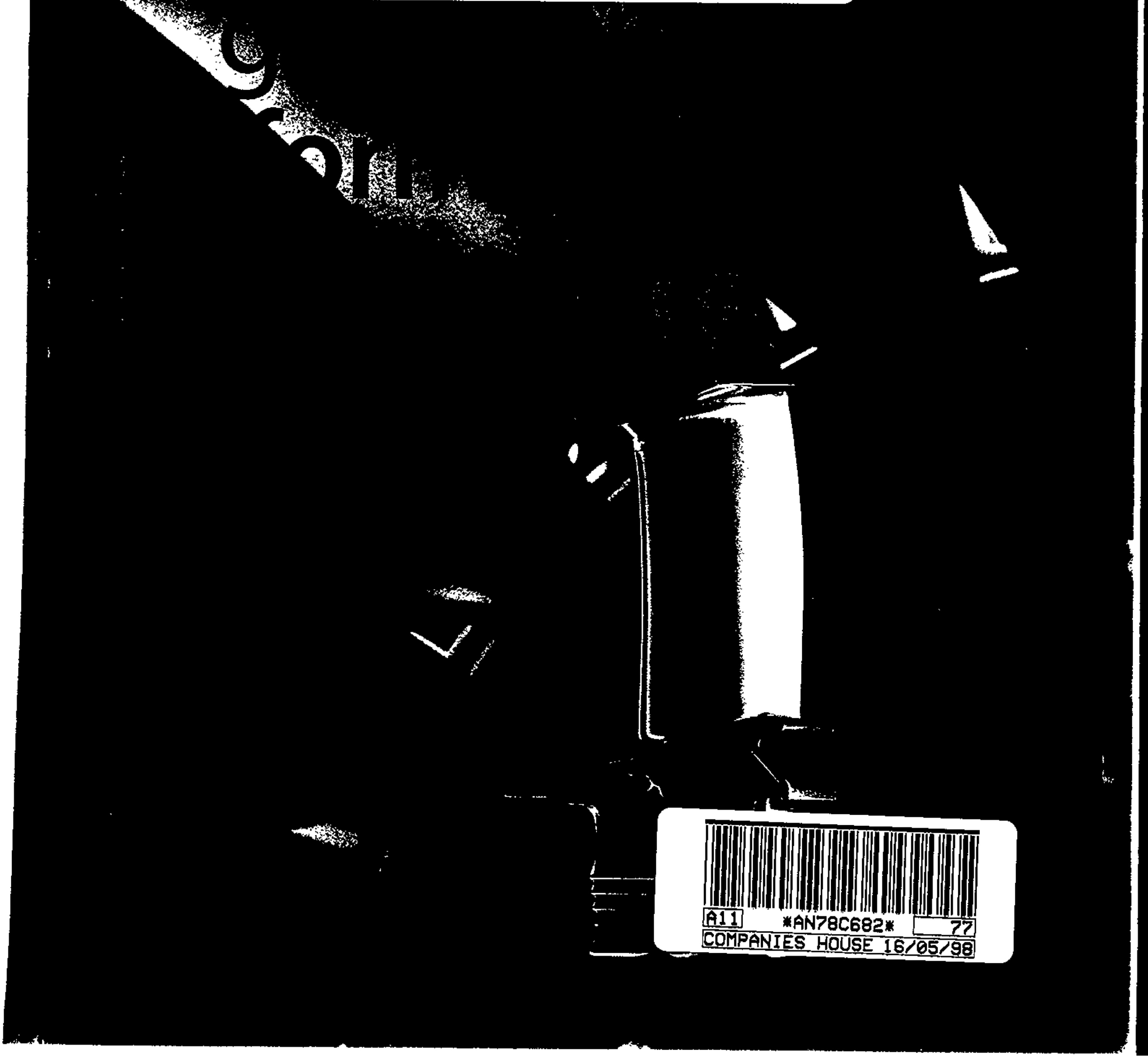
Rolls-Royce

Rolls-Royce plc

Annual Report 1997

COMPANY NUMBER
1003142



Group financial highlights

FOR THE YEAR ENDED DECEMBER 31, 1997

	1997 £m	1996 £m
Turnover	4,334	3,902
Research and development (net)	(216)	(199)
Profit before exceptional items and taxation	276	220
Exceptional and non-operating items	—	(248)
Profit/(loss) before taxation	276	(28)
Profit/(loss) attributable to ordinary shareholders	224	(47)
Equity shareholders' funds	1,443	1,303
Earnings/(loss) per ordinary share		
— net basis	15.16p	(3.19)p
— net basis before exceptional items	15.16p	12.70p
Dividend per ordinary share	5.90p	5.30p

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

Telephone: 0171 222 9020

Company number: 1003142

Rolls-Royce

Corporate profile:

Our objective is to deliver shareholder value through a strategy of continuously improving our performance, investing to secure leading positions in growth markets and becoming the most efficient supplier to the industry.

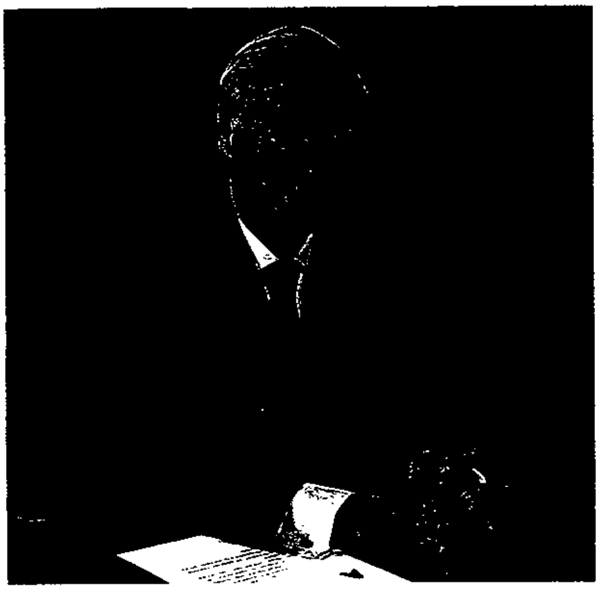
Rolls-Royce is one of the world's foremost engineering companies, supplying aero engines and power systems to customers in international markets. The Group is focused upon understanding the individual needs of customers to ensure we deliver the best products and services.

By providing customers with solutions that encompass the Rolls-Royce core values of reliability, integrity and innovation, the Group will be successful in growing its position in chosen markets and be recognised by customers as 'Trusted to deliver excellence'.

The market sectors served by our customer facing businesses are: airlines, corporate operators and regional airlines, helicopter, military, power generation, marine power, oil and gas, electrical transmission and distribution and materials handling.

With world-class people, products and services we are well placed to build on our success in these markets.

Building on success



Chairman of Rolls-Royce plc Sir Ralph Robins

We intend to demonstrate to our customers that we are the most efficient and responsive in our industry.

ROLLS-ROYCE ESTABLISHED a firm platform for better business performance and growing profitability in 1997.

We achieved record profits and sales and our best ever share of the commercial aero-engine market. At the same time we continued to manage the business efficiently, resulting in a strong balance sheet and further improvements in sales per employee and return on capital employed.

This success has been built upon the strong foundations of our core gas turbine technology and the pursuit of consistent strategies over a number of years to establish leading positions in growth markets.

We substantially completed the withdrawal from the large steam power generation business during the year, within the provisions established in 1996. As a result, more than 90 per cent of all of our business activities are built around our gas turbine products.

Aerospace activities have dominated the growth of the Group. We won a 34 per cent share of the available world market for civil turbofans and more than 80 per cent of the market for new large twin-engined aircraft, where the Trent has established a strong position. We see more than half the future civil engine market requiring engines of this size.

Our strategy to offer a broad and competitive product range has led to new developments across the whole of the range – from the excellent order intake of the AE3007, which has established a strong position in the emerging 50-seat regional jet market, the confirmation of the BR715 as sole powerplant on the Boeing 717 and the choice of the Trent 500 to power the Airbus Industrie A340-500 and 600.

In the defence sector we continue to see a stable future. In particular, the commitment of the European partner governments to the production programme for the Eurofighter 2000 was an important step, paving the way for production of 1,500 engines. In addition, we anticipate that there will be opportunities to export the EJ200 engine to other countries.

We are also well placed in the next major international military programme, the United States' Joint Strike Fighter, which takes us into the heavy combat sector for the first time.

The restructuring of the industrial businesses continues. In addition to the sale of the large steam power generation businesses, we made a number of smaller disposals, aimed at improving the focus of the Group on those businesses which can develop strong and profitable positions in growing markets.

Through a company-wide initiative, 'Better Performance *Faster*', we are developing improved ways of working so that we obtain maximum value from our investment in systems, plant and equipment. Our objective is to ensure that we are the most efficient producer in our target market sectors.

Clearly, our people are crucial to our success and we continue to invest heavily in education and training at all levels. We have enhanced the element of performance related pay for all employees. While our demanding targets mean that not everybody will benefit directly, the majority of employees will do so for the second successive year.

I would like to take this opportunity to thank all our workforce for their personal contributions to our success and congratulate Jerry Lewis who received an OBE in the Birthday Honours and Alan Westaway who received an MBE in the New Year's Honours List.

I would particularly like to thank Harold Mourgue and John Sandford, who, on their retirement from the Board, will have completed 12 years and eight years service respectively. I welcome to the Board Jim Guyette, who is responsible for Rolls-Royce in North America.

Prospects

We are confident of our continuing success. There has been much speculation about the economic problems in Asia and the possible impact upon the aerospace industry. We have built a robust business which is not over-dependent upon any sector or any single economy: therefore we do not expect significant adverse impact, other than a slowdown in the rate of new orders from Asia. The strength of our business in other sectors, particularly the recent growth of order intake in North America and Europe will allow us to offset any effect of such a slowdown.

Furthermore, our success in gaining market share in Asia will be profoundly important in the long-term as we believe that this area will continue to be one of the most important growth sectors over the next 20 years.

We described last November how our growing market share has led to a change in the mix of aero engine sales, with a higher proportion of new engine deliveries leading to a dilution of trading margins. We expect this trend to continue as we further increase market share and exploit new opportunities. Each new engine delivered develops a future embedded value in the form of profitable aftermarket business.

We are confident that our continued investment in new products and capability will create enhanced value for our shareholders. Based upon our current industry projections we are targeting to achieve annual double-digit earnings growth.

Dividend

Your Board has recommended a final dividend payment of 3.70p per share, making a total for the year of 5.90p, an increase of 11 per cent on 1996, reflecting its confidence in the long-term prospects of the Group.

Ralph Robins

Sir Ralph Robins, Chairman, March 4, 1998

Better all-round performance

Chief Executive John Rose

Using our products and expertise to help our customers operate more efficiently and cost-effectively is the best way of meeting the needs and expectations of our shareholders and employees.

OUR PROGRESS IN 1997 REPRESENTS another important stage in the Group's development.

We have always prided ourselves on the technical excellence that has earned us a place among the top three aero-engine manufacturers in the world. In recent years we have built on this reputation by turning ourselves from a British company with overseas operations into one that is truly global.

At the same time, we have made our products available to more customers by broadening our engine portfolio. Our core business is the gas turbine and our strength in this technology generates more than 90 per cent of our business in the growing markets for civil and military aero engines, power generation, oil and gas power systems and marine power.

Today we power more types of civil aircraft than any other manufacturer (32 in all, from helicopters and business jets to the largest airliners) and offer the widest range of military engines.

Technical quality, global reach and a wide portfolio have all contributed to our strong sales and rising market share. Our success in winning new orders has resulted in a 50 per cent increase in manufacturing output during 1997 and our engineering productivity has increased by 17 per cent over the last two years.

A step change in performance

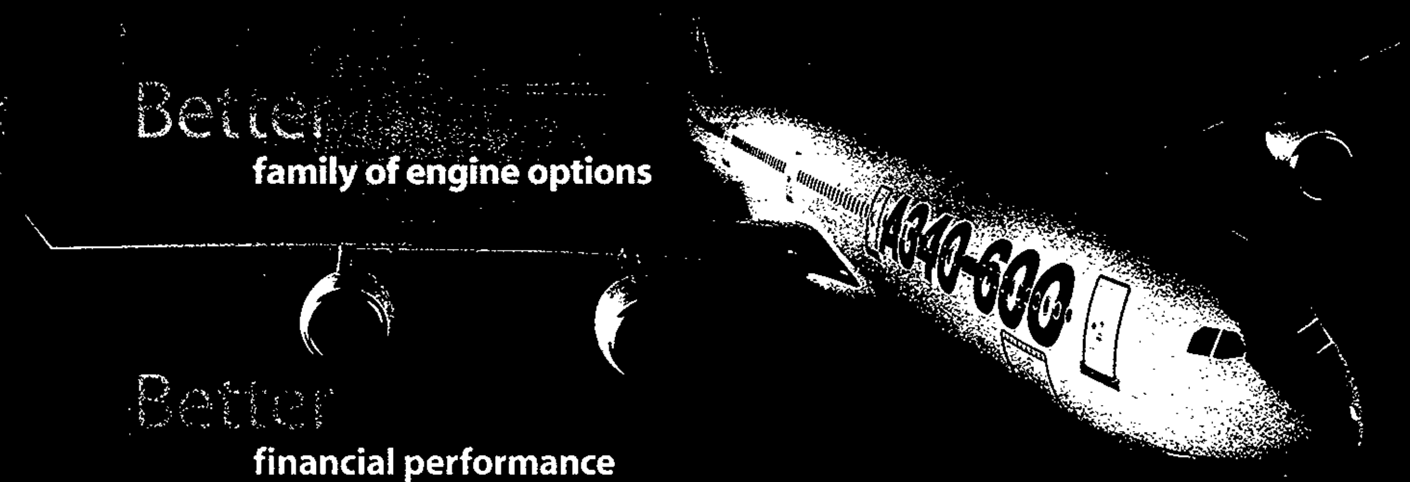
It is a fundamental element of our strategy that the quality of engineering is matched by commercial and business excellence. Our priority is to generate value for our customers, the Company and shareholders, and we are committed to a continued improvement in

The Trent 500 engine has been selected by Airbus Industrie to power its new four engined A340-500/600 long range wide bodied airliner.

Better
cost efficiencies

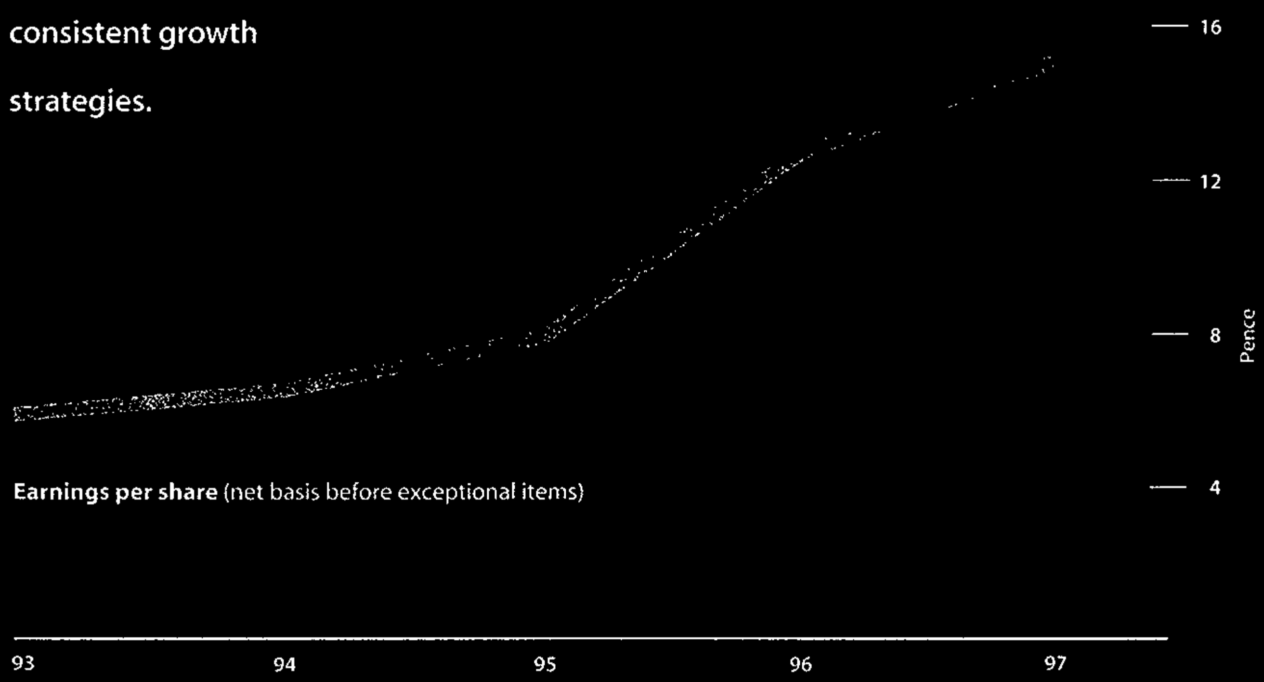
Better
market share

Better
family of engine options



Better
financial performance

We are seeing the benefits of pursuing consistent growth strategies.



