	—	**57**	**12**
Disposals	**(1)**	—	—	**(1)**	—
At December 31, 2001	**92**	**77**	—	**169**	**77**
Net book value at December 31, 2001	**769**	**34**	**20**	**823**	**34**
Net book value at December 31, 2000 as restated	836	41	—	877	41

[1] See Accounting policies page 41.

[2] Adjustment resulting from the adoption of FRS 19 'Deferred Tax' (see Accounting policies page 41), of which £2m relates to the 2000 adjustments to fair values.

Notes to the financial statements
continued

10 Tangible fixed assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Group					
Cost or valuation:					
At January 1, 2001	**492**	**1,701**	**202**	**143**	**2,538**
Exchange adjustments	**(2)**	**(1)**	**3**	**—**	**—**
Additions at cost	**8**	**81**	**7**	**125**	**221**
On disposals of businesses	**(3)**	**(6)**	**(2)**	**—**	**(11)**
Reclassifications	**10**	**62**	**—**	**(72)**	**—**
Disposals/write-offs	**(31)**	**(79)**	**(37)**	**(1)**	**(148)**
At December 31, 2001	**474**	**1,758**	**173**	**195**	**2,600**
Accumulated depreciation:					
At January 1, 2001	**61**	**655**	**50**	**—**	**766**
Exchange adjustments	**—**	**(1)**	**—**	**—**	**(1)**
Provided during year	**19**	**166**	**13**	**—**	**198**
On disposals of businesses	**(1)**	**(3)**	**—**	**—**	**(4)**
Disposals/write-offs	**(19)**	**(64)**	**(8)**	**—**	**(91)**
At December 31, 2001	**60**	**753**	**55**	**—**	**868**
Net book value at December 31, 2001	**414**	**1,005**	**118**	**195**	**1,732**
Net book value at December 31, 2000	431	1,046	152	143	1,772
Company					
Cost or valuation:					
At January 1, 2001	**275**	**1,010**	**—**	**63**	**1,348**
Additions at cost	**4**	**49**	**—**	**42**	**95**
Reclassifications	**7**	**44**	**—**	**(51)**	**—**
Disposals/write-offs	**(2)**	**(38)**	**—**	**—**	**(40)**
At December 31, 2001	**284**	**1,065**	**—**	**54**	**1,403**
Accumulated depreciation:					
At January 1, 2001	**36**	**437**	**—**	**—**	**473**
Provided during year	**11**	**91**	**—**	**—**	**102**
Disposals/write-offs	**(1)**	**(31)**	**—**	**—**	**(32)**
At December 31, 2001	**46**	**497**	**—**	**—**	**543**
Net book value at December 31, 2001	**238**	**568**	**—**	**54**	**860**
Net book value at December 31, 2000	239	573	—	63	875

10 Tangible fixed assets continued

Tangible fixed assets include:	Group 2001 £m	Group 2000 £m	Company 2001 £m	Company 2000 £m
Net book value of finance leased assets	**113**	104	**27**	27
Assets held for use in operating leases:				
Cost	**153**	178	**—**	—
Depreciation	**(44)**	(37)	**—**	—
Net book value	**109**	141	**—**	—
Non-depreciable land	**80**	85	**58**	59

	Group 2001 £m	Group 2000 £m	Company 2001 £m	Company 2000 £m
Land and buildings at cost or valuation comprise:				
Cost	**248**	235	**83**	72
Valuation at December 31, 1985	**1**	1	**—**	—
Valuation at December 31, 1996[1]	**225**	256	**201**	203
	474	492	**284**	275
Land and buildings at net book value comprise:				
Freehold	**383**	400	**230**	231
Long leasehold	**19**	19	**8**	9
Short leasehold	**12**	12	**—**	(1)
	414	431	**238**	239
On a historical cost basis the net book value of land and buildings would have been as follows:				
Cost	**458**	475	**266**	256
Depreciation	**(147)**	(152)	**(125)**	(118)
	311	323	**141**	138
Capitalised interest included in net book value of assets in course of construction	**5**	4	**—**	—
Capital expenditure commitments – contracted but not provided for	**96**	91	**30**	27

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.

Notes to the financial statements
continued

11 Investments – subsidiary undertakings

	Shares £m	Loans £m	Total £m
Company			
Cost:			
At January 1, 2001	**1,385**	**502**	**1,887**
Additions/(repayments)	**87**	**(215)**	**(128)**
At December 31, 2001	**1,472**	**287**	**1,759**

The principal subsidiary undertakings are listed on pages 65 and 66.

12 Investments – joint ventures

	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m
Group				
At January 1, 2001	**121**	**42**	**11**	**174**[1]
Exchange adjustments	**—**	**—**	**—**	**—**
Additions	**21**	**—**	**6**	**27**
Disposals and repayments	**—**	**—**	**(2)**	**(2)**
Share of retained profit	**—**	**5**	**—**	**5**
At December 31, 2001	**142**	**47**	**15**	**204**[1]
Company				
At January 1, 2001	**47**	**—**	**4**	**51**
Additions	**—**	**—**	**—**	**—**
At December 31, 2001	**47**	**—**	**4**	**51**

The principal joint ventures are listed on pages 67 and 68.

[1] Investments in joint ventures are represented by:

	2001 £m	2000 £m
Share of aggregate assets:		
Fixed	**856**	710
Current	**485**	407
Share of aggregate liabilities:[2]		
Due within one year	**(431)**	(437)
Due after one year	**(713)**	(506)
Goodwill	**7**	—
	204	174
[2] Includes borrowings of	**(781)**	(602)

13 Investments – other

	Unlisted investments at cost £m	Own shares held under trust[1] £m	Total £m
Group			
At January 1, 2001	**23**	**10**	**33**
Additions less amortisation	**1**	**(4)**	**(3)**
At December 31, 2001	**24**	**6**	**30**
Company			
At January 1, 2001	**—**	**10**	**10**
Additions less amortisation	**—**	**(4)**	**(4)**
At December 31, 2001	**—**	**6**	**6**

[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 Remuneration report on pages 30 to 35).
This independently managed trust purchased shares on the open market:

		£m
June 25, 1997	504,296 at £2.42 per share	1.2
April 24, 1998	651,103 at £2.82 per share	1.8
March 26, 1999	569,800 at £2.54 per share	1.4
June 30, 1999	1,475,000 at £2.73 per share	4.0

At December 31, 2001, these shares had a market value of £5.3m. 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. In accordance with UITF 17, no amortisation charge has been made. At December 31, 2001, a total of 401,283 of these shares had still not been allocated to option holders, their market value being £0.7m. These outstanding allocations are expected to occur in 2002.

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	
	2001 £m	2000 £m	**2001 £m**	2000 £m
Raw materials	**218**	258	**52**	65
Work in progress	**334**	354	**76**	99
Long-term contracts work in progress	**96**	119	**47**	13
Finished goods	**815**	674	**583**	475
Payments on account	**35**	33	**30**	22
	1,498	1,438	**788**	674
Progress payments received against:				
Long-term contracts work in progress	**(27)**	(97)	**—**	—
Other stocks[1]	**(249)**	(162)	**(111)**	(113)
	1,222	1,179	**677**	561
[1] Includes payments received from joint ventures	**(23)**	(5)	**(23)**	(5)

Notes to the financial statements
continued

15 Debtors – amounts falling due within one year

	Group		Company	
	2001 £m	2000 £m	**2001 £m**	2000 £m
Trade debtors	**991**	919	**382**	352
Amounts recoverable on contracts	**74**	94	**7**	18
Amounts owed by – subsidiary undertakings	**—**	—	**621**	645
– joint ventures	**195**	156	**156**	129
Corporate taxation	**5**	11	**—**	7
Deferred tax assets (note 23)	**15**	—	**—**	—
Other debtors	**182**	201	**39**	40
Prepayments and accrued income	**178**	210	**126**	143
	1,640	1,591	**1,331**	1,334

16 Debtors – amounts falling due after one year

	Group		Company	
	2001 £m	Restated 2000 £m	**2001 £m**	2000 £m
Trade debtors	**48**	18	**47**	17
Amounts recoverable on contracts	**274**	97	**245**	93
Amounts owed by – subsidiary undertakings	**—**	—	**10**	13
– joint ventures	**68**	57	**54**	43
Corporate taxation	**—**	26	**—**	26
Deferred tax assets (note 23)	**82**	108	**—**	—
Other debtors	**40**	49	**—**	—
Prepayments and accrued income	**117**	78	**102**	76
Prepaid pension contributions	**181**	157	**7**	5
	810	590	**465**	273

17 Short-term deposits and investments

	Group		Company	
	2001 £m	2000 £m	**2001 £m**	2000 £m
Short-term deposits	**262**	106	**203**	—
Investments – government securities and corporate bonds	**39**	36	**—**	—
	301	142	**203**	—

18 Borrowings – amounts falling due within one year

	Group		Company	
	2001 £m	2000 £m	**2001 £m**	2000 £m
Overdrafts	**56**	103	**—**	—
Bank loans	**187**	103	**99**	25
Other loans	**11**	57	**—**	—
Obligations under finance leases	**22**	9	**14**	1
	276	272	**113**	26

19 Other creditors – amounts falling due within one year

	Group		Company	
	2001	2000	**2001**	2000
	£m	£m	**£m**	£m
Payments received on account [1]	**234**	257	**92**	118
Trade creditors	**587**	584	**269**	266
Amounts owed to – subsidiary undertakings	**—**	—	**644**	662
– joint ventures	**161**	118	**158**	95
Corporate taxation	**211**	187	**100**	101
Other taxation and social security	**60**	63	**23**	33
Other creditors	**631**	526	**460**	378
Accruals and deferred income	**704**	698	**362**	332
Interim dividend since paid	**51**	47	**51**	47
Final proposed dividend	**81**	79	**81**	79
	2,720	2,559	**2,240**	2,111
[1] Includes payments received from joint ventures	**44**	70	**44**	70