Earnings per share (net basis before exceptional items) financial performance. This will be achieved by improving our market position and therefore revenue and by ensuring that our operational efficiency is world-class.

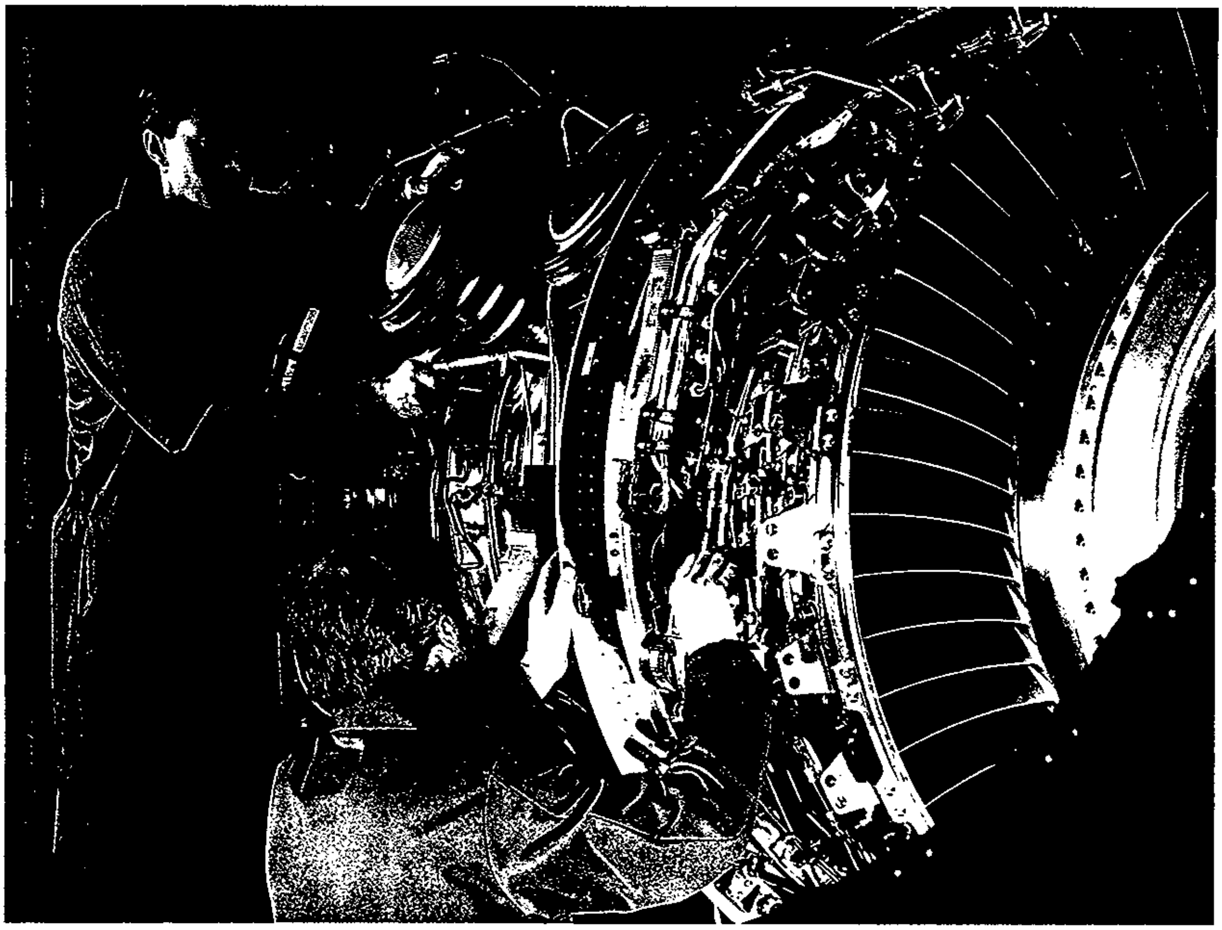
We recognise that we need to develop products and services better and faster in order to stay competitive and improve our profitability. At the beginning of 1996, we began a programme to transform our business performance by streamlining our processes and beating our competitors on cost, quality and delivery. Known as 'Better Performance *Faster*', the programme was launched in our aerospace businesses in 1996 and extended to the rest of the Group in 1997.

To emphasise the importance of the present changes, we increasingly reward our people according to their progress in implementing 'Better Performance *Faster*' initiatives.

'Better Performance *Faster*' covers everything we do from procurement and product development to supporting our customers in the marketplace.

One project, for example, is helping us to develop new products more efficiently through the use of multi-disciplinary teams with faster access to more data. Another is improving our sourcing by forging closer relationships with fewer suppliers who can then work alongside us to satisfy our customers. Others are streamlining our production, integrating our systems, introducing lean manufacture and improving our programme management.

Further initiatives not only enhance our own performance but also help our customers and



'Better Performance *Faster*' is improving efficiency throughout the Group. Above: engine-build fitters Andy Bould and Graham Holmes are part of a team that has helped to reduce engine-build time to 15 days.

suppliers to operate more effectively. The re-engineering of processes in the repair and overhaul business is reducing the time it takes to overhaul engines. Supplying information to our customers on CD-ROM gives them instant access to technical data and makes their engineering functions more efficient.

The underlying principles are focus and integration. We are concentrating more rigorously on the skills, products and activities that offer the greatest potential rewards. At the same time, we are sharpening our manufacturing performance by integrating our processes and ensuring that nothing is done twice that need only be done once.

Combined with further investment of around £200 million in fixed assets in 1997, 'Better Performance *Faster*' is producing tangible benefits. For example, a new production cell for the V2500 engine took just 12 weeks from concept to producing components and has reduced lead times from six weeks to ten days. We are also installing the latest technology for machining turbine blades and developing a world-class production centre for compressor aerofoils.

Investments such as these in capital and improved ways of working have had a considerable impact. It used to take 12 weeks to make a compressor disc: now it takes four and the target is two. We have reduced the lead time for manufacturing shafts from 104 days in 1996 to 48 days at the end of 1997 and are now in sight of our target of 15 days. In the last two years the lead time for Trent and V2500 compressor blades has fallen by 50 per cent and the engine-build time for the RB211-535 by 25 per cent.

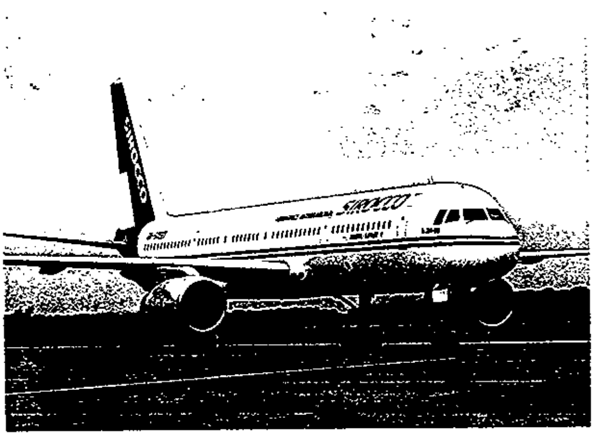
Sales per employee have risen nearly 60 per cent over the last five years.

While these improvements are encouraging, they are only a start and we remain committed to further improving operational performance.

Steve Jones, general manager at Hong Kong Aero Engine Services Limited, and K M Pang, engine overhaul manager, are part of our expanding worldwide repair and overhaul business.

It is our ability to keep costs down that ensures the viability and competitive position of the Group.

High technology, low costs



The RB211-535 is the power for the Russian-built Tu-204. The engine is the most reliable in its class.

Rolls-Royce is a significant supplier wherever cost-effective engineering solutions are required.

The T406 engine is making a significant contribution to the development programme for the V-22 Osprey tilt-rotor aircraft.

FUTURE GROWTH is based on the strength of our product portfolio and the ability to meet the future needs of our customers. By focusing on our gas turbine technology we are developing our position in a number of growth markets.

Airline customers

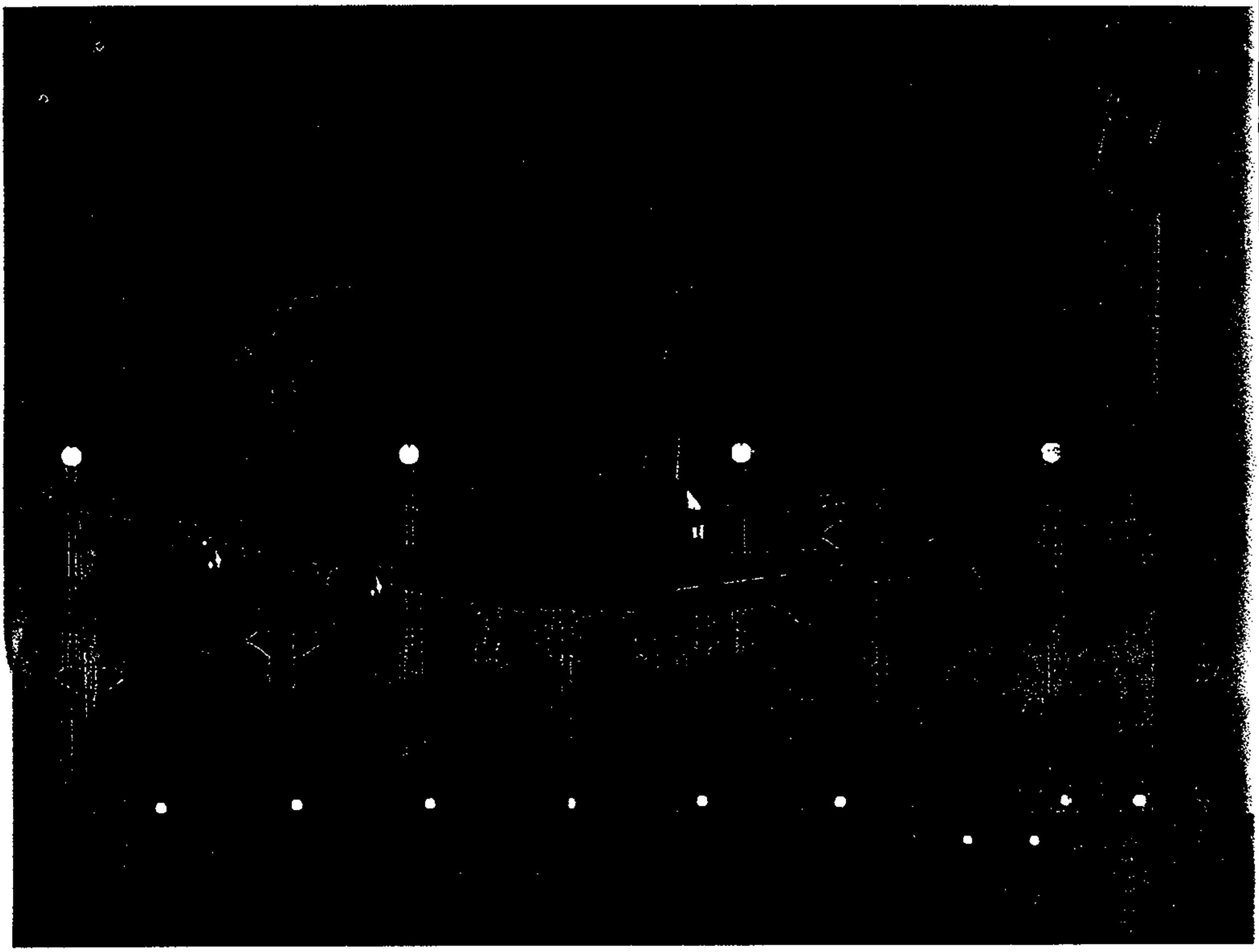
The market for aero engines and spare parts for airline customers will be worth $380 billion over the next 20 years. We have established a very competitive engine range to address this opportunity.

The Trent family of engines has established a 40 per cent share of the world market for the new generation of wide-bodied, high capacity aircraft. Ranging in thrust from 53,000lb to over 100,000lb, the Trent is the only engine family able to power every large airliner, existing or planned. This offers clear advantages to the customer through commonality of product and support arrangements.

The Trent owes much of its success to a development philosophy that bases new engines on proven technology. This reduces cost and risk and the time it takes to bring new products to market.

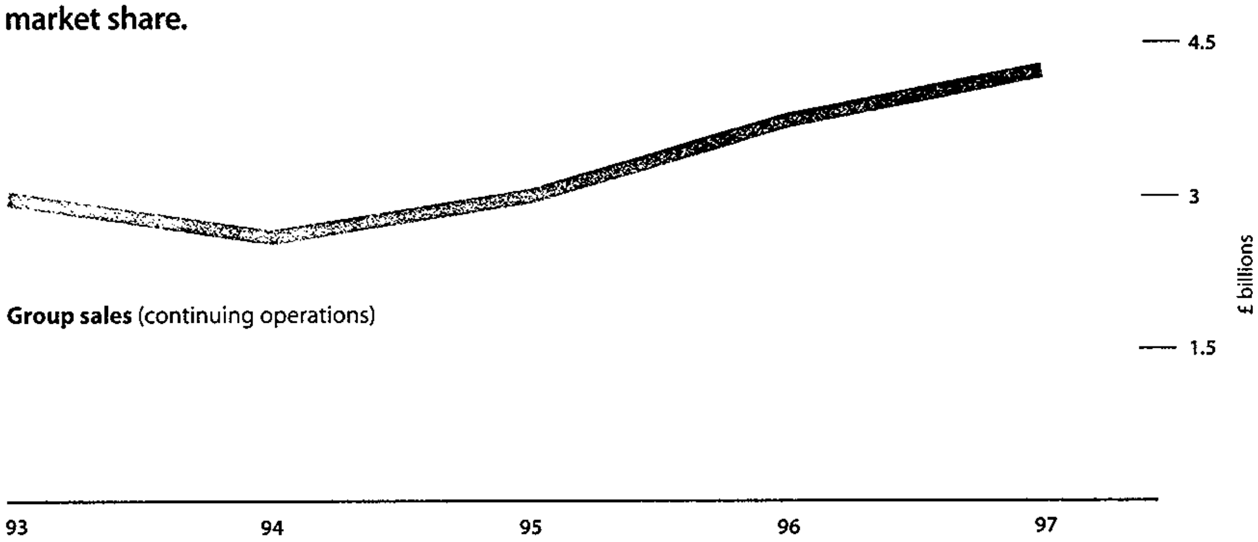
The Trent 700 for the Airbus A330 won further orders from Emirates, Monarch and Air Canada and now has a market share of 40 per cent.

The larger Trent 800 also had a good year. Delta Air Lines became the first customer in the USA to select the Trent 800 for its Boeing 777s, followed by American Airlines' selection of 11 firm and 39 option Trent-powered Boeing 777s. The Trent 800 achieved a market share of 41 per cent while the Trent family



An RB211-powered Boeing 747 landing at Heathrow Airport, London. Trent technology is being incorporated into the latest RB211-524G/H-T engine for the 747-400 version, making it the most fuel-efficient on the aircraft.

Our broad product range has led to increased sales and an improved market share.



achieved a market share of 80 per cent of new wide-bodied twin-engined aircraft ordered in 1997.

In November the latest members of the Trent family were announced – the Trent 500, 600 and 8104. The UK government will participate in these programmes with an investment similar to a risk and revenue sharing partner.

The Trent 500 secured the launch position on the new A340-500 and 600 aircraft. Airbus Industrie confirmed this programme with orders for 100 aircraft from seven customers. This represents engine business worth up to $4 billion, the strongest launch platform for an engine achieved by Rolls-Royce.

Trent technology is being applied to other Rolls-Royce engines. The RB211-524G/H-T combines Trent and RB211 technology to create a lighter, more fuel-efficient engine for the Boeing 747-400 and the Boeing 767. South African Airways, Cathay Pacific and the air freight carrier Cargolux, have all placed orders for this engine.

The RB211-535 and the International Aero Engines' (IAE) V2500 continue to perform well in their respective markets. The 1000th RB211-535 was delivered last year and 80 per cent of Boeing 757 operators have chosen this engine. The IAE order intake for the V2500 amounted to $1.6 billion.

Regional airlines and corporate operators

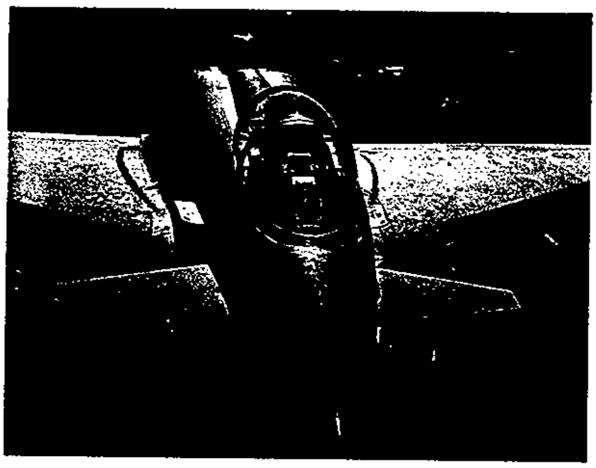
The strength of Rolls-Royce is its ability to serve customers in each sector. We estimate the aero-engine market in regional airlines and for corporate aircraft operators to be worth $40 billion over the next 20 years.

A highlight was the continuation of the Boeing 717 programme (formerly the McDonnell Douglas MD-95). This new 100-seat aircraft addresses a market requiring 2,500 such aircraft over the next 20 years. The BMW Rolls-Royce BR715 is the only powerplant offered on this aircraft.

In the market for 35 to 50-seat regional jets, the AE3007-powered Embraer RJ145 took substantial orders from a number of international customers. The 37-seat Embraer RJ135 was also launched, with the AE3007 offered as the exclusive powerplant. Orders for the two jets totalled 145 aircraft during 1997.

The AE3007 powers the Citation X corporate jet which had a successful entry into service. The Tay engine benefited from the continuing strong demand for the Gulfstream IV, and the BMW Rolls-Royce BR710 entered service on the Gulfstream V. The BR710 engine will enter service in 1998 on the other new long-range executive jet, the Bombardier Global Express. In all of these applications Rolls-Royce is the only choice of engine on the aircraft.

Lufthansa already operates the V2500-powered A321 aircraft (above) and has now selected the A340-600 with Trent engines.



The Eurofighter 2000 development programme is well advanced and the production contracts are now in place.

Defence

Rolls-Royce has a comprehensive range of engines available for more than 30 different military applications from helicopters to combat aircraft, a market worth $190 billion over the next 20 years.

We are involved in two of the world's new combat aircraft programmes. Rolls-Royce is a major partner in the programme to develop the EJ200 engine for the Eurofighter 2000. With five EJ200-powered prototype Eurofighters now flying, the defence ministers of the four participating nations signed a production contract for 620 Eurofighter aircraft and 1,500 EJ200 engines. The aircraft is due to enter service in 2001 and offers enormous export potential.

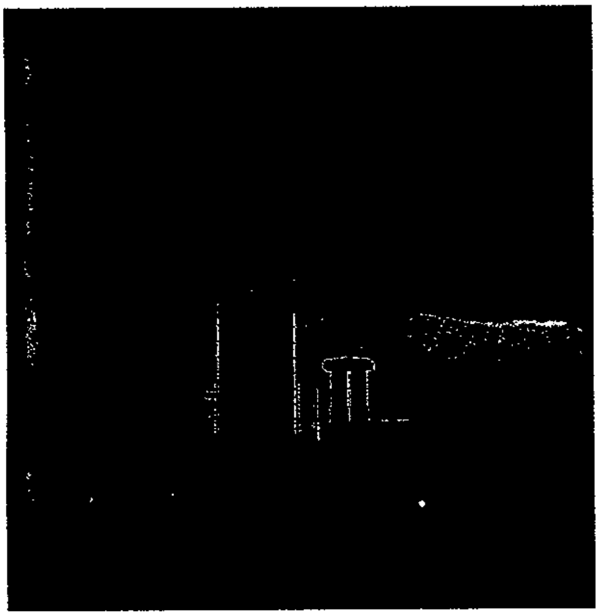
In the United States, Rolls-Royce is involved in the Joint Strike Fighter (JSF) programme. We are working with General Electric to develop the F120 engine – one of two proposed powerplants for JSF and, in addition, we are working with both Boeing and Lockheed Martin, on the short take-off and vertical landing technology to be incorporated in one of the versions of JSF. These contracts give the Group an important stake in the next generation of fighter aircraft, some 3,000 of which will be built over the next 15 years.

For trainer aircraft, Rolls-Royce launched the Adour 900. Embodying the latest technology, the engine sets new standards of cost and reliability. It is a member of the Adour family which powers the Hawk, Jaguar and the US Navy's T-45A Goshawk. In 1997 the Adour won orders in Australia and Canada.

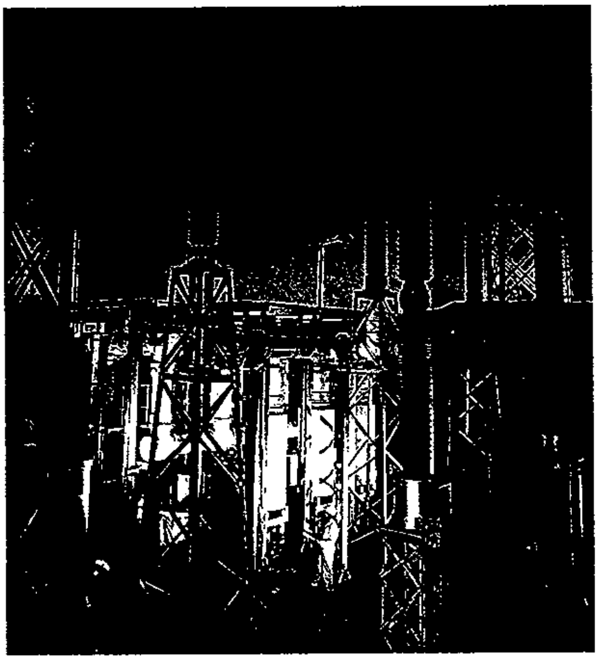
In the market for transport aircraft, engine contracts were signed for 32 AE2100-powered C-130J aircraft for the United States and Italy. These contracts were worth more than $250 million to Rolls-Royce.

The helicopter engine business also achieved notable successes in 1997, including a $189 million contract with the US Army for Model 250 engines to be used in Kiowa Warrior helicopters.

Gas turbines are our core business. Through this technology we have developed strengths and leading positions across a number of markets.



Efficient power with minimal environmental impact: the benefits of aero-derived gas turbines are now widely recognised in the power industry.



Our transmission and distribution business has been successful in providing expertise and equipment to customers worldwide.

Developments in our industrial businesses follow our intent to focus on activities where Rolls-Royce can develop a significant position and create value.

Power generation

The growing market for distributed power is served by our range of aero-derived gas turbines which covers power requirements from 3-50 megawatt (MW). With a new family of small gas turbines, the 601K and 701K series, improvements to the existing RB211 and the development of the industrial Trent at 50MW, our enhanced range satisfies power needs up to 150MW in combined cycle. The Trent will enter service later than planned as we have extended the programme to overcome difficult technical challenges associated with emissions control. Similar challenges are faced by all manufacturers in this market. We are confident that the engine will meet its original targets.

Transmission and distribution products complement the power generation activities. In 1997 new joint ventures were announced in Saudi Arabia, Jordan and Indonesia.

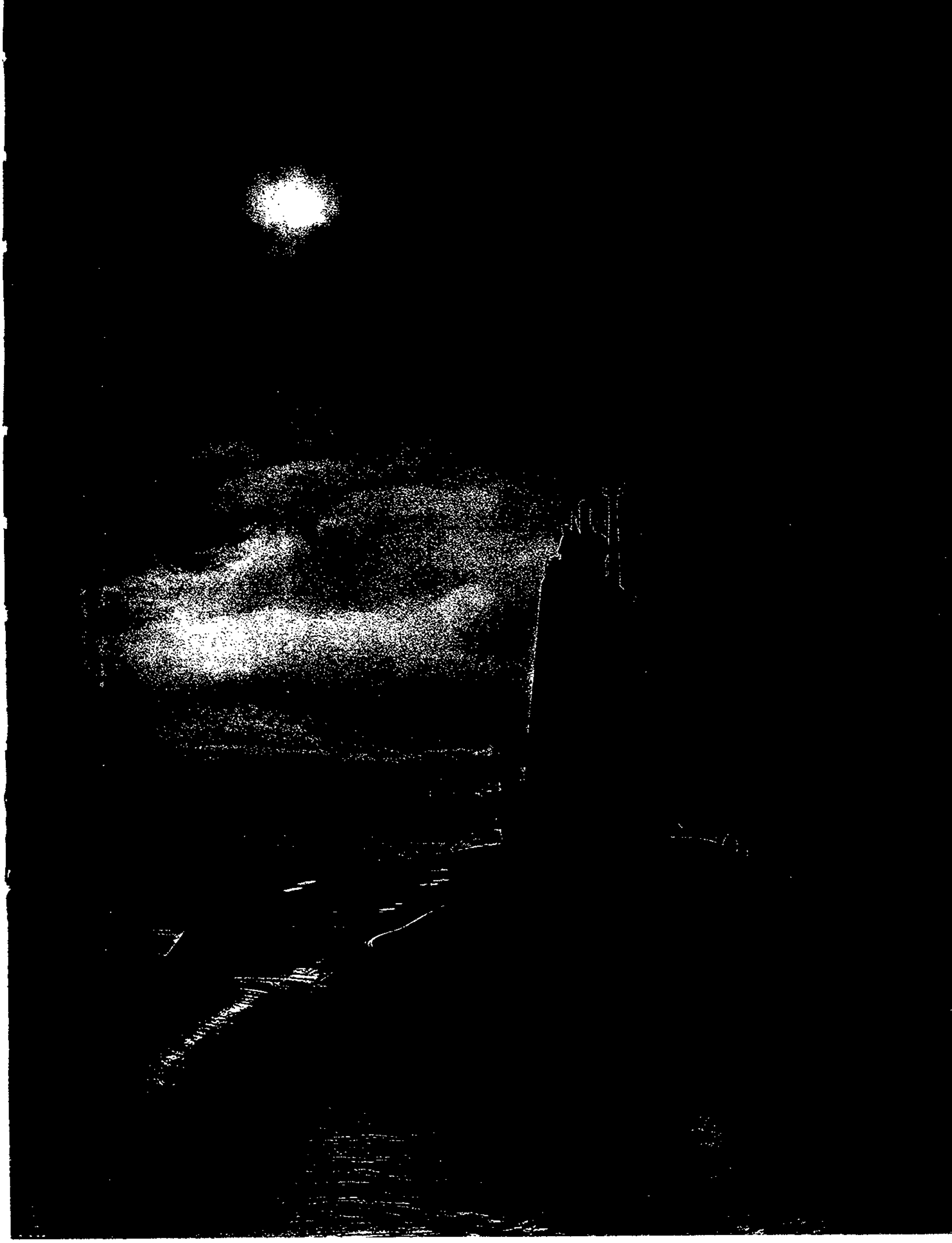
Marine power

Rolls-Royce is at the forefront of two major naval developments. The WR-21 large marine gas turbine, a joint venture with Northrop Grumman, successfully completed its 500-hour endurance test, leaving us well placed to offer a unique product to the world's navies. Rolls-Royce has been nominated to design and supply the reactor plants for the Royal Navy's next generation of nuclear submarines and we also serve marine customers through our materials handling business.

Oil and gas

For the oil and gas market we, again, exploit our gas turbine technology for pumping and compression. Together with our diesel engines, we have a full product range from 3MW to 50MW. In 1997 we announced an extension of this capability in the form of a joint venture with Russian design bureau, Lyulka Saturn.

Rolls-Royce reactor plants power the Royal Navy's nuclear submarine fleet and will power the new Astute class announced during 1997.



Expanding global presence

We have been successful in following strategies to improve our global market presence through the development of new products, joint ventures and international collaboration.

By concentrating on local needs we expand our global presence.

WE CONTINUE TO EXPAND internationally, building our presence and seeking business in markets that offer attractive returns to our shareholders. 1997 saw good progress in each of our major territories.

In North America substantial orders from leading airlines such as Delta Air Lines, American Airlines and Air Canada were secured, ensuring the continuation of long-term customer relationships in the North American marketplace.

We remain strong in Asia, which we expect to be a significant long-term growth market. In the developing Chinese market, our engines have been specified by ten local airlines and we now have a joint training centre with China's aviation authority. In Indonesia we are providing a £25 million substation with local partners.

In Europe we have benefited from our military contracts and further developments in the Airbus range. The new Rolls-Royce powered Airbus A340-500/600 has won orders from major European carriers including Lufthansa, Virgin Atlantic and Swissair, developing our business with these prominent airlines.

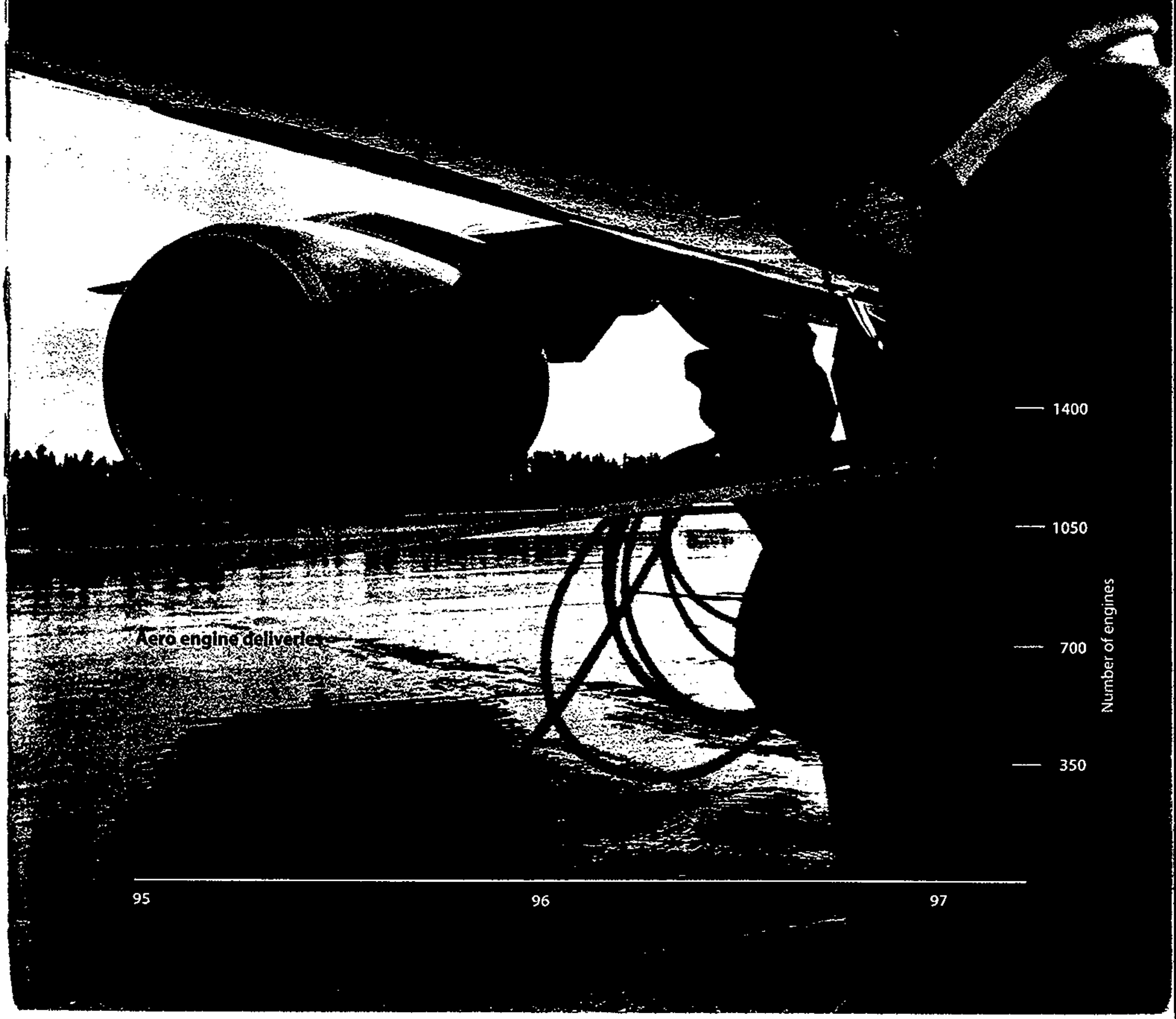
Ninety per cent of our order intake in 1997 was secured in Europe and North America.

A growing aftermarket business

Rolls-Royce has over 53,000 engines in service – one of the largest fleets in the world. To service this fleet we are developing a large and successful global repair and overhaul business. Our market share for the repair and overhaul of Rolls-Royce engines has more than doubled in the last three years and our target is to

Singapore Airlines began operating the first of its 61 Rolls Royce Trent-powered Boeing 777s, during 1997.

We are pursuing a strategy of global market penetration through acquisitions, joint ventures and by developing our overseas manufacturing and customer support.



double sales within the next five years. We are growing this activity in association with key customers in order to provide capability across the world.

Last year we announced a joint venture with American Airlines to create a repair and overhaul base for Rolls-Royce engines in the Americas. The new company will work on a number of engine types, including RB211-535, Tay and Trent 800.