20 Borrowings – amounts falling due after one year

	Group		Company	
	2001	2000	**2001**	2000
	£m	£m	**£m**	£m
Unsecured				
Bank loans	**87**	23	**—**	—
7⅛% Notes 2003 [1]	**200**	199	**—**	—
4½% Notes 2005 [2]	**177**	177	**177**	177
6⅜% Notes 2007 [2]	**310**	310	**310**	310
7 ⅜% Notes 2016	**200**	200	**200**	200
Other loan 2009 (interest rate nil)	**4**	4	**—**	—
Secured				
Bank loans	**13**	13	**—**	—
Obligations under finance leases payable: [3]				
Between one and two years	**10**	23	**2**	16
Between two and five years	**50**	33	**3**	3
After five years	**10**	37	**1**	1
Zero-coupon bonds 2005/2007 (including 9.0% interest accretion) [4]	**43**	39	**—**	—
	1,104	1,058	**693**	707
Repayable				
Between one and two years – by instalments	**10**	26	**2**	16
– otherwise	**201**	—	**—**	—
Between two and five years – by instalments	**84**	37	**3**	3
– otherwise	**247**	378	**177**	177
After five years – by instalments	**19**	68	**1**	1
– otherwise	**543**	549	**510**	510
	1,104	1,058	**693**	707

[1] 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.

[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.

Notes to the financial statements
continued

21 Other creditors – amounts falling due after one year

	Group 2001 £m	Group 2000 £m	Company 2001 £m	Company 2000 £m
Payments received on account [1]	**109**	66	**109**	66
Amounts owed to – subsidiary undertakings	**—**	—	**198**	198
– joint ventures	**24**	—	**—**	—
Other creditors	**43**	57	**32**	41
Accruals and deferred income	**112**	83	**25**	24
	288	206	**364**	329
[1] Includes payments received from joint ventures	**26**	—	**26**	—

22 Provisions for liabilities and charges

	Restated at January 1, 2001 [1] £m	Exchange adjustments £m	ACT movement £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At December 31, 2001 £m
Group							
Post-employment, pensions and other post-retirement benefits	**130**	**2**	**—**	**—**	**28**	**(3)**	**157**
Deferred taxation	**168**	**1**	**(33)**	**(7)**	**20**	**—**	**149**
Warranty/guarantees	**187**	**(1)**	**—**	**(6)**	**63**	**(46)**	**197**
Contract loss	**115**	**—**	**—**	**(2)**	**54**	**(79)**	**88**
Customer financing	**35**	**—**	**—**	**—**	**57**	**(10)**	**82**
Insurance	**22**	**—**	**—**	**—**	**—**	**(1)**	**21**
Restructuring and rationalisation [2]	**30**	**—**	**—**	**—**	**146**	**(26)**	**150**
Other	**33**	**—**	**—**	**(2)**	**18**	**(11)**	**38**
	720	**2**	**(33)**	**(17)**	**386**	**(176)**	**882**
Company							
Deferred taxation	**109**	**—**	**(33)**	**(7)**	**—**	**—**	**69**
Warranty/guarantees	**42**	**—**	**—**	**(4)**	**10**	**(11)**	**37**
Contract loss	**3**	**—**	**—**	**—**	**2**	**(2)**	**3**
Customer financing	**6**	**—**	**—**	**—**	**30**	**(6)**	**30**
Restructuring	**9**	**—**	**—**	**—**	**113**	**(8)**	**114**
Other	**7**	**—**	**—**	**—**	**1**	**(1)**	**7**
	176	**—**	**(33)**	**(11)**	**156**	**(28)**	**260**

[1] Deferred taxation restated for FRS 19 (see note 23).
[2] Includes exceptional rationalisation provision of £144m.

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

23 Deferred taxation

	Group Restated £m	Company Restated £m
At January 1, 2001 (as previously reported)	**(49)**	**—**
Prior year adjustment [1]	**(11)**	**(109)**
At January 1, 2001 (as restated)	**(60)**	**(109)**
Amount (charged)/credited to profit and loss account	**(29)**	**7**
Exchange movements	**2**	**—**
Transfers	**35**	**33**
At December 31, 2001	**(52)**	**(69)**

[1] The adoption of FRS 19 'Deferred Tax' (see Accounting policies page 41) has resulted in a net prior year adjustment of £11m. This comprises an increase in deferred tax provisions of £119m offset by the recognition of deferred tax assets of £108m.

There are other deferred tax assets totalling **£27m** (2000 £22m) that have not been recognised on the basis that their future economic benefit is uncertain.

The analysis of the deferred tax position is as follows:

	Group		Company	
	2001 £m	Restated 2000 £m	**2001 £m**	Restated 2000 £m
Fixed asset timing differences	**(110)**	(134)	**(112)**	(113)
Other timing differences	**4**	53	**8**	2
Advance corporation tax	**54**	21	**35**	2
	(52)	(60)	**(69)**	(109)
Included in:				
Provisions	**(149)**	(168)	**(69)**	(109)
Debtors	**97**	108	**—**	—
	(52)	(60)	**(69)**	(109)

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.