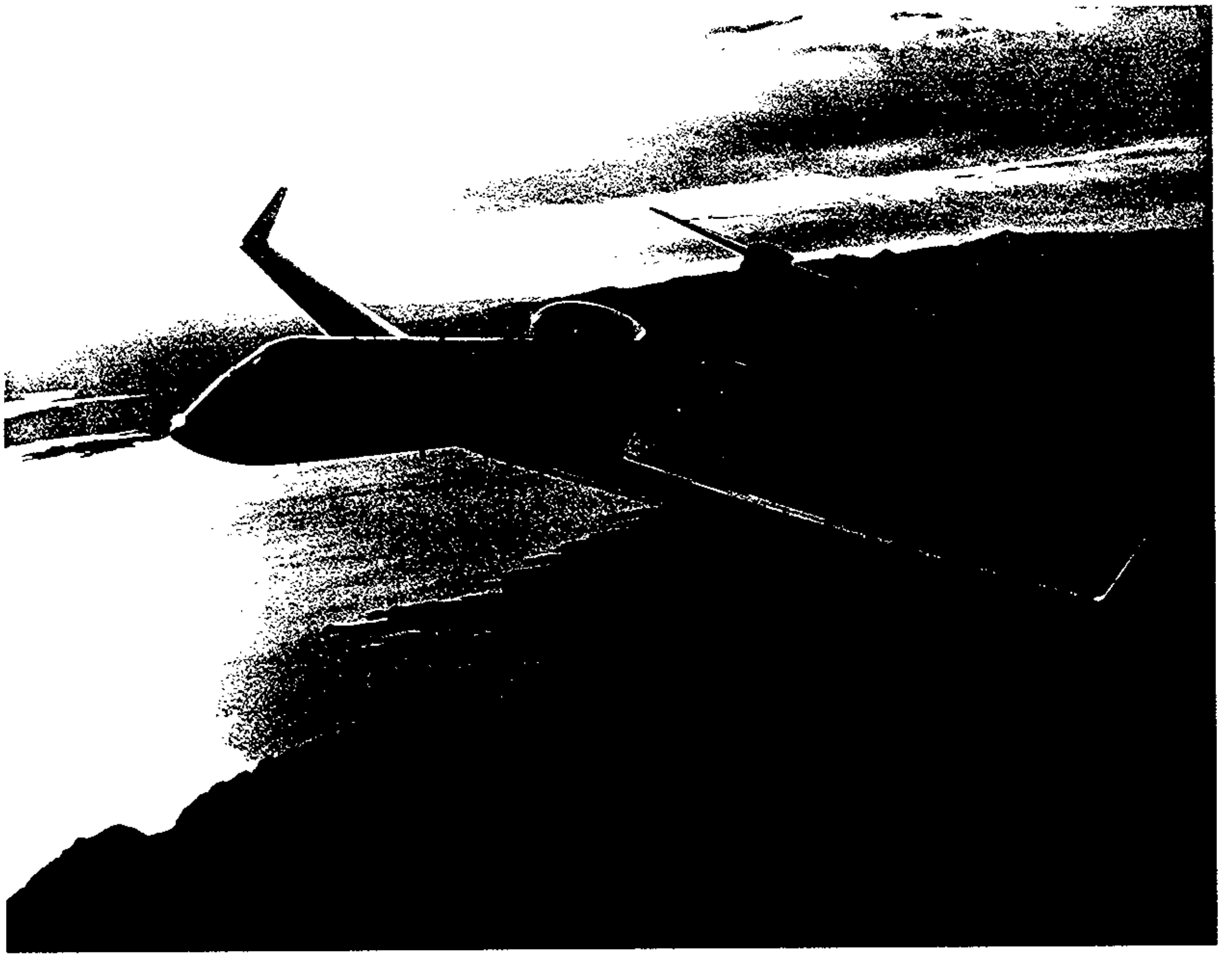
In Asia our new joint venture repair and overhaul business has opened in Hong Kong. We have also announced the formation of a base in Singapore for the repair and overhaul of Trent engines. The latter is a tri-party agreement between ourselves, Hong Kong Aero Engine Services Limited and Singapore Airlines Engineering Company, a subsidiary of Singapore Airlines.

In addition to the sale of spare parts and the repair and overhaul of engines, Rolls-Royce offers a comprehensive range of services to customers, including one of the world's largest engine leasing businesses.

The industrial businesses also present important aftermarket opportunities with similar characteristics to those of the aerospace businesses. The Group is pursuing these opportunities aggressively.

International manufacturing

As we expand we increasingly integrate our manufacturing across national boundaries. Our US operations now supply components for the RB211, Tay and Pegasus engines. Our new joint venture factory at Xian, in China will soon be making components for the RB211, Tay, BR710 and the BR715.



Our success in providing power for the corporate and business jet market continues. The new Gulfstream V long-range executive jet is powered by BR710 engines.

Investing for the future

Our long-term value demands first-class training and development of Rolls-Royce people. This investment has resulted in sales per employee improving by 60 per cent in the last five years.

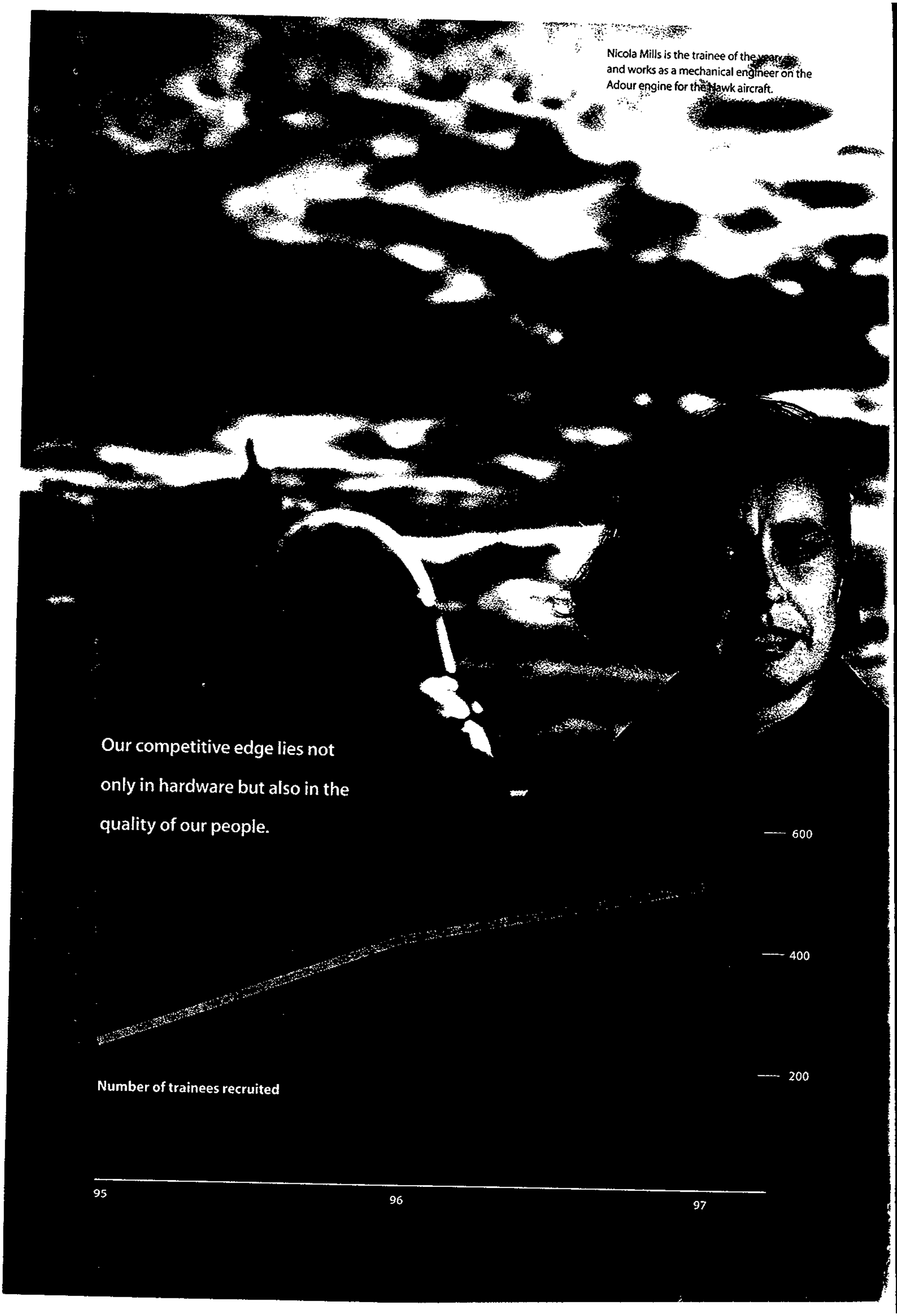
THE STEP CHANGE that we intend to achieve depends crucially on the skills, attitude and flexibility of our people. That is why, along with streamlining our processes, we are devoting considerable effort to training and developing our employees and improving their awareness of creating customer and shareholder satisfaction. We require our people not only to do their jobs well but to understand the commercial imperatives and be motivated to make the greatest possible contribution.

A new management development policy entitled, 'World Class People – World Class Business' (Management Development in Action) has been published and communicated through senior management meetings.

At all levels we are training people to operate in new ways and be more involved in affecting the performance of the Group. The aerospace businesses have already involved 14,000 employees in the 'One Small Step...' programme to encourage this contribution to improving our operational performance. This mechanism for encouraging dialogue will be used throughout the organisation.

We are changing processes and improving skills to create shareholder value. We develop our management skills on a company-wide basis and are thoroughly reviewing our policies and practices for developing these broad skills.

Our Business Leadership Programme ensures that our senior people are better equipped to operate in an innovative, competitive and global business. Additional courses are providing the same messages



Nicola Mills is the trainee of the year and works as a mechanical engineer on the Adour engine for the Hawk aircraft.

Our competitive edge lies not only in hardware but also in the quality of our people.

to all managers and first-time management appointees. A small number of high-potential younger managers also benefit from our new International Business Awareness Course which gives them a greater appreciation of the global nature of our business. To emphasise the point, this course has been successfully piloted and run at our joint venture training centre in Tianjin, China.

During 1997 these courses and programmes have helped some 250 senior individuals to further develop their management skills. Another 300 managers are expected to take part in 1998, providing significant business training and development for the Group's senior managers. In addition, around 200 managers have been trained in specific operational skills through our Management Development Curriculum. This provides training in subject areas such as managing money, people projects, information and operations. The modules cater for individual learning styles by offering a variety of learning methods to participants.

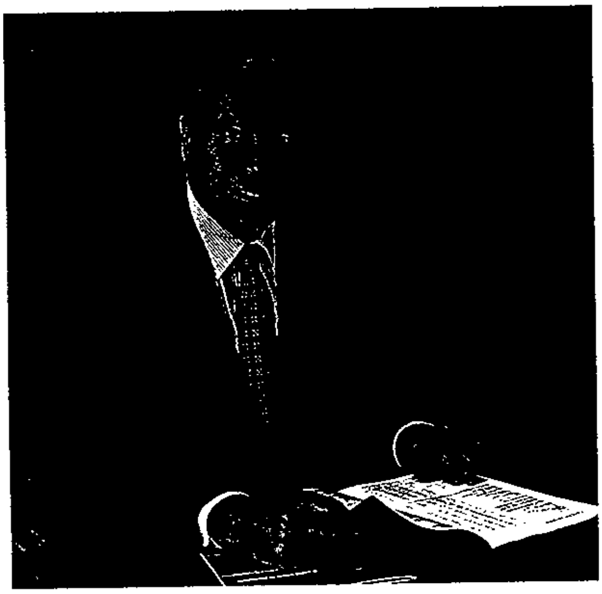
Looking ahead

Rolls-Royce has made enormous strides in recent years. We are now doing more business than we would have thought possible ten years ago. With 34 per cent of all civil turbofan orders placed in 1997 and a 19 per cent share of all engine deliveries during the year, we are making progress towards our goal of a third share of the world civil market. The future for our military business is encouraging, with contracts signed for the production of the new EJ200 and our increasing involvement in major North American defence programmes like the Joint Strike Fighter (JSF). In the industrial businesses our strategy of concentrating on activities where Rolls-Royce can establish market-leading positions is aimed at producing higher financial returns in the future.

Above all we have skilled and committed people who have embraced the opportunities and shown their enthusiasm for transforming Rolls-Royce, to satisfy our customers and generate greater rewards for our shareholders.

We are partnering China's aviation administration (CAAC) in developing extensive technical and management training programmes, which include a new training centre at Tianjin where training administrator Ma Miao (right) welcomes course delegate Shi Feng of China Xinjiang Airlines.

Finance Director's review



Finance Director Michael Townsend

Competition remains intense but the Group's order book is at a record level and we continue to improve our financial performance.

OUR FINANCIAL PERFORMANCE in 1997 showed continuing improvement in most respects – turnover and the order book were at record levels, profit increased, earnings per share and return on capital improved, and a net cash inflow was generated.

This was achieved despite there being no reduction in the competitive pressures in the marketplaces we serve, and without reduction in the investments being made for the future in capital equipment, research and development, operational improvements and the scale of our international business.

Results for the year

Turnover, at £4,334 million, increased by £432 million or 11 per cent over 1996. These values are stated net of discounts for the first time, to reflect a developing trend in the aerospace industry towards net pricing and to provide increased clarity of underlying manufacturing costs. Had the previous presentation been adopted, turnover would have amounted to £4,990 million, an increase of 16 per cent.

Aerospace turnover increased by 19 per cent and industrial (which amounted to 27 per cent of Group turnover) by 5 per cent. Within aerospace the increase was concentrated on civil engines, where turnover increased by about a third; the balance of aerospace turnover, including civil spares, was 15 per cent ahead over the year.

Aero engine deliveries, including BMW Rolls-Royce GmbH (BRR), were 17 per cent up, at 1,256, but with an increased proportion of big engines.

78 per cent (1996 76 per cent) of turnover

originated in the United Kingdom, and 76 per cent (1996 78 per cent) of turnover was delivered to overseas customers. Rolls-Royce continues to be one of the UK's most significant exporters.

Gross margins reduced to 17.8 per cent (1996 18.9 per cent). This decline reflects the continuing pricing pressures in both our market segments and the growing proportion of turnover represented by new civil engines, particularly the Trent where launch orders are increasingly being delivered. In addition, delays in the introduction to the market of the industrial Trent depressed margins in the industrial segment.

Self-funded research and development increased to £216 million (1996 £199 million), although as a percentage of sales it declined from 5.1 per cent to 5.0 per cent. In industrial businesses research and development remained constant, while aerospace expenditure increased as a result of very successful improvements to the RB211-524 engine in the first half of the year and the launch of the Trent 500 and 8104 programmes at the end of the year. Risk and revenue sharing partners (RRSP) have been attracted by these latter programmes. Research and development is shown net of £52 million RRSP receipts (1996 £18 million).

Gross research and development, incorporating expenditure funded by customers, partners and others, increased by £68 million to £595 million.

The Group made a profit before tax of £276 million (1996 £235 million on a continuing operations basis), which represents 6.5 per cent of turnover (1996 6.4 per cent).

Aerospace profits increased by £56 million to 7.8 per cent on turnover (1996 7.2 per cent). Industrial profits reduced by £21 million, to 3.1 per cent on turnover, being primarily affected by the industrial Trent delays.

The impact of BRR on gross profit was £43 million (1996 £59 million). This charge represents the provision made against part of the Group's contribution to the financing of BRR – an associated undertaking – which records neither a profit nor a loss because its results are offset by subvention payments. The balance of the contribution is carried forward as a debtor and at December 31, 1997 amounted to £94 million (1996 £72 million). The Group is currently forecasting a positive return from BRR early in the next decade.

A final dividend of 3.70p is proposed, making 5.90p for the year (1996 5.30p). The dividend cover is 2.5 times (1996 2.6 on a continuing operations basis).

After tax and dividends, £136 million of retained profit was added to equity shareholders' funds.

The order book at the end of 1997 amounted to £8.0 billion at gross value, with a further £2.1 billion announced but not contracted (1996 £7.0 billion and £0.7 billion respectively). This reflects, among other factors, the 34 per cent civil engine market capture in 1997.

The number of Group employees reduced by 600 over the year. Industrial numbers reduced by 3,000, all in relation to businesses sold during the year. Aerospace increased by 2,400, including 300 in Gear Systems Inc. in the USA – acquired during the year. The majority of the underlying increase in aerospace was related to the increased output and turnover. Group turnover per employee increased by 11 per cent to £101,700 (1996 £91,600).

Cash

The Group cash flow statement is shown on page 40. Year end net funds amounted to £328 million, representing a net inflow over the year of £41 million.

A total of £26 million was invested in a combination of joint ventures, the acquisition of the net assets of Gear Systems Inc., the purchase of the 50 per cent of Orca Energy, Inc. which the Group did not already own and the redemption of Rolls-Royce Power Engineering plc's outstanding preference shares.

Net proceeds totalling £65 million were received in respect of the sale of industrial businesses (see page 60). The discontinued businesses (Parsons and

International Combustion) utilised a net £12 million before recognising the £39 million proceeds of sale.

Capital expenditure, net of disposals, amounted to £203 million, more than double 1996's £96 million. Of this sum, the investment activities of Rolls-Royce Capital Limited and Rolls-Royce Power Ventures represented £10 million and £33 million respectively.

Working capital remained almost constant, and on average across the year increased by less than 2 per cent, notwithstanding the 11 per cent increase in turnover. Provisions for liabilities and charges, including the utilisation of the provisions in respect of discontinued operations, reduced by £50 million (page 41).