Notes to the financial statements
continued

24 Financial instruments

Details 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 page 41. The following disclosures provide additional information regarding the effect of these instruments on the financial assets and liabilities of the Group, excluding short-term debtors and creditors where permitted by FRS 13.

Funding and interest rates

	Sterling £m	**US Dollar £m**	**Euro £m**	**Other £m**	**2001 Total £m**
Financial 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**
Financial 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)**

	Sterling £m	US Dollar £m	Euro £m	Other £m	2000 Total £m
Financial assets					
Cash at bank and in hand [1]	474	14	6	4	498
Short-term deposits [2]	10	32	10	54	106
Government securities and corporate bonds [3]	34	2	—	—	36
Unlisted fixed asset investments [4]	—	13	—	10	23
Debtors – amounts falling due after one year [4]	60	26	23	15	124
	578	87	39	83	787
Financial liabilities [5]					
Floating-rate borrowings [6]	—	(15)	(59)	(164)	(238)
Fixed-rate borrowings	(976)	(83)	—	(29)	(1,088)
Borrowings on which no interest is paid [7]	—	—	—	(4)	(4)
Other creditors – amounts falling due after one year [4]	(50)	(1)	—	(6)	(57)
Provisions [4]	(11)	—	—	(3)	(14)
	(1,037)	(99)	(59)	(206)	(1,401)

Notes

[1] Cash at bank and in hand comprises bank balances and deposits placed on money markets overnight.

[2] The short-term deposits are deposits placed on money markets for periods ranging from two nights up to one month.

[3] The interest on the securities and bonds are at fixed rates. The weighted average interest rate on the sterling securities is 6.4% (2000 6.7%) and the weighted average interest rate on the US Dollar securities is 5.0% (2000 9.0%). The weighted average time for these securities is 2.6 years (2000 2.5 years).

[4] These amounts do not incur or accrue interest.

[5] Financial liabilities are stated after taking into account the various interest rate and currency swaps entered into by the Group.

[6] The 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.

[7] The weighted average period for borrowings on which no interest is paid is eight years (2000 nine years).

24 **Financial instruments** continued

The analysis of fixed-rate borrowings is as follows:

	2001			2000		
	Total £m	**Weighted average interest rate at which fixed %**	**Weighted average period for which rate is fixed Months**	Total £m	Weighted average interest rate at which fixed %	Weighted average period for which rate is fixed Months
Currency						
Sterling	**820**	**5.4**	**15**	976	6.2	23
US Dollar	**83**	**7.1**	**47**	83	7.1	59
Other	**29**	**5.4**	**60**	29	5.4	72

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

	2001 £m	2000 £m
In one year or less, or on demand	**276**	286
In more than one year but not more than two years	**250**	57
In more than two years but not more than five years	**365**	441
In more than five years	**562**	617
	1,453	1,401

Borrowing facilities

The Group has various borrowing facilities available to it. The undrawn committed facilities available at December 31, 2001 were as follows:

	2001 £m	2000 £m
Expiring within one year	**399**	15
Expiring in one to two years	**75**	238
Expiring thereafter	**500**	790
	974	1,043

Exchange risk management

The table below shows the Group's currency exposures at December 31, 2001 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, 2001 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.

	2001 Net foreign currency monetary assets/(liabilities)				2000 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	**—**	**(1)**	**—**	**1**	—	7	(8)	2
US Dollar	**—**	**—**	**—**	**—**	—	—	—	—
Euro	**—**	**—**	**—**	**1**	—	1	—	1
Other	**2**	**1**	**3**	**(1)**	(2)	—	3	6

Notes to the financial statements
continued

24 Financial instruments continued

Fair values of financial assets and financial liabilities

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

	2001 Book value £m	2001 Fair value £m	2000 Book value £m	2000 Fair value £m
Unlisted fixed asset investments	**24**	**24**	23	23
Cash at bank and in hand	**578**	**578**	498	498
Short-term deposits and investments	**301**	**301**	142	140
Short-term debt	**(276)**	**(274)**	(272)	(273)
Long-term debt	**(1,104)**	**(1,133)**	(1,058)	(1,121)
Other creditors – amounts falling due after one year	**(67)**	**(64)**	(57)	(54)
Debtors – amounts falling due after one year	**133**	**127**	124	117
Provisions	**(6)**	**(6)**	(14)	(14)
Derivatives used to hedge the interest, currency and commodity exposure of the business:				
Jet fuel swaps	**—**	**(6)**	—	4
Interest rate swaps	**(40)**	**(97)**	(17)	(55)
Currency options	**—**	**(3)**	—	(5)
Forward foreign currency contracts	**(4)**	**(550)**	(20)	(273)
Forward purchase of shares to meet share option commitments	**—**	**(21)**	—	(1)

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

Cash 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.

Derivatives:

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.

Hedges of future transactions

As 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

Gains and losses on instruments used for hedging are as outlined in the accounting policies on page 41.