The average net funds for the year were £65 million (1996 £50 million).

The Group retains a comfortable margin over covenants agreed with its lenders.

Derivatives and other financial instruments

The Group uses various types of financial instruments to manage its exposure to market risks which arise from its business operations. The main risks, as in the past, are from movements in foreign currency exchange rates, interest rates and commodity prices.

The Board regularly reviews the Group's exposures and forward cover, which are also considered in detail by a specialist committee. All such exposures are managed by Group Treasury, which reports to the Finance Director and which operates within written policies approved by the Board.

Foreign exchange risk

The Group's most significant currency exposure is to the US dollar with the Deutschmark ranking next. US dollar income, net of dollar expenditure, represents about 32 per cent of Group turnover (excluding Allison). The Group has a less significant exposure to other foreign currencies.

The Group seeks to hedge its exposures using a variety of financial instruments, with the objective of minimising fluctuations in exchange rates on future transactions and cash flows.

All hedging is undertaken for commercial reasons and we continue to believe that the accounting treatment should reflect this position.

The level of cover taken is determined by the written policies set by the Board and the forward cover is managed within the parameters of these policies in order to achieve the Group's objectives.

The result has been to maintain a relatively stable achieved rate on foreign exchange. In converting transactions denominated in US dollars, 1997 results have suffered by about £5 million (0.7 cents on the achieved rate) by comparison with 1996.

Deutschmark cover extends for periods up to three years, whilst US dollar cover extends for up to ten years, though predominantly in the one to five year period. The majority of cover is in the form of standard foreign exchange contracts, although some cover, primarily of longer duration, includes instruments on which the exchange rates achieved may be dependent on future interest rates. Total US dollar cover approximates to two years net US dollar income (unchanged from the end of 1996).

In the absence of hedging, the Group is exposed to a gain/loss each year of at least £7 million per one cent movement in the US dollar/sterling relationship, and up to £3.5 million for a 1 per cent movement in interest rates.

Interest rate risk

The Group has borrowed US$300 million through a subsidiary, Rolls-Royce Capital Inc., in order to provide a fixed rate loan for general Group purposes. This has been translated into sterling after taking account of future contracts and is managed by using interest rate swaps, which effectively change this fixed rate borrowing into a floating rate borrowing in order to match rates achieved on short-term deposits and cash at bank.

Additionally the Group has a £150 million borrowing, with maturity in 1998, which is also managed by using interest rate swaps to convert the borrowing from a fixed rate into a floating rate.

Borrowings and interest rates

After taking into account the various currency and interest rate swaps entered into by the Group, the currency and interest rate structure of the gross borrowings of the Group as at December 31, 1997 was:

Currency	Total £m	Floating borrowings £m	Fixed borrowings £m
Sterling	428	402	26
US dollar	96	96	—
Other	27	18	9
	551	516	35

The analysis of fixed borrowings is:

Currency	Total £m	Weighted average interest rate Per cent	Weighted average time for which rate is fixed Years
Sterling	26	5.5	4.4
Other	9	nil	10.2

The maturity of the Group's borrowings is:

	1997 £m	1996 £m
Within 1 year	302	88
Between 1 and 2 years	8	158
Between 2 and 5 years	31	24
Over 5 years	210	221
	551	491

Commodity risk

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

Sales financing

In both our business segments, customers sometimes require us to provide financing support. This may take a number of forms, but primarily involves asset value or credit guarantees. In the latter case support by export credit agencies is an important feature.

Where the Group is required to accept recourse, we seek to structure the financing in such a way as to make it saleable to third parties. During the year about 10 per cent of our gross exposure was successfully sold down.

Note 24 to the financial statements describes the nature of financing support in our aerospace business. Such support is normally secured on the aircraft, and Note 24 also shows the balance of exposure to the Group. This net exposure can only arise over a number of years, and the risk of its crystallisation is considered remote. The value of this exposure has reduced slightly to £68 million (1996 £84 million). Were the value of the underlying aircraft security to fall by 20 per cent, the equivalent exposure would be £156 million (1996 £174 million).

Rolls-Royce Capital Limited is the subsidiary which arranges our aerospace financing and manages the exposures arising therefrom. It also provides a lease engine facility for our airline customers, and at December 31, 1997 owned 58 engines, all manufactured by members or associates of the Group, 95 per cent of which were revenue earning at that date. The net book value of these engines at December 31, 1997 was £86 million.

Power project investments

Rolls-Royce Power Ventures (RRPV) is the subsidiary which deals with the development, construction and financing of power projects, generally in the range of 150 megawatts or less. RRPV seeks to develop projects in both the independent power market and in the private industrial sector. RRPV utilises, to the fullest extent possible, equipment and services provided by other Group companies and uses a variety of structures and arrangements to meet the needs of the ultimate power user and other project sponsors. As needed, RRPV will commit equity and debt to complete the projects but the structuring of the investments allows RRPV to sell down all or a portion of the investment when financially advantageous to do so.

At the year end, RRPV had invested £62 million in eight projects of which five had commenced construction. A further £22 million investment is required to complete these projects.

Taxation

The tax charge of £51 million represents an effective rate of about 18.5 per cent.

The Company has no UK tax losses brought forward and is accordingly paying mainstream corporation tax. However the UK tax charge is reduced by the net benefit of timing differences (where no deferred tax is provided) and by the write-back of the Group's advance corporation tax (ACT) written off in previous years.

At the end of 1997, the Group had surplus ACT previously written off of £150 million (1996 £170 million). Although the Government has announced that ACT will be abolished with effect from April 1999, it has stated that ACT previously unrecovered will continue to be recoverable on, broadly, the same basis as at present. The Group therefore expects to benefit from the recovery of this ACT over the next few years, by offset against corporation tax liabilities.

Overseas tax amounted to £18 million, primarily related to the results of North American businesses, including Allison.

Financial Reporting Standards (FRS)

FRS 9, associates and joint ventures, and FRS 10, goodwill and intangible assets, have recently been published. Whilst their impact on the Group's future financial statements is under review, they are not reflected in the 1997 statements.

Year 2000

The Group is working to address the computer problems generally referred to as 'Year 2000'. A number of systems and a substantial volume of computer hardware will be replaced in the next two years and guarantees that the new equipment is 'Year 2000 compliant' are being sought. Remaining systems and hardware are being addressed and costs in excess of £20 million are currently estimated for the Group. Such costs are being written off as incurred.

We are seeking assurances from our supply chain that they are 'Year 2000 compliant'.

There can be no absolute guarantee that the problem will have been eliminated in advance of the date, but we believe that the majority of our businesses are relatively well advanced in this area.

South-East Asia

Balance sheet and currency exposure to this region is insignificant and – whilst some orders are being deferred and options not exercised – no orders have yet been cancelled.

Shareholder value

The Company's share price fell in 1997, ending the year at 235p, down from 257p. During the year the price ranged between 190p and 272p, the latter an all time high.

The UK Stock Market, as measured by the FTSE 100 index, ended the year at 5136, having peaked at 5331.

The Group's market capitalisation at the end of the year was £3,478 million (1996 £3,793 million).

The return on average capital employed in 1997 improved again to 14.5 per cent before tax (1996 12.5 per cent). For this computation capital employed includes net cash balances and goodwill written off to reserves, and is averaged by reference to opening and closing figures.

The number of shares in issue at the year end was 1,480 million, an increase of 4 million over the year. This reflects the exercise of options and the issue of shares as a result of the take up of scrip dividends. The average number of shares in issue during the year was 1,478 million.

The resultant earnings per share amounted to 15.16p (1996 12.70p before exceptional items).

The foreign ownership of the Company's shares, which is restricted to 29.5 per cent by the Articles of Association – and about which limit the Company is in discussion with the Government – generally ranged between 27.5 and 29.5 per cent during the year. At the end of 1997 the figure was 28.4 per cent.

Board of directors

AT MARCH 4, 1998

Sir Ralph Robins
BSc, F Eng[3]
Chairman
Elected to the Board in 1982. He joined Rolls-Royce in 1955, became Managing Director in 1984 and was appointed Chairman in 1992. Age 65.

John E V Rose MA[3]
Chief Executive
Elected 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. Age 45.

Lord Moore of Lower Marsh PC, BSc[1,2,3]
Non-executive Deputy Chairman
Elected to the Board in 1994 and appointed Deputy Chairman in 1996. He is Chairman of Credit Suisse Asset Management Limited. Age 60.

Peter J Byrom
BSc, FCA[1,2,3]
Non-executive director
Elected to the Board with effect from January 1, 1997. He was a director of N M Rothschild & Sons Limited from 1977 to 1996. Age 53.

Colin H Green
BSc, C Eng
Managing Director – Aerospace Group
Elected to the Board in 1996. He joined Rolls-Royce in 1968, became Managing Director, Rolls-Royce Military Aero Engines in 1994, Vice President – Business Operations, Allison Engine Company Inc. in 1995 and Managing Director – Aerospace Group in 1996. Age 49.

James M Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Elected to the Board with effect from January 1, 1998. Until 1994 he was Executive Vice President Marketing and Planning of United Airlines. Age 52.

Paul Heiden
BSc, ARCS, ACA
Managing Director – Industrial Businesses
Elected to the Board with effect from July 1, 1997. He joined Rolls-Royce in 1992 and became Finance Director, Aerospace Group later that year and Managing Director – Industrial Businesses in 1997. Age 41.

Sir Gordon Higginson
BSc, PhD, F Eng[2,3]
Non-executive director
Elected to the Board in 1988. Until 1994 he was Vice Chancellor, University of Southampton. Age 68.

Harold G Mourgue
FCA[1,2,3,4]
Non-executive director
Elected to the Board in 1985. He was Chairman of Kenwood Appliances plc until 1996. He retires from the Board with effect from March 31, 1998. Age 70.

Sir Robin Nicholson
F Eng, FRS[2,3]
Non-executive director
Elected to the Board in 1986. He was an executive director of Pilkington plc until 1996. Age 63.

Philip C Ruffles BSc, F Eng
Director – Engineering and Technology
Elected to the Board with effect from January 1, 1997. He joined Rolls-Royce in 1961, became Director – Engineering, Aerospace Group in 1991 and Director – Engineering and Technology in 1997. Age 58.

Michael Townsend
MA, FCA
Finance Director
Elected to the Board in 1991. He joined Rolls-Royce in 1990 and was appointed Finance Director in 1991. Age 56.

Richard T Turner
OBE, BA
Group Marketing Director
Elected to the Board in 1992. He joined Rolls-Royce in 1991 having previously been with the Company from 1965 to 1988. Age 55.

Company Secretary
Charles Blundell MA
He joined Rolls-Royce in 1993 and was appointed Company Secretary in 1995. Age 46.

[1] Member of the audit committee.
[2] Member of the remuneration committee.
[3] Member of the nomination committee.
[4] Chairman of the Trustees of The Rolls-Royce Pension Fund.

Note:
Committees 1 and 2 are made up entirely of 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, 1997.

THE GROUP'S PRINCIPAL ACTIVITIES are described in the Corporate profile (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 3.70p a share. With the interim dividend of 2.20p a share, paid on January 5, 1998, this will make a total dividend of 5.90p a share for the year. Subject to approval of the recommended final dividend by shareholders, the total cost of dividends for 1997 is £88 million. If approved, the Company will pay the final dividend on July 6, 1998 to shareholders registered on May 1, 1998.

Employment

The number of Group employees at the end of the year was 42,300 (1996 42,900) of whom 28,100 (1996 25,700) were in aerospace and 14,200 (1996 17,200) were in the industrial businesses.

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. It also operates an equal opportunities policy, details of which are contained in a recently updated guide.

There are various forms of employee communication across the Group, each adapted to the particular needs of individual businesses. The Group consults with employees and their elected representatives on a comprehensive 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.

Health, Safety & Environment (HS&E)

The Group believes strongly that HS&E is an integral and important part of day-to-day business management, ranking equally with all other activities. It sets goals of continual improvement for HS&E performance. The Chief Executive retains accountability to the Board for health, safety and environmental matters. The Board has also appointed the Director – Engineering and Technology to run a Group Environmental Steering Committee and a Product Stewardship Board in order to sharpen focus on product design and its impact on HS&E.

The Group reinforces the priority it attaches to HS&E through a combined HS&E policy, which is regularly reviewed, and through a set of eight strategic objectives. These are now being applied to all the Group's operations worldwide. In the UK a manual of HS&E standards and guidance backs the policy. A cycle of external health and safety audits monitors compliance with the Group's HS&E management system and the standards. A corporate audit group runs a cycle of environmental audits, which is being externally verified.

The Board has decided that the Group should seek accreditation to the environmental management standard ISO 14001 by the end of the year 2000, and that it will publish its first stand-alone HS&E report in 1999.

The overall accident record remains better than the UK national average for manufacturing for both major and 'over three-day lost time' injuries (at 0.69 and 6.5 per 1,000 employees respectively) and reflects an improvement on 1996.

There were no fatal industrial injuries during the year. However, following a fatality in 1996 for which the Company was later prosecuted and a number of other major accidents that year on customers' premises, a major review was launched, the results of which are being rigorously applied across all relevant parts of the Group's operations.

Progress continues to be made in environmental management with audits showing improvement on all but one site. There was, however, a substantial fuel leak at Hucknall which necessitated a major clean-up operation. There were no environmental prosecutions in 1997. The Group continues to strive to reduce the environmental impact of its products and operations, and is developing the means to monitor performance effectively. In the recently published BiE Index of Corporate Environmental Engagement, the Group's rating improved from the fourth to the third quintile and its absolute score improved from 48 per cent to 73 per cent.

A copy of the HS&E policy document is available on written request to the Company Secretary.

Employee development and training

In support of 'Better Performance *Faster*', the aerospace businesses ran a communication programme for employees. Called 'One Small Step...', it gave employees the opportunity to spend a day hearing customers' views, understanding the business position, and sharing ideas for accelerating change and improvement. In parallel, training programmes have been designed to develop the skills needed for the changes required by 'Better Performance *Faster*'.

Several businesses achieved the prestigious Investors in People award. Peebles Electric won a Department of Trade and Industry National Languages for Export award with an innovative multimedia transformer product training package. It was translated into Mandarin for customers working on the Tianhuangping pumped storage project for which Peebles Electric is providing six 500kV generator transformers.

A consortium of major British companies led by Rolls-Royce began a five-year training initiative to support state-owned enterprises in China under the auspices of the State Economic and Trade Commission. Senior management training programmes have been developed for the State Planning Commission of China.

In the United Kingdom 1997 was designated the 'Year of Engineering Success'. Rolls-Royce graduates supported this national initiative with an interactive software package for use in schools to demonstrate the theory, design, manufacture and marketing of aero engines.

In 1997 Rolls-Royce recruited 318 graduates, 46 sponsored undergraduates and 152 modern apprentices. Many of the graduates attended a training programme at EURESAS in Toulouse whilst others had international secondments with partner companies or worked on customer projects.

Rolls-Royce co-hosted with Derby University an international Euroavia design workshop for the European Aerospace Students Association.

Support for community projects continues in all businesses. Reyrolle apprentices were involved in a crime prevention project with local police in the Jarrow area, helping to fit security devices to homes. The result was a 56 per cent drop in burglaries. This initiative has been nominated for the South Tyneside Enterprise Partnership Award.

Rolls-Royce hosted The Rt Hon Andrew Smith MP, Minister of State for Welfare to Work and Equal Opportunities, as part of the launch of the Government's Welfare to Work scheme, designed to help unemployed 18-24 year olds into work. Rolls-Royce will play a full and active role in supporting this scheme.

Directors

Directors who held office during 1997 are listed on page 25, apart from Mr R H Maudslay who resigned with effect from July 1, 1997 and Mr J W Sandford who retired on December 31, 1997. Mr P Heiden was appointed with effect from July 1, 1997 and Mr J M Guyette with effect from January 1, 1998.

Mr H G Mourgue will retire from the Board with effect from March 31, 1998.

All directors are subject to re-election by rotation every three years. The directors retiring by rotation at the Annual General Meeting are Sir Ralph Robins, Lord Moore of Lower Marsh and Sir Robin Nicholson. Mr P Heiden and Mr J M Guyette, the new directors, also retire at the Annual General Meeting. Sir Ralph Robins' current contract expires on September 30, 1998. He has agreed to continue as Chairman until December 31, 1999. Lord Moore of Lower Marsh and Sir Robin Nicholson, as non-executive directors, do not have service contracts. They all offer themselves for re-election.

The fees paid to non-executive directors are determined by the executive directors, informed by independent market surveys. Each non-executive director receives an annual fee of £20,000. In addition, fees of £5,000 per annum are paid in respect of membership of the audit and remuneration committees and £7,500 per annum to the committee chairmen (Mr H G Mourgue and Sir Robin Nicholson respectively). Mr H G Mourgue also received £10,000 per annum in respect of his chairmanship of the Trustees of The Rolls-Royce Pension Fund. Non-executive directors do not participate in any of the Company's share schemes, performance pay arrangements or pension schemes.

Internal controls

The directors are responsible for the Group's system of internal controls, financial and otherwise, recognising that such a system can provide only reasonable and not absolute assurance against material misstatement or loss.

The control environment is defined by a corporate Code of Business Conduct, by detailed delegation of authorities within a clearly defined organisation structure and by written job descriptions and operating manuals.

The Board has identified the major risks affecting the business, and the controls addressing each of these have been examined by the use of detailed questionnaires and through specific investigations by internal audit.

Both financial and non-financial indicators are reported on a monthly basis. A comprehensive budgeting system is operated, with an annual budget approved by the directors. Monthly actual results are reported against budget, and variances regularly reviewed. Revised forecasts for the year are prepared at least quarterly.

The Group has an audit committee comprised solely of non-executive directors. Separate audit committees operate in North America and South Africa.

The Group also has an internal audit department which works closely with the external auditors and operates to a work programme agreed with the audit committee and based on risk assessment. Specifically, areas of information technology and systems change are addressed, including 'Year 2000' issues.

Key financial issues such as credit and foreign exchange management, sales financing and risk management are reported regularly to the Board.

Additionally the finance and general management of individual businesses are required to acknowledge in writing that their routine financial reporting is based on reliable data. They are also required to acknowledge by interview and in writing that they are fully aware of their responsibility to operate internal financial control systems and that their results are properly stated in accordance with Group and statutory requirements.

Where necessary, corrective action is taken based on regular review, reports by internal and external auditors and the findings of other audits both from within and outside the Group.

The directors have reviewed the effectiveness of the system of internal financial controls, utilising the processes set out above.

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.

Corporate governance

The Company continues to attach a high priority to all aspects of corporate governance and has complied throughout the financial year with the *Code of Best Practice* published by the Committee on the Financial Aspects of Corporate Governance.

The Board meets regularly throughout the year. It considers all issues relating to the strategy, direction and future development of the Group. The non-executive directors bring an independence of judgement and a wide range of experience to these discussions. The Board also has access to legal advice through Mr B Baker, General Counsel, who attends Board meetings.

Membership of three standing Board committees is noted on page 25. The audit committee meets regularly to review with the external auditors the Group's annual and interim financial statements and also ensures that appropriate accounting policies and compliance procedures are in place. The remuneration committee is responsible for all aspects of the remuneration of executive directors. Its report is on pages 31 to 37. The nomination committee is responsible for recommending Board appointments.

The auditors, KPMG Audit Plc, have confirmed that in their opinion:

i) with respect to the statement on internal controls (other than statements going beyond internal financial control which are outside the scope of their report) and the statement on going concern, the directors have provided the disclosures required by the Listing Rules of the London Stock Exchange and such statements are not inconsistent with the information of which they are aware from their audit work on the financial statements; and

ii) that the directors' statement on page 29 appropriately reflects the Company's compliance with the other aspects of the *Code of Best Practice* specified by the Listing Rules of the London Stock Exchange for their review.

They have carried out their review in accordance with the relevant guidance issued by the Auditing Practices Board, which does not require them to perform any additional work necessary to express a separate opinion on the effectiveness of either the Group's system of internal financial control or the Company's corporate governance procedures, or on the ability of the Group to continue in operational existence.

Fixed assets

At the end of 1997 a revaluation of the Company's land and buildings was carried out by professional valuers, which suggests a value marginally greater than the figure shown in the financial statements.

Payment to suppliers

The Company 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. Suppliers are, in this way, made aware of these terms. The Company complies whenever it is satisfied that suppliers have provided the goods or services in accordance with the agreed terms and conditions. In the event of disputes, efforts are made to resolve them quickly.

The Company had 69 days purchases outstanding at December 31, 1997 based on the average daily amount invoiced by suppliers during the year.

Donations

During 1997 the Group made charitable donations amounting to £338,750. The annual donations budget is administered by a committee of the Board and by local site committees. The Group's policy on donations is to direct its support primarily towards assisting military services' benevolent associations and charities with engineering, scientific or educational objectives, as well as objectives connected with the Group's business and place in the community.

A list of the principal donations made in 1997 is available on written request to the Company Secretary.

The Group made no political contributions in 1997.

Share capital

The following has a notifiable interest in the Company's ordinary shares:

	% of issued share capital
Merrill Lynch & Co., Inc.	16.13

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 E. Blundell

Charles E Blundell
Company Secretary
March 4, 1998

Report of the remuneration committee

THE REMUNERATION COMMITTEE consists exclusively of non-executive directors who have no personal interest in the matters dealt with by the committee. The members are Sir Robin Nicholson (Chairman), Mr P J Byrom, Sir Gordon Higginson, Lord Moore of Lower Marsh and Mr H G Mourgue (who retires on March 31, 1998). The committee meets regularly and has access to professional advice inside and outside the Company.

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

The committee's main function is to determine the Group's overall policy on employment conditions and remuneration for senior executives and to decide the actual remuneration benefits and terms of employment for each executive director and a number of senior executives. In the case of a termination of contract, the committee would also determine the level of compensation and mitigation.

Compliance

The committee confirms that the constitution and the operation of the committee fully comply with the provisions contained in Section A of the best practice provisions annexed to the Listing Rules of the London Stock Exchange. In forming its policy for remuneration and in determining the remuneration packages for directors and senior executives in 1997, the committee also confirms that it has given full consideration to Section B of the best practice provisions annexed to the Listing Rules of the London Stock Exchange.

Remuneration policy

Following a review during 1996, the committee has adopted a remuneration policy which reflects 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;

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.

Over the last year the committee has developed a remuneration structure which is consistent with these principles. The following sections of the report identify the main components of remuneration and those areas which have been changed to reflect the outcome of the committee's review.

The main components of remuneration

The emoluments of executive directors and senior executives currently comprise the following elements: a base salary, an annual performance reward scheme, the long-term incentive plan, pension contributions and other benefits. The executive share option scheme has been discontinued.

Base salary

In setting the level of base salaries for executive directors and senior executives, the committee obtains independent advice from a leading firm of compensation and benefits consultants and compares the Group's pay levels with a comparator group of more than 50 major quoted industrial groups. It also takes into account pay levels elsewhere in the Group. The committee believes that in order to attract and retain executive directors of the right calibre and to provide them with adequate incentives to deliver the Group's objectives, the Group should pursue a policy of offering median level base salaries for its executive directors and senior executives, and through the annual performance reward scheme and the long-term incentive plan (see below), the opportunity of upper quartile earnings for upper quartile performance.

Annual performance reward scheme

Executive directors and senior executives participate in an annual performance reward scheme. In line with the committee's view that a significant proportion of total remuneration should be based on performance, the scheme enables a maximum performance reward of up to 40 per cent of salary to be paid to executive directors, for exceptional performance against pre-determined targets for average daily cash balances and profit before tax, with a tapered scale of maximum percentages for 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.

Long-term incentive plan

Executive directors and certain senior executives are eligible to participate in the long-term incentive plan (LTIP). The LTIP was approved by shareholders at the 1997 Annual General Meeting and has operated with effect from January 1, 1997. The committee believes that the introduction of the LTIP will greatly strengthen the identity of interest between senior executives and shareholders by creating a new and powerful incentive towards improved performance in the longer term.

The LTIP involves the grant of awards of shares in the Company which can be realised in the form of shares and cash if demanding performance targets are met. The committee intends to make awards on a rolling annual basis. In June 1997 awards were granted to 60 participants, including all the executive directors, over 913,585 shares having a value at grant equivalent to a percentage of the participant's annual salary at the commencement of a three-year performance measurement period. The maximum value of the awards was 60 per cent of salary for executive directors, with a tapered and reducing scale of maximum percentages for senior executives. Details of the conditional awards made to executive directors in 1997 are shown on page 37.

The percentage of the award, and therefore the value which can be realised, will depend upon the Company's total shareholder return (TSR) over the three-year period compared to that achieved over the same period by a group of 19 comparator companies comprising other leading engineering and industrial companies. However, no award will be realised unless the average growth in the Group's earnings per share (EPS) over the three-year measurement period is at least two per cent per annum greater than the average increase in the UK retail price index over the same period.

The percentage of shares comprised in the award which can be realised will be determined by the Company's TSR ranking against the comparator group. 100 per cent of the share award would be secured for a first, second or third ranking with a uniform sliding scale of percentages then being applied to each ranking down to and including ninth place which would earn 40 per cent of the share award. No award would be made if the Company's TSR ranking was tenth or below.

On realisation of an award, the participant would receive one half of its value at the release date in the form of shares and the other half in cash.

The participant would be required to retain at least half the shares for a minimum of two years.

Executive share option scheme

In the light of the decision to introduce the LTIP, the committee concluded that those UK executives participating in the LTIP should cease to be eligible for any grants of share options under the executive share option scheme. The scheme expired in April 1997 and no further grants were made to executive directors or senior executives during 1997.

Details of the options held by each executive director are shown on page 36. All the options were granted at the market value on the date of issue and no discount was applied.

Sharesave schemes

Having received approval at the 1997 Annual General Meeting for the introduction of a new savings-related share option scheme, the Company issued invitations to employees in October 1997 and granted options over some 21,500,000 shares.

During 1997 over 450 employees converted their scheme savings into Rolls-Royce shares. At the end of the year, over 16,000 employees (being 50 per cent of eligible employees) participated in the Company schemes. The committee believes that sharesave schemes, described in more detail on page 56, make a very significant contribution to the close involvement and interest of all employees in the Group's performance. In this respect, they complement the All Employee Performance Related Pay Scheme which has operated since 1996 and which also encourages all eligible employees to take a continuing interest in the Group's performance.

Pensions

Mr J W Sandford participated in pension plans sponsored by Rolls-Royce Inc. until his retirement on December 31, 1997. Mr J M Guyette, who was appointed to the Board with effect from January 1, 1998, also participates in pension plans sponsored by Rolls-Royce 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 taxable remuneration, subject to completion of the necessary service.

The Company also operates the Rolls-Royce 1994 Senior Executive Retirement Scheme (SERS) to fund pensions provision above the earnings cap introduced in the 1989 Finance Act. The scheme is administered by three trustees, under the chairmanship of Sir Gordon Higginson, none of whom has a beneficial interest in the scheme. The members of the scheme include Mr P Heiden, Mr M Townsend and Mr R T Turner. They joined the Group after the introduction of the 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.

Details of the pension benefits which accrued over the year in the Group's approved UK pension schemes and pension plans sponsored by Rolls-Royce Inc. are given below[1, 6]:

	Additional pension earned in excess of inflation during the year ended Dec 31, 1997 £000 per annum	Transfer value of additional pension earned in excess of inflation during the year ended Dec 31, 1997[2] £000	Total accrued pension entitlement at Dec 31, 1997 £000 per annum
Mr C H Green	27	558	103
Mr P Heiden[3]	1	13	16
Mr R H Maudslay[4]	4	88	104
Mr J E V Rose	24	415	87
Mr P C Ruffles	19	352	101
Mr J W Sandford[5]	11	143	99
Mr M Townsend	Nil	Nil	17
Mr R T Turner	1	17	9

Details of the retirement benefits which accrued over the year in the SERS are given below [7]:

	Additional retirement lump sum earned in excess of inflation during the year ended Dec 31, 1997 £000	Transfer value of additional retirement lump sum earned in excess of inflation during the year ended Dec 31, 1997 [8] £000	Total accrued retirement lump sum entitlement at Dec 31, 1997 £000
Mr P Heiden[3]	10	8	116
Mr M Townsend	69	64	387
Mr R T Turner	49	42	252

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 and Rolls-Royce Inc. 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. 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] Appointed on July 1, 1997.
[4] Resigned on July 1, 1997.
[5] Benefits are translated at US$1.64 = £1.00
[6] Members of the schemes have the option to pay Additional Voluntary Contributions. Neither the contributions nor the resulting benefits are included in the above table.
[7] The lump sum entitlement shown is that which would be paid on retirement based on service to the end of the year.
[8] The transfer value has been calculated as the contributions and related payments paid over the calendar year.

Terms and conditions

Service contracts

Sir Ralph Robins has a fixed-term contract which expires on September 30, 1998. He has entered into a new fixed-term contract for the period October 1, 1998 to December 31, 1999 under which he will work for the Company at an equivalent rate of three days a week.

Mr J M Guyette, who was elected to the Board with effect from January 1, 1998 and who is offering himself for re-election, has a contract with Rolls-Royce North America Inc. drawn up under US law. It is for an indefinite term and provides that on termination without cause on or after the third anniversary, he is entitled to one year's severance pay without mitigation. If terminated by the Company without cause prior to the third anniversary, the severance pay period would extend to October 1, 2001 without mitigation. The terms are consistent with US practice and in the view of the committee, were fully justified in order to attract a US executive of the calibre and experience of Mr Guyette.

Mr C H Green, Mr P Heiden (who is offering himself for re-election), Mr J E V Rose, Mr P C Ruffles, Mr M Townsend and Mr R T Turner all have two-year rolling contracts which provide for 24 months' notice in the event of termination of employment by the Company. The committee gives regular and careful consideration to the case for maintaining its policy of offering UK executive directors two-year rolling contracts. It remains of the view that they are necessary to attract and retain executives of the calibre required to perform effectively in a complex, technologically advanced and long-term business operating in a highly competitive, international market.

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.

Mr R H Maudslay resigned as a director with effect from July 1, 1997. He remained employed by the Company until December 31, 1997 and continued to receive his previous salary and benefits until this date. Mr Maudslay received a termination payment of £220,000 consistent with the above mitigation policy.

Individual directors' emoluments

The individual directors' emoluments are analysed as follows:

	1997						1996
	Basic salaries £000	Board and committee fees £000	Taxable benefits £000	Rolls-Royce plc Annual performance reward scheme £000	Compensation for loss of office £000	Aggregate emoluments excluding pension contributions £000	Aggregate emoluments excluding pension contributions £000
Sir Ralph Robins	362	—	28	160	—	550	393
Mr J E V Rose	312	—	19	140	—	471	314
Mr C H Green	239	—	18	81	—	338	185
Mr P Heiden [1]	104	—	5	59	—	168	—
Mr R H Maudslay [2]	111	—	7	—	220	338	222
Mr P C Ruffles [3]	187	—	10	80	—	277	—
Mr J W Sandford [4]	211	—	11	85	—	307	273
Mr M Townsend	229	—	17	96	—	342	266
Mr R T Turner	204	—	13	84	—	301	237
Mr P J Byrom [3]	—	27	—	—	—	27	—
Sir Gordon Higginson	—	25	—	—	—	25	24
Lord Moore of Lower Marsh	—	30	—	—	—	30	26
Mr H G Mourgue [5]	—	43	—	—	—	43	38
Sir Robin Nicholson	—	27	—	—	—	27	23
Mr L J Clark [6]	—	—	—	—	—	—	3
Sir Terence Harrison [6]	—	—	—	—	—	—	130
Mr S C Miller [6]	—	—	—	—	—	—	250
	1,959	152	128	785	220	3,244	2,384

[1] Mr P Heiden was appointed to the Board with effect from July 1, 1997.

[2] Mr R H Maudslay resigned as a director with effect from July 1, 1997 and he continued as an employee until December 31, 1997 for which he received a salary of £111,000.

[3] Mr P J Byrom and Mr P C Ruffles were appointed to the Board with effect from January 1, 1997.

[4] Mr J W Sandford retired on December 31, 1997. He was paid in US dollars translated at $1.64 = £1.00 (1996 $1.57).

[5] Mr H G Mourgue will retire from the Board with effect from March 31, 1998.

[6] Former directors who left the Board during 1996.

Directors' share interests

The directors, including their immediate family, at December 31, 1997 had the following beneficial interests, including options and LTIP awards, in the ordinary share capital of the Company:

	Holdings	
	December 31 1997	January 1 [1] 1997
Sir Ralph Robins	41,091	40,237
Lord Moore of Lower Marsh	11,598	11,358
Mr J E V Rose	7,281	7,281
Mr C H Green	81,538	3,007
Mr P Heiden	10,179	10,179
Mr P C Ruffles	6,494	494
Mr J W Sandford	16,673	16,326
Mr M Townsend	17,231	17,231
Mr R T Turner	10,727	10,352
Mr P J Byrom	457	447
Sir Gordon Higginson	3,703	3,703
Mr H G Mourgue	7,036	7,036
Sir Robin Nicholson	7,036	7,036

[1] or date of appointment if later.

Mr J M Guyette was appointed to the Board with effect from January 1, 1998. He had interests in 5,000 shares.

Sir Ralph Robins, Lord Moore of Lower Marsh, Mr C H Green and Mr P J Byrom took 394; 111; 782; 4 shares respectively, instead of cash dividends in January 1998. During February 1998 Mr C H Green, Mr P C Ruffles and Mr M Townsend exercised options to purchase 2,792; 3,613; 7,159 shares respectively under the Company's sharesave schemes. Otherwise, there has been no change in the directors' interests between December 31, 1997 and March 4, 1998.