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

	2001 Gains £m	2001 (Losses) £m	2001 Total net gains/(losses) £m	2000 Gains £m	2000 (Losses) £m	2000 Total net gains/(losses) £m
Unrecognised gains and losses on hedges at January 1, 2001	**96**	**(389)**	**(293)**	64	(20)	44
Gains and losses arising in previous year that were recognised in 2001	**(44)**	**90**	**46**	(27)	2	(25)
Gains and losses arising in previous year that were not recognised in 2001	**52**	**(299)**	**(247)**	37	(18)	19
Gains and losses arising in 2001 that were not recognised in 2001	**26**	**(412)**	**(386)**	59	(371)	(312)
Unrecognised gains and losses on hedges at December 31, 2001 of which:	**78**	**(711)**	**(633)**	96	(389)	(293)
Gains and losses expected to be recognised in 2002	**33**	**(227)**	**(194)**	54	(116)	(62)
Gains and losses expected to be recognised thereafter	**45**	**(484)**	**(439)**	42	(273)	(231)

25 Share capital

	Non-equity special share of £1	Equity ordinary shares of 20p each	Nominal value £m
Authorised			
At January 1 and December 31, 2001	**1**	**2,000,000,000**	**400**
Issued and fully paid			
At January 1, 2001	**1**	**1,569,258,078**	**314**
Exercise of share options	**—**	**10,100,220**	**2**
In lieu of paying dividends in cash	**—**	**21,785,415**	**4**
At December 31, 2001	**1**	**1,601,143,713**	**320**

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, 2001, the following ordinary shares were subject to options:

	Date of grant	Number	Exercise price	Exercisable dates
Executive share option scheme	1992	117,060	125p	2002
	1995	1,523,500	176p	2002-2005
	1996	100,800	238p	2002-2006
Executive share option plan	1999	1,334,698	269p	2002-2009
	1999	254,896	216p	2002-2009
	2000	2,197,455	194p	2003-2010
	2000	7,326,157	194p	2003-2010
	2000	36,808	163p	2003-2010
	2000	410,664	163p	2003-2010
	2000	29,326	170p	2003-2010
	2000	85,045	170p	2003-2010
	2001	1,095,974	216p	2004-2011
	2001	11,181,224	216p	2004-2011
	2001	19,141,485	216p	2004-2011
	2001	27,522	218p	2004-2011
	2001	297,337	218p	2004-2011
Sharesave schemes	1995	3,805,464	150p	2003
	*1996	821	168p	2002
	1997	10,549,360	205p	2003/2005
	*1997	58,818	154p	2002
	*1998	421,262	107p	2002/2004
	1999	16,207,711	194p	2002/2003/2005/2007
	2001	54,857,304	108p	2003/2004/2006/2008

Under the terms of the executive share option scheme and the executive share option plan, options granted to 522 directors and senior executives were outstanding at December 31, 2001.

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 32 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.

Notes to the financial statements
continued

26 Reserves

	Share premium £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m
	Non-distributable			
Group				
At January 1, 2001 (as previously reported)	**623**	**108**	**182**	**836**
Prior year adjustment (see Accounting policies page 41)	—	—	—	**(23)**
At January 1, 2001 (as restated)	**623**	**108**	**182**	**813**
Exchange adjustments	—	—	—	**(11)**
Scrip dividend adjustment	—	—	—	**42**
Ordinary shares issued relating to scrip dividend	**(4)**	—	—	—
Write-back of purchased goodwill relating to disposals	—	—	**7**	—
Arising on share issues (net of expenses)	**14**	—	—	—
Relating to Qualifying Employee Share Trust	**3**	—	—	**(3)**
Transfers between reserves	—	**(5)**	—	**5**
Retained loss for the year	—	—	—	**(26)**
At December 31, 2001	**636**	**103**	**189**	**820**
Company				
At January 1, 2001 (as previously reported)	**623**	**101**	**167**	**924**
Prior year adjustment (see Accounting policies page 41)	—	—	—	**(109)**
At January 1, 2001 (as restated)	**623**	**101**	**167**	**815**
Scrip dividend adjustment	—	—	—	**42**
Ordinary shares relating to scrip dividend	**(4)**	—	—	—
Arising on share issues (net of expenses)	**14**	—	—	—
Relating to Qualifying Employee Share Trust	**3**	—	—	**(3)**
Transfers between reserves	—	**(4)**	—	**4**
Retained loss for the year	—	—	—	**(69)**
At December 31, 2001	**636**	**97**	**167**	**789**

The cumulative amount of goodwill, arising on the acquisition of undertakings still in the Group at December 31, 2001, written off against other reserves amounts to **£380m** (2000 £387m). The continuance of this basis, in respect of pre-1998 acquisitions, is permitted under the transitional arrangements of FRS 10.

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.

27 Operating lease annual commitments

	Group		Company	
	2001 £m	2000 £m	**2001 £m**	2000 £m
Leases of land and buildings which expire:				
Within one year	**2**	2	—	—
Between one and five years	**6**	5	**2**	2
After five years	**6**	6	**3**	3
Other leases which expire:				
Within one year	**2**	2	—	—
Between one and five years	**12**	12	**6**	6
After five years	**52**	42	—	—

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 December 31, 2001, the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions amounted to **£857m** (2000 £766m), of which **£78m** (2000 £101m) 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 **£206m** (2000 £184m). Sensitivity calculations are complex, but, for example, if the value of the relevant security was reduced by 20%, a net contingent liability of approximately **£283m** (2000 £347m) 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.

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.

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 in the 2000 accounts, 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, 2001, there were other Company guarantees in respect of financial obligations of subsidiary undertakings **£156m** (2000 £38m), and in respect of joint ventures **£51m** (2000 £14m).

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:

	2001 £m	2000 £m
Other income	**16**	16
Purchases of goods and services	**(333)**	(233)

30 Post-retirement benefits

Pensions

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

The 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 projected 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 Group 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 would 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 were valued on a market related basis.

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

The total pension cost for the Group was **£72m** (2000 £70m) of which **£17m** (2000 £12m) relates to overseas schemes.

The 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 represented 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 value of the projected accrued liabilities.

The 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 increases) is being amortised over periods of between 8.5 and 13 years, being the average expected remaining service lives of the pensionable employees.

Prepayments of **£181m** (2000 £157m) are included in debtors and accruals of **£33m** (2000 £24m) are included in provisions for liabilities and charges, being the differences between the accumulated amounts paid into the pension funds and the accumulated pension costs.

Post-retirement benefits other than pensions

In 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. In the USA, 262 retired employees currently benefit from these provisions and it is estimated that 5,300 current employees will be eligible on retirement.

The cost of post-retirement benefits other than pensions for the Group was **£17m** (2000 £14m). Provisions for the benefit obligations at December 31, 2001 amounted to **£118m** (2000 £102m) and are included in provisions for liabilities and charges. There were no plan assets at either December 31, 2001 or December 31, 2000. The future costs of benefits are assessed in accordance with the advice of independent qualified actuaries and are based on a weighted average discount rate of 7.25% and a weighted average assumed healthcare costs trend rate of 5.0%.

30 Post-retirement benefits continued

FRS 17 disclosures

FRS 17 'Retirement Benefits' will replace SSAP 24 'Accounting for Pension Costs' for periods ending on or after June 22, 2003. In the transition period 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, 2001 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, 2001 by a qualified actuary taking account of the requirements of FRS 17.

The principal actuarial assumptions were as follows:

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

[1] Weighted average percentage.

The assets in the principal schemes and the expected rates of return at December 31, 2001 were as follows:

	Group				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)**[1]	**—**	**(566)**
Related deferred tax asset	**—**	**122**	**—**	**61**	**—**	**170**
Net pension liability	**—**	**(284)**	**—**	**(113)**	**—**	**(396)**

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

If the above amounts had been recognised in the financial statements, the net assets for the Group and the Company at December 31, 2001 would be reduced by £422m and £401m respectively, with a matching reduction in profit and loss reserve. These amounts have been calculated after taking account of pensions prepayments and provisions for pensions and other post-retirement benefits, net of related deferred tax.

Notes to the financial statements
continued

31 Disposal or termination of businesses

During the year the Group disposed of or terminated its interests in several small businesses, as summarised below:

	£m
Intangible fixed assets	10
Tangible fixed assets	7
Stocks	9
Debtors	3
Creditors	(5)
Net assets	24
Write-back of goodwill	7
Loss on sale or termination of businesses	(11)
Disposal proceeds less costs	20
Receipts deferred at December 31, 2000	79
Accrued costs	3
Net cash inflow – Group cash flow statement	102

Principal subsidiary undertakings
at December 31, 2001

Incorporated within the UK

Civil aerospace	
Rolls E.L. Turbofans Limited	FJ44 engine support services/holding company
Defence	
Vickers Engineering plc [1]	Defence systems
Marine systems	
Rolls-Royce Marine Power Operations Limited	Nuclear submarine propulsion systems
Financial services and corporate	
NEI Overseas Holdings Limited [2]	Holding company
Rolls-Royce Aircraft Management Limited	Sales finance and other financial services
Rolls-Royce Capital Limited [3]	Sales finance and other financial services
Rolls-Royce International Limited	International support and commercial information services
Rolls-Royce Leasing Limited	Engine leasing
Rolls-Royce Overseas Holdings Limited	Holding company
Rolls-Royce Power Engineering plc	Power generation and marine systems
Rolls-Royce Power Ventures Limited	Provision of project development capabilities
Sourcerer Limited [3]	Supply of goods, services and utilities to the engineering sector
Vickers plc	Holding company

[1] The interest is held by Vickers plc.
[2] The interest is held by Rolls-Royce Power Engineering plc.
[3] These subsidiaries act as agents of Rolls-Royce plc.