Directors' share interests continued

	Options								
	January 1[1] 1997	Granted in 1997	Exercised in 1997	December 31, 1997	Exercise price	Market[4] price	Aggregate gains 1997 £000	Aggregate gains 1996 £000	Exercisable dates
Sir Ralph Robins	126,407			126,407	172p				1998-2000
	125,890			125,890	139p				1998-2001
		7,438[3]		7,438[3]	205p				2003
	252,297	7,438		259,735	157p[2]			207	
Mr J E V Rose	33,308		33,308		198p	243.5p			
	28,647		28,647		172p	243.5p			
	116,750			116,750	176p				1998-2005
		7,438[3]		7,438[3]	205p				2003
	178,705	7,438	61,955	124,188	178p[2]		36	140	
Mr C H Green	45,825		45,825		172p	247.5p			
	56,893		56,893		139p	247.5p			
	80,685		80,685		125p	247.5p			
	67,250			67,250	176p				1998-2005
	2,792			2,792[3]	145p				1998
	8,633			8,633[3]	106p				2000
		4,756[3]		4,756[3]	205p				2005
	262,078	4,756	183,403	83,431	169p[2]		195		
Mr P Heiden	66,750			66,750	176p				1998-2005
		7,438[3]		7,438[3]	205p				2003
	66,750	7,438		74,188	179p[2]				
Mr P C Ruffles	44,377		44,377		198p	266p			
	58,652			58,652	139p				1998-2001
	80,685			80,685	125p				1998-2002
	66,750			66,750	176p				1998-2005
	3,613			3,613[3]	106p				1998
	4,600			4,600[3]	150p				2001
		2,894[3]		2,894[3]	205p				2003
	258,677	2,894	44,377	217,194	146p[2]		30		
Mr M Townsend	118,959			118,959	125p				1998-2002
	116,750			116,750	176p				1998-2005
	7,159			7,159[3]	106p				1998
	5,750			5,750[3]	150p				2001
		342[3]		342[3]	205p				2001
	248,618	342		248,960	149p[2]			80	
Mr R T Turner	105,750			105,750	176p				1998-2005
	6,900			6,900[3]	150p				2001
	112,650			112,650	174p[2]			182	

[1] or date of appointment if later.
[2] weighted average exercise price of December 31, 1997 balance.
[3] Sharesave schemes.
[4] at date exercised.

No options were granted during 1997 to executive directors under the Company's executive share option scheme.

The market price of the Company's ordinary shares ranged between 190p and 272p during 1997 and was 235p on December 31, 1997.

Directors' share interests continued

Conditional awards granted under the LTIP to executive directors (which were all granted during the year ended December 31, 1997) are set out below. The extent to which the maximum number of shares comprised in an award (as stated below) is realised will depend on the satisfaction of demanding performance conditions (see page 32).

	Aggregate conditional awards 1997
Sir Ralph Robins	75,728
Mr J E V Rose	64,077
Mr C H Green	51,262
Mr P Heiden	21,747
Mr P C Ruffles	40,776
Mr M Townsend	51,262
Mr R T Turner	46,601

In addition to the individual interests in shares awarded under the LTIP shown above, each of the executive directors is, for Companies Act purposes, regarded as interested in all the 685,189 shares held by the discretionary trust linked to the LTIP. These shares are held for the purpose of satisfying awards granted under the LTIP to a total of 60 employees (including executive directors).

Group profit and loss account

FOR THE YEAR ENDED DECEMBER 31, 1997

	Notes	Continuing operations £m	Discontinued operations £m	1997 £m	Restated [1] 1996 £m
Turnover	2	4,216	118	4,334	3,902
Cost of sales		(3,465)	(142)	(3,607)	(3,310)
Gross profit/(loss)		751	(24)	727	592
Commercial, marketing and product support costs		(142)	(2)	(144)	(143)
General and administrative costs		(131)	(13)	(144)	(132)
Research and development (net)*		(215)	(1)	(216)	(199)
Share of profits of associated undertakings		13	—	13	8
Utilisation of provision for loss on sale/termination of businesses		—	40	40	—
Operating profit		276	—	276	126
Profit/(loss) on sale of businesses	28	1	(9)	(8)	—
Utilisation/(creation) of provision for loss on sale/termination of businesses		—	9	9	(147)
Profit/(loss) on ordinary activities before interest	2	277	—	277	(21)
Net interest payable	4			(1)	(7)
Profit/(loss) on ordinary activities before taxation	3			276	(28)[2]
Taxation	5			(51)	(16)
Profit/(loss) on ordinary activities after taxation				225	(44)
Equity minority interests in subsidiary undertakings				(1)	(3)
Profit/(loss) attributable to ordinary shareholders				224	(47)
Dividends	6			(88)	(78)
Transferred to/(from) reserves	22			136	(125)
*Research and development (gross)				(595)	(527)
Earnings/(loss) per ordinary share	7				
Net basis				15.16p	(3.19)p
Net basis before exceptional items				15.16p	12.70p

There have been no material acquisitions.

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/(loss) attributable to ordinary shareholders', a profit of £167m (1996 £119m) has been dealt with in the profit and loss account of the Company.

[1] 1996 turnover and cost of sales have been restated to reflect the amended accounting policy for sales discounts adopted for 1997.

[2] Included an exceptional loss of £248m (see note 3).

Balance sheets

AT DECEMBER 31, 1997

	Notes	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Fixed assets					
Tangible assets	9	1,055	962	633	564
Investments – subsidiary undertakings	10	—	—	683	677
– other	11	102	85	51	44
		1,157	1,047	1,367	1,285
Current assets					
Stocks	12	959	798	658	522
Debtors – amounts falling due within one year	13	1,075	1,047	777	678
– amounts falling due after one year	14	332	262	284	233
Short-term deposits and investments	15	368	544	323	512
Cash at bank and in hand		511	231	445	147
		3,245	2,882	2,487	2,092
Creditors – amounts falling due within one year					
Borrowings	16	(302)	(88)	(274)	(56)
Other creditors	17	(1,898)	(1,571)	(1,684)	(1,383)
Net current assets		1,045	1,223	529	653
Total assets less current liabilities		2,202	2,270	1,896	1,938
Creditors – amounts falling due after one year					
Borrowings	18	(249)	(403)	(24)	(175)
Other creditors	19	(84)	(84)	(263)	(263)
Provisions for liabilities and charges	20	(407)	(458)	(114)	(92)
		1,462	1,325	1,495	1,408
Capital and reserves					
Called up share capital	21	296	295	296	295
Share premium account	22	522	519	522	519
Revaluation reserve	22	121	125	107	109
Other reserves	22	71	54	184	167
Profit and loss account	22	433	310	386	318
Equity shareholders' funds		1,443	1,303	1,495	1,408
Minority interests in subsidiary undertakings					
Equity interests		13	13	—	—
Non-equity interests		6	9	—	—
		1,462	1,325	1,495	1,408

The financial statements on pages 38 to 64 were approved by the Board on March 4, 1998 and signed on its behalf by:

Sir Ralph Robins
Chairman
M Townsend
Director

Group cash flow statement

FOR THE YEAR ENDED DECEMBER 31, 1997

		1997 £m	1996 £m
Net cash inflow from operating activities	*A*	308	166
Returns on investments and servicing of finance	*B*	(2)	(5)
Taxation paid		(30)	(26)
Capital expenditure and financial investment	*C*	(203)	(96)
Acquisitions and disposals	*D*	42	(21)
Equity dividends paid		(78)	(69)
Cash inflow/(outflow) before use of liquid resources and financing		37	(51)
Management of liquid resources	*E*	176	(387)
Financing	*F*	23	71
Increase/(decrease) in cash		236	(367)

Reconciliation of net cash flow to movement in net funds		
Increase/(decrease) in cash	236	(367)
Cash (inflow)/outflow from (decrease)/increase in liquid resources	(176)	387
Cash inflow from increase in borrowings	(19)	(53)
Change in net funds resulting from cash flows	41	(33)
New finance leases	—	(3)
Exchange adjustments	3	6
Movement in net funds	44	(30)
Net funds at January 1	284	314
Net funds at December 31	328	284

Analysis of net funds	At January 1, 1997 £m	Cash flow £m	Other non-cash changes £m	Exchange adjustments £m	At December 31, 1997 £m
Cash at bank and in hand	231	277	—	3	511
Overdrafts	(12)	(41)	—	—	(53)
Short-term deposits and investments	544	(176)	—	—	368
Other borrowings due within one year	(68)	(24)	(150)	—	(242)
Borrowings due after one year	(356)	(2)	150	—	(208)
Finance leases	(55)	7	—	—	(48)
	284	41	—	3	328

		Continuing operations £m	Discontinued operations £m	1997 £m	1996 £m
	Reconciliation of operating profit to operating cash flows				
	Operating profit	276	—	276	126
	Associated undertakings – share of profits	(13)	—	(13)	(8)
	– dividends received	3	—	3	4
	Depreciation of tangible fixed assets (note 3)	92	2	94	103
	(Profit) on disposals of tangible fixed assets	(3)	—	(3)	(3)
	(Decrease)/increase in provisions for liabilities and charges	(25)	(25)	(50)	19
	Increase in stocks	(171)	—	(171)	(39)
	(Increase)/decrease in debtors	(148)	17	(131)	(190)
	Increase/(decrease) in creditors	309	(6)	303	154
A	**Net cash inflow/(outflow) from operating activities**	320	(12)	308	166
	Returns on investments and servicing of finance				
	Interest received			44	35
	Interest paid			(43)	(37)
	Interest element of finance lease payments			(3)	(3)
B	**Net cash outflow from returns on investments and servicing of finance**			(2)	(5)
	Capital expenditure and financial investment				
	Purchases of tangible fixed assets			(222)	(142)
	Disposals of tangible fixed assets			21	52
	Other investments			(2)	(6)
C	**Net cash outflow for capital expenditure and financial investment**			(203)	(96)
	Acquisitions and disposals				
	Acquisitions of businesses (note 27)			(4)	—
	Deferred consideration in respect of 1996 acquisitions			(5)	(3)
	Disposals of businesses – including overdrafts disposed of (note 28)			68	—
	Investments in associated undertakings			(10)	(20)
	Loans to associated undertakings			(3)	(5)
	(Repayments to)/investments by non-equity minority interests in subsidiary undertakings			(4)	7
D	**Net cash inflow/(outflow) for acquisitions and disposals**			42	(21)
	Management of liquid resources				
	Decrease/(increase) in short-term deposits			179	(385)
	(Increase) in government securities and corporate bonds			(3)	(2)
E	**Net cash inflow/(outflow) from management of liquid resources**			176	(387)
	Financing				
	Borrowings due within one year:				
	Redemption of preference shares issued by a subsidiary undertaking			—	(6)
	Increase in bank loans			24	67
	Borrowings due after one year – new loans			2	2
	Capital element of finance lease payments			(7)	(10)
	Net cash inflow from increase in borrowings			19	53
	Issue of ordinary shares			4	18
F	**Net cash inflow from financing**			23	71

Group statement of total recognised gains and losses

FOR THE YEAR ENDED DECEMBER 31, 1997

	1997 £m	1996 £m
Profit/(loss) attributable to the shareholders of Rolls-Royce plc	224	(47)
Unrealised surplus on revaluation of properties	—	33
Exchange adjustments on foreign currency net investments	(4)	(26)
Total recognised gains and (losses) for the year	220	(40)

Group historical cost profits and losses

FOR THE YEAR ENDED DECEMBER 31, 1997

	1997 £m	1996 £m
Profit/(loss) on ordinary activities before taxation	276	(28)
Realisation of property revaluation gains of previous years	2	5
Difference between the historical cost depreciation charge and the actual depreciation charge for the year calculated on the revalued amount	2	3
Historical cost profit/(loss) on ordinary activities before taxation	280	(20)
Historical cost transfer to/(from) reserves	140	(117)

Reconciliations of movements in shareholders' funds

FOR THE YEAR ENDED DECEMBER 31, 1997

	Group		Company	
	1997 £m	1996 £m	1997 £m	1996 £m
At January 1	1,303	1,345	1,408	1,418
Total recognised gains and (losses) for the year	220	(40)	167	46
Ordinary dividends (net of scrip dividend adjustments)	(84)	(74)	(84)	(74)
New ordinary share capital issued	4	18	4	18
Goodwill written off on acquisitions	(3)	(24)	—	—
Goodwill transferred to the profit and loss account in respect of disposals of businesses	3	78	—	—
At December 31	1,443	1,303	1,495	1,408

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.

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 of associated undertakings up to December 31. Any subsidiary and associated undertakings 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.

Goodwill, which represents the excess of the value of the purchase consideration for shares in subsidiary and associated undertakings over the fair value to the Group of the net assets acquired, is written off to reserves in the year of acquisition.

The profit or loss on the disposal of a previously acquired business takes into account the attributable value of purchased goodwill relating to that business.

Turnover
Turnover excludes value added tax and discounts. In previous years discounts were included in cost of sales. The impact of the change has been to reduce 1997 turnover and cost of sales by £656m (1996 £389m). 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 non-refundable cash or other payments in kind. Depending on the terms of the arrangements the sums received are credited to turnover or to research and development.

Research and development
The charge to the profit and loss account consists of total research and development expenditure incurred in the year less known recoverable costs on contracts, contributions to shared engineering programmes and matching government assistance.

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 investment, and from the translation of the profits or losses at average rate, 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.

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 paid to airframe manufacturers in respect of meeting regulatory certification requirements for new civil engine/aircraft combinations are carried forward in prepayments to the extent that they can be recovered out of future sales and are charged to the profit and loss account over the five years following certification.

Taxation
Provision for taxation is made at the current rate and for deferred taxation at the projected rate on all timing differences where a liability is expected to crystallise in the foreseeable future. Advance corporation tax which is not recoverable in the immediate future by offset against United Kingdom corporation tax liabilities is included in the taxation charge for the year.

Notes to the financial statements

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1 ACCOUNTING POLICIES CONTINUED

Scrip dividends

The amounts of dividends taken as shares instead of in 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 23 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 ten to 25 years (average 19 years).

iv) In course of construction

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

2 Segmental analysis

	Turnover 1997 £m	Turnover Restated[1] 1996 £m	Profit/(loss) before interest 1997 £m	Profit/(loss) before interest 1996 £m	Net assets[2] 1997 £m	Net assets[2] 1996 £m
Analysis by businesses:						
Aerospace	3,071	2,570	241	185	846	778
Industrial	1,145	1,086	36	57	285	305
	4,216	3,656	277	242	1,131	1,083
Industrial						
Discontinued operations	118	246	—	(263)	3	(42)
	4,334	3,902	277	(21)	1,134	1,041
Geographical analysis by origin:						
United Kingdom	3,366	2,973	176	(94)	1,083	953
Other	968	929	101	73	51	88
	4,334	3,902	277	(21)	1,134	1,041
Geographical analysis by destination:						
United Kingdom	1,020	871				
Rest of Europe	322	346				
USA	1,439	1,144				
Canada	154	124				
Asia	994	1,062				
Africa	143	155				
Australasia	125	139				
Other	137	61				
	4,334	3,902				
Exports from United Kingdom	2,347	2,129				
Sales to overseas subsidiaries	(127)	(110)				
Sales by overseas subsidiaries	1,094	1,012				
Total overseas	3,314	3,031				

[1] Turnover has been restated to reflect the amended accounting policy for sales discounts adopted for 1997.
[2] Net assets exclude net funds of **£328m** (1996 £284m).

Notes to the financial statements

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3 Profit/(loss) on ordinary activities before taxation

	1997 £m	1996 £m
After crediting		
Risk and revenue sharing partnership receipts	77	43
Operating lease rentals receivable	30	24
After charging		
Depreciation of owned tangible fixed assets [1]	90	99
Depreciation of tangible fixed assets held under finance leases [1]	4	4
Operating lease rentals payable – hire of plant and equipment	17	21
– hire of other assets	13	17

Auditors' fees were as follows during the year:

Audit 1997 – Group **£1.8m** (1996 £1.8m) including Company **£0.4m** (1996 £0.4m)
Other 1997 – United Kingdom **£0.5m** (1996 £0.5m)
– Rest of World **£0.4m** (1996 £0.3m)

[1] Including appropriate amounts charged to stocks.

The 1996 profit and loss account comparative figures were as follows:

	Continuing operations £m	Discontinued operations £m	Restated [1] 1996 £m
Turnover	3,656	246	3,902
Cost of sales	(2,966)	(344)	(3,310)
Gross profit/(loss)	690	(98)	592
Commercial, marketing and product support costs	(141)	(2)	(143)
General and administrative costs	(119)	(13)	(132)
Research and development (net)	(196)	(3)	(199)
Share of profits of associated undertakings	8	—	8
Operating profit/(loss)	242	(116)	126
Provision for loss on sale/termination of businesses	—	(69)	(69)
Goodwill previously written off directly to reserves	—	(78)	(78)
Profit/(loss) on ordinary activities before interest	242	(263) [2]	(21)
Net interest payable			(7)
Loss on ordinary activities before taxation			(28)

[1] Turnover has been restated to reflect the amended accounting policy for sales discounts adopted for 1997.
[2] In July 1996 the directors made the strategic decision to withdraw from large steam power generation. An exceptional loss of £248m was included within the total loss of £263m in respect of businesses to be discontinued.