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

Principal subsidiary undertakings
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
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		
Norway	**Rolls-Royce Marine AS** [5]	Holding company
Sweden	**Kamewa Holdings AB** [5]	Holding company
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** [6]	Industrial gas turbines and aero engine sales, service and overhaul
Canada	**Rolls-Royce Holdings Canada Inc.**	Holding company
India	**Rolls-Royce Energy Systems India Pty Limited** [1]	Project management and customer support
Singapore	**Rolls-Royce Pte** [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.** [7]	Holding company
USA	**Rolls-Royce North America Holdings Inc.** [8]	Holding company
USA	**Rolls-Royce Capital Inc.** [9]	Financial services

[1] The interests are held by Rolls-Royce Overseas Holdings Limited.
[2] The interest is held as follows: 50.5% Rolls-Royce Erste Beteiligungs GmbH, 49.5% 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 Holdings Canada Inc.
[7] The interest is held by Rolls-Royce (Ireland).
[8] The interest is held by Rolls-Royce North America (USA) Holdings Co.
[9] The interest is held by Rolls-Royce North America Ventures II Inc.

The above companies operate principally in the country of their incorporation. The effective Group interest is 100%.

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

Principal joint ventures
at December 31, 2001

Incorporated within the UK

	Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Civil aerospace			
TRT Limited	A Ordinary	—	49.5
Turbine blade repair services	B Ordinary	100	
Turbine Surface Technologies Limited	A Ordinary	—	50
Turbine surface coatings	B Ordinary	100	
Defence			
Rolls-Royce Snecma Limited (UK & France)	A Shares	—	50
Engine collaboration	B Shares	100	
Rolls-Royce Turbomeca Limited (UK & France)	A Shares	—	50
Adour and RTM322 engines collaboration	B Shares	100	
Turbo-Union Limited (UK, Germany & Italy)	Ordinary	40	40
RB199 engine collaboration	A Shares	37.5	
Energy			
Rolls Wood Group (Repair and Overhauls) Limited	A Ordinary	100	50
Repair and overhaul	B Ordinary	—	
Financial services and corporate			
Alpha Partners Leasing Limited	A Ordinary	100	50
Engine leasing	B Ordinary	—	

Incorporated overseas

		Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Civil aerospace				
China	**Xian XR Aero Components Co Limited** Manufacturing facility for aero-engine parts	Ordinary	49	49
Hong Kong	**Hong Kong Aero Engine Services Limited** [1] Repair and overhaul	Ordinary	45	45
Israel	**TechJet Aerofoils Limited** [1] Manufacture of compressor aerofoils	A Ordinary B Ordinary	50 50	50
Italy	**Europea Microfusioni Aerospaziali SPA** Operation of castings facility	Ordinary	33.3	33.3
Saudi Arabia	**Middle East Propulsion Company** [2] Repair and overhaul	Foreign Ordinary	16.7 —	16.7
Singapore	**International Engine Component Overhaul Pte Limited** [1] Repair and overhaul	Common	50	50
Singapore	**Singapore Aero Engine Services Limited** [1] (effective interest 39%) Repair and overhaul	Ordinary	30	30
Spain	**Industria de Turbo Propulsores SA** Manufacture and maintenance of aero engines	Ordinary	46.9	46.9
Switzerland	**IAE International Aero Engines AG** (UK, Germany, Japan & USA) V2500 series engine collaboration	A Shares B Shares C Shares D Shares	100 — — —	32.5
USA	**Data Systems & Solutions, LLC** [3] Advanced controls and predictive data management	Common	50	50
USA	**Texas Aero Engine Services, LLC** [4] Repair and overhaul	Ordinary	50	50
USA	**Williams-Rolls Inc.** [5] (UK & North America) FJ44 engine collaboration	Common	15	15

Principal joint ventures
continued

Incorporated overseas continued

		Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Defence				
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	Common	50	50
USA	**Alpha Leasing (US) (No. 2) LLC** [7] Engine leasing	Common	50	50
USA	**Exostar LLC** [8] B2B exchange	Common	17.6	17.6
USA	**Rolls-Royce & Partners Finance (US) LLC** [7] Engine leasing	Common	50	50

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 interest is held by Rolls-Royce Control Systems Holdings Co.
[4] The interest is held by Rolls-Royce Engine Services Holdings Co.
[5] The interest is held by Rolls E.L. Turbofans Limited.
[6] The interest is held by Rolls-Royce & Partners Finance (Netherlands) BV.
[7] The interests are held by Rolls-Royce Finance Holdings Co.
[8] The interest is held by 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, 2001

		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.

Directors' responsibilities
for the financial statements

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

In preparing those financial statements, the directors are required to:
i) select suitable accounting policies and then apply them consistently;
ii) make judgements and estimates that are reasonable and prudent;
iii) state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements;
iv) 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.

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

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

We have audited the financial statements on pages 36 to 68. We have also examined the amounts disclosed relating to emoluments, share options, long-term incentive plan interests and directors' pension entitlements which form part of the Remuneration report on pages 30 to 35.

Respective responsibilities of directors and auditors
The directors are responsible for preparing the annual 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 are 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 or the Listing Rules 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 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. 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 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.

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, 2001 and of the profit of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants, Registered Auditor
London
March 6, 2002

Group five year review
for the years ended December 31

Profit and loss account	2001 £m	2000 £m	1999 £m	1998 £m	1997 £m
Group turnover [1]	**6,328**	5,864	4,634	4,471	4,323
Operating profit before exceptional items and net research and development	**822**	806	713	626	539
Operating exceptional items	**(230)**	(145)	—	—	—
Research and development (net)*	**(358)**	(371)	(337)	(310)	(268)
Group operating profit [2]	**234**	290	376	316	271
Share of operating profit of joint ventures	**82**	76	31	17	17
Non-operating exceptional items	**(5)**	(77)	6	9	1
Net interest payable	**(119)**	(123)	(53)	(17)	(13)
Profit on ordinary activities before taxation	**192**	166	360	325	276
Taxation	**(86)**	(87)	(123)	(76)	(75)
Profit on ordinary activities after taxation	**106**	79	237	249	201
Equity minority interests in subsidiary undertakings	—	—	(2)	(2)	(1)
Profit attributable to ordinary shareholders	**106**	79	235	247	200
Dividends	**(132)**	(126)	(112)	(99)	(88)
Transferred (from)/to reserves	**(26)**	(47)	123	148	112
*Research and development (gross)	**(636)**	(604)	(626)	(668)	(595)
[1] **Group turnover**					
Continuing operations	**6,328**	5,864	4,634	4,301	3,919
Discontinued operations	—	—	—	170	404
[2] **Group operating profit/(loss)**					
Continuing operations	**234**	290	376	326	266
Discontinued operations	—	—	—	(10)	5
Earnings per ordinary share					
Underlying	**20.20p**	19.38p	16.47p	16.18p	13.53p
Basic	**6.67p**	5.07p	15.60p	16.51p	13.53p
Dividends per ordinary share	**8.18p**	8.00p	7.25p	6.55p	5.90p

The profit and loss accounts for 1997 to 2000 have been restated for FRS 19 'Deferred Tax'.

Balance sheet	**2001 £m**	2000 £m	1999 £m	1998 £m	1997 £m
Fixed assets	**2,789**	2,856	2,839	1,406	1,309
Current assets	**4,551**	4,000	3,974	3,408	3,284
	7,340	6,856	6,813	4,814	4,593
Liabilities and provisions	**(5,270)**	(4,815)	(4,833)	(3,070)	(3,093)
	2,070	2,041	1,980	1,744	1,500
Share capital	**320**	314	309	301	296
Reserves	**1,748**	1,726	1,658	1,431	1,185
Equity shareholders' funds	**2,068**	2,040	1,967	1,732	1,481
Minority interests in subsidiary undertakings	**2**	1	13	12	19
	2,070	2,041	1,980	1,744	1,500

The balance sheets for 1997 to 2000 have been restated for FRS 19 'Deferred Tax'.

Cash flow	**2001 £m**	2000 £m	1999 £m	1998 £m	1997 £m
Cash inflow from operating activities	**418**	479	359	309	331
Interest, dividends and taxation	**(147)**	(162)	(152)	(98)	(113)
Capital expenditure and financial investment	**(179)**	(253)	(199)	(333)	(214)
Acquisitions and disposals	**79**	(53)	(666)	87	42
	171	11	(658)	(35)	46
Cash flow from financing	**111**	(360)	622	113	13
Increase/(decrease) in cash and liquid resources	**282**	(349)	(36)	78	59

Shareholders' information

Financial calendar

Ex dividend date for final dividend	April 24, 2002
Calculation period for scrip dividend	April 24-30, 2002
Qualifying (record) date for final dividend	April 26, 2002
Last date for new scrip dividend instructions	May 27, 2002
Annual General Meeting, The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1	11am May 30, 2002
Payment of final/scrip dividend	July 1, 2002
Press advertisement of 2002 interim results*	August 23, 2002
Ex dividend date for interim dividend	October 16, 2002
Calculation period for scrip dividend	October 16-22, 2002
Qualifying (record) date for interim dividend	October 18, 2002
Last date for new scrip dividend instructions	November 15, 2002
Financial year end	December 31, 2002
Payment of interim/scrip dividend	January 6, 2003
Press advertisement of 2002 preliminary results*	March, 2003
2002 Annual Report published	April, 2003

* Note: Preliminary and interim results are notified by press advertisements and will also be available on the Company's website.

Analysis of ordinary shareholders at December 31, 2001

Number of shares	Number of holdings	% of total holdings	% of total shares
1 – 150	120,611	36.93	0.96
151 – 500	159,582	48.85	2.55
501 – 10,000	44,388	13.59	5.08
10,001 – 100,000	1,400	0.43	2.43
100,001 – 1,000,000	482	0.15	10.35
1,000,001 and over	160	0.05	78.63
	326,623	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 to, or telephone, the Registrar at the following address:

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

You may also contact the Registrar through the Internet at www.computershare.com

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 (telephone 020 7895 5489). Both are members of the Securities and Futures Authority and NatWest Stockbrokers is also 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 through the Internet on www.rolls-royce.com

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