The exceptional loss was:	1996 £m
Charged against operating profit	(101)
Non-operating items	(147)
	(248)

4 Net interest payable

	1997 £m	1996 £m
Interest payable on:		
Borrowings repayable within five years	(27)	(21)
Borrowings repayable after five years	(17)	(18)
Finance leases	(3)	(3)
	(47)	(42)
Interest receivable	46	35
	(1)	(7)

5 Taxation

	1997 £m	1996 £m
United Kingdom – corporation tax at 31.5%	51	—
– advance corporation tax written back	(20)	—
– deferred tax	(1)	1
	30	1
Overseas – current tax	13	16
– deferred tax	5	(5)
Associated undertakings	3	4
	51	16

In 1996 the UK mainstream corporation tax charge was reduced by the utilisation of trading losses brought forward.

	1997 £m	1996 £m
Analysis of taxation charge:		
Trading activities	51	30
Operating exceptional items	—	(11)
Non-operating exceptional items – provision for loss on sale of businesses	—	(3)
	51	16

6 Dividends – ordinary shares

	1997 £m	1996 £m
Interim 2.20p (1996 2.00p) per share	33	29
Final proposed 3.70p (1996 3.30p) per share	55	49
	88	78

Notes to the financial statements

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7 EARNINGS/(LOSS) PER ORDINARY SHARE

Earnings/(loss) per ordinary share on the net basis are calculated by dividing the profit/(loss) attributable to ordinary shareholders of **£224m** (1996 loss £47m) by **1,478 million** (1996 1,472 million) ordinary shares, being the average number of ordinary shares in issue during the year, excluding shares on which dividends have been waived.

In 1996 adjusted earnings per ordinary share before exceptional items were calculated as follows. They were presented to show the underlying earnings by excluding the effects of exceptional items.

	1996	
	Pence	£m
Loss attributable to ordinary shareholders	(3.19)	(47)
Exclude exceptional items:		
Withdrawal from large steam power generation (note 3)	16.84	248
Related tax effect	(0.95)	(14)
Earnings per ordinary share before exceptional items	12.70	187

Dilution of the earnings/(loss) per ordinary share figure based upon outstanding share options is not material.

8 EMPLOYEE INFORMATION

	1997 Number	1996 Number
Average weekly number of Group employees during the year		
United Kingdom	31,600	31,500
Overseas	11,000	11,100
	42,600	42,600
Aerospace businesses	26,900	25,100
Industrial businesses	15,700	17,500
	42,600	42,600

	£m	£m
Group employment costs		
Wages and salaries	1,068	1,014
Social security costs	89	92
Pensions and other post-retirement benefits (note 26)	62	56
	1,219	1,162

9 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, 1997	307	1,109	161	53	1,630
Exchange adjustments	—	3	3	—	6
Additions at cost	11	89	20	109	229
On acquisition of businesses	1	1	—	9	11
Reclassifications	7	29	—	(36)	—
Disposals/write-offs	(18)	(143)	(11)	(2)	(174)
At December 31, 1997	308	1,088	173	133	1,702
Accumulated depreciation:					
At January 1, 1997	13	596	59	—	668
Provided during year	10	78	6	—	94
Disposals/write-offs	(7)	(105)	(3)	—	(115)
At December 31, 1997	16	569	62	—	647
Net book value at December 31, 1997	292	519	111	133	1,055
Net book value at December 31, 1996	294	513	102	53	962
Company					
Cost or valuation:					
At January 1, 1997	204	718	—	35	957
Additions at cost	9	63	—	62	134
Reclassifications	4	22	—	(26)	—
Disposals/write-offs	—	(36)	—	—	(36)
At December 31, 1997	217	767	—	71	1,055
Accumulated depreciation:					
At January 1, 1997	—	393	—	—	393
Provided during year	8	54	—	—	62
Disposals/write-offs	—	(33)	—	—	(33)
At December 31, 1997	8	414	—	—	422
Net book value at December 31, 1997	209	353	—	71	633
Net book value at December 31, 1996	204	325	—	35	564

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9 Tangible fixed assets continued

Tangible fixed assets include:	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Net book value of finance leased assets	53	65	37	39
Assets held for use in operating leases:				
Cost	173	161	—	—
Depreciation	(62)	(59)	—	—
Net book value	111	102	—	—
Non-depreciable land	72	72	59	59
Land and buildings at cost or valuation comprise:				
Cost	27	25	13	—
Valuation at December 31, 1985	1	3	—	—
Valuation at December 31, 1996 [1]	280	279	204	204
	308	307	217	204
Land and buildings at net book value comprise:				
Freehold	276	271	201	197
Long leasehold	17	24	9	9
Short leasehold	(1)	(1)	(1)	(2)
	292	294	209	204
On an historical cost basis the net book value of land and buildings would have been as follows:				
Cost	288	286	199	186
Depreciation	(118)	(118)	(97)	(91)
	170	168	102	95
Capital expenditure commitments – contracted but not provided for	60	28	37	19

[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.

10 INVESTMENTS – SUBSIDIARY UNDERTAKINGS

	Shares £m	Loans £m	Total £m
Company			
Cost:			
At January 1, 1997	431	246	677
Additions	6	—	6
At December 31, 1997	437	246	683

The principal subsidiary undertakings are listed on pages 61 and 62.

11 INVESTMENTS – OTHER

	Associated undertakings					
	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Unlisted investments at cost £m	Own shares held under trust [1] £m	Total £m
Group						
At January 1, 1997	49	13	13	10	—	85
Exchange adjustments	—	(5)	—	—	—	(5)
Additions	10	—	3	—	2	15
Share of retained profit	—	7	—	—	—	7
At December 31, 1997	59	15	16	10	2	102
Company						
At January 1, 1997	40	—	4	—	—	44
Additions	5	—	—	—	2	7
At December 31, 1997	45	—	4	—	2	51

The principal associated undertakings are listed on pages 63 and 64.

[1] As described in the 'Report of the remuneration committee', during the year the Company has established a long-term incentive plan for the purpose of providing a share incentive scheme for its executive directors and certain senior executives. The shares in the Company (own shares) are held by an independently managed trustee. At December 31, 1997 685,189 ordinary shares of the Company were held by the trust, with a market value of £1.6m. Dividends have been waived by the trust and the costs of administering the trust have been charged to the profit and loss account. In accordance with UITF* 17 'Employee share schemes', the Company is required to amortise the cost of the likely awards over three years and to include this charge as part of the cost of 'wages and salaries'.

*The UITF (Urgent Issues Task Force) is a committee of the Accounting Standards Board.

Notes to the financial statements

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12 Stocks

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Raw materials	112	82	62	40
Work in progress	514	450	235	239
Long-term contracts work in progress	44	20	—	—
Finished goods	492	417	427	356
Payments on account	28	19	80	33
	1,190	988	804	668
Progress payments received against:				
Long-term contracts work in progress	(25)	(12)	—	—
Other stocks[1]	(206)	(178)	(146)	(146)
	959	798	658	522
[1] Includes payments received from associated undertakings	(37)	(30)	(37)	(19)

13 Debtors – amounts falling due within one year

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Trade debtors	735	670	384	353
Amounts recoverable on contracts	124	127	6	1
Amounts owed by – subsidiary undertakings	—	—	237	148
– associated undertakings	82	122	77	116
Amounts receivable under finance leases	2	15	—	—
Corporate taxation	1	2	—	—
Other debtors	36	40	11	11
Prepayments and accrued income	95	71	62	49
	1,075	1,047	777	678

14 Debtors – amounts falling due after one year

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Trade debtors	48	47	37	24
Amounts owed by – subsidiary undertakings	—	—	53	65
– associated undertakings	8	1	8	1
Amounts receivable under finance leases	8	2	—	—
Advance corporation tax recoverable	32	19	32	19
Other debtors[1]	108	84	94	72
Prepayments and accrued income	55	45	55	44
Prepaid pension contributions	73	64	5	8
	332	262	284	233
Finance leases:				
Rentals receivable during year	17	1	—	—
Assets acquired during year	8	15	—	—

[1] Other debtors include £94m (1996 £72m) in connection with the Company's contribution to the financing of BMW Rolls-Royce GmbH.

15 SHORT-TERM DEPOSITS AND INVESTMENTS

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Short-term deposits	339	518	323	512
Investments – government securities and corporate bonds	29	26	—	—
	368	544	323	512

16 BORROWINGS – AMOUNTS FALLING DUE WITHIN ONE YEAR

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Overdrafts	53	12	30	3
Bank loans	92	68	92	50
Notes	150	—	150	—
Obligations under finance leases	7	8	2	3
	302	88	274	56

17 OTHER CREDITORS – AMOUNTS FALLING DUE WITHIN ONE YEAR

	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Payments received on account [1]	246	186	154	134
Trade creditors	542	592	331	360
Amounts owed to – subsidiary undertakings	—	—	378	368
– associated undertakings	103	85	103	85
Corporate taxation	84	56	52	26
Other taxation and social security	38	35	19	14
Other creditors	443	425	332	244
Accruals and deferred income	354	114	227	74
Interim dividend since paid	33	29	33	29
Final proposed dividend	55	49	55	49
	1,898	1,571	1,684	1,383
[1] Includes payments received from associated undertakings	66	65	66	64

continued

18 BORROWINGS – AMOUNTS FALLING DUE AFTER ONE YEAR

	Group		Company	
	1997 £m	1996 £m	1997 £m	1996 £m
Unsecured				
11⅝% Notes 1998 [1]	—	150	—	150
7⅛% Notes 2003 [1,2]	199	198	—	—
Other loans 1999-2008 (interest rates nil)	9	8	—	—
Obligations under finance leases payable:				
Between one and two years	7	8	2	3
Between two and five years	28	22	17	6
After five years	6	17	5	16
	249	403	24	175
Repayable				
Between one and two years – by instalments	8	8	2	3
– otherwise	—	150	—	150
Between two and five years – by instalments	31	24	17	6
– otherwise	—	—	—	—
After five years – by instalments	11	23	5	16
– otherwise	199	198	—	—
	249	403	24	175

[1] 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 Company at variable rates of interest.
[2] 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.

19 OTHER CREDITORS – AMOUNTS FALLING DUE AFTER ONE YEAR

	Group		Company	
	1997 £m	1996 £m	1997 £m	1996 £m
Payments received on account [1]	34	13	34	13
Amount owed to subsidiary undertaking	—	—	198	198
Other creditors	24	31	7	13
Accruals and deferred income	26	40	24	39
	84	84	263	263
[1] Includes payments received from associated undertakings	5	—	5	—

20 PROVISIONS FOR LIABILITIES AND CHARGES

	Pensions and other post-retirement benefits £m	Deferred taxation £m	Discontinued operations £m	Other £m	Total £m
Group					
At January 1, 1997	60	10	69	319	458
Exchange adjustments	2	—	—	5	7
On acquisition of businesses	—	—	—	4	4
On disposals of businesses	—	—	—	(7)	(7)
Net charge to profit and loss account	19	4	—	107	130
Utilised	(3)	—	(49)	(133)	(185)
At December 31, 1997	78	14	20	295	407
Company					
At January 1, 1997	—	—	—	92	92
Net charge to profit and loss account	—	—	—	57	57
Utilised	—	—	—	(35)	(35)
At December 31, 1997	—	—	—	114	114

Other provisions include, principally, warranty relating to sales up to the year end, estimated future losses on current contracts and problems arising from customer weakness.

Deferred taxation	Group 1997 £m	Group 1996 £m	Company 1997 £m	Company 1996 £m
Provided in accounts:				
Fixed asset timing differences	9	9	—	—
Other timing differences	8	4	—	—
Advance corporation tax	(3)	(3)	—	—
	14	10	—	—
Full potential (asset)/liability:				
Fixed asset timing differences	103	102	78	74
Other timing differences	(25)	(48)	(30)	(35)
Trading losses	(3)	(2)	—	—
	75	52	48	39
Advance corporation tax	(150)	(170)	(131)	(151)
	(75)	(118)	(83)	(112)

Notes to the financial statements

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21 SHARE CAPITAL

	Non-equity special share of £1	Equity ordinary shares of 20p each	Nominal value £m
Authorised			
At January 1 and December 31, 1997	1	2,000,000,000	400
Issued and fully paid			
At January 1, 1997	1	1,475,671,585	295
Exercise of share options	—	2,536,272	1
In lieu of paying dividends in cash	—	1,816,905	—
At December 31, 1997	1	1,480,024,762	296

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, 1997 the following ordinary shares were subject to options:

	Date of grant	Number	Exercise price	Exercisable dates
Executive share option scheme	1988	19,243	*109p*	*1998*
	1989	41,170	*182p*	*1998-1999*
	1990	734,340	*172p*	*1998-2000*
	1991	475,218	*139p*	*1998-2001*
	1992	640,620	*125p*	*1998-2002*
	1995	3,431,750	*176p*	*1998-2005*
	1996	126,000	*238p*	*1999-2006*
Sharesave schemes	1990	3,741,289	*145p*	*1998*
	1992	14,284,584	*106p*	*1998/2000*
	1995	17,475,076	*150p*	*2001/2003*
	1997	21,540,443	*205p*	*2001/03/05*

Under the terms of the executive share option scheme, options granted to 92 directors and senior executives were outstanding at December 31, 1997.

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.

22 Reserves

	Share premium £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m
	Non-distributable			
Group				
At January 1, 1997	519	125	54	310
Exchange adjustments	—	—	—	(4)
Scrip dividend adjustment	—	—	—	4
Goodwill written off on acquisitions	—	—	(3)	—
Write-back of purchased goodwill relating to disposals	—	—	3	—
Arising on share issues	3	—	—	—
Transfers between reserves	—	(4)	17	(13)
Profit for the year	—	—	—	136
At December 31, 1997	522	121	71	433
Company				
At January 1, 1997	519	109	167	318
Scrip dividend adjustment	—	—	—	4
Arising on share issues	3	—	—	—
Transfers between reserves	—	(2)	17	(15)
Profit for the year	—	—	—	79
At December 31, 1997	522	107	184	386

The cumulative amount of goodwill, arising on the acquisition of undertakings still in the Group at December 31, 1997, written off against other reserves amounts to £514m (1996 £514m).

The undistributed profits of overseas subsidiary and associated undertakings may be liable to overseas taxes and/or United Kingdom tax (after allowing for double tax relief) if remitted as dividends to the UK.

The Company has paid £17m to a qualifying share ownership trust (QUEST), which will be utilised on the exercise of share options under the Company's share option schemes. The consequent transfer from distributable to non-distributable reserves is reflected in the reserves table above.

23 Operating lease annual commitments

	Group		Company	
	1997 £m	1996 £m	1997 £m	1996 £m
Leases of land and buildings which expire:				
Within one year	4	2	1	1
Between one and five years	6	4	1	—
After five years	2	3	2	2
Other leases which expire:				
Within one year	5	2	1	—
Between one and five years	7	7	5	3
After five years	6	6	—	—

Notes to the financial statements

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24 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, 1997 having regard to the estimated net realisable value of the relevant security the net contingent liabilities in respect of financing arrangements on all delivered aircraft amounted to **£68m** (1996 £84m). Sensitivity calculations are complex, but, for example, if the value of the relevant security was reduced by 20%, a net contingent liability of approximately **£156m** 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 engine 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. 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.

The Group and Company enter into forward exchange and swap transactions, including interest rate swaps, to improve the achieved rate and limiting exposure to exchange rate movements in the medium and long-term.

In addition to the guarantee referred to in note 18, there are other Company guarantees in respect of financial obligations of subsidiary undertakings **£13m** (1996 £14m) and associated undertakings **£34m** (1996 £37m).

25 RELATED PARTY TRANSACTIONS

Associated undertakings

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

	1997 £m	1996 £m
Sales of goods to	633	458
Purchases of goods from	(339)	(286)
Rendering of services to	16	25
Receipt of services from	(13)	(14)
Transfer of research and development to	46	75
Contribution to the financing of	(43)	(59)

26 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 the advice of independent qualified actuaries using the projected unit method. The latest actuarial valuations of the principal schemes were as at April 5, 1995 (for NEI) and March 31, 1997 (for Rolls-Royce). The principal assumptions used were that in the long-term the average return on investments would be between 1.5% and 2.5% per annum higher than the average increase in pay and between 4.5% and 5.5% per annum higher than the average increase in pensions. Assets have been valued using the discounted income method assuming that UK equity dividends increase at a rate of between 4.75% and 5.1% per annum less than the return on investments.

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 **£50m** (1996 £46m) of which **£7m** (1996 £7m) relates to the overseas schemes.

The aggregate of the market values of the UK schemes at the dates of the latest actuarial valuations was **£3,069m**. The actuarial value of the assets of the principal schemes represented respectively 131% (for NEI) and 94.4% (for Rolls-Royce) 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 as a percentage of scheme earnings over periods of between eight and 13 years, being the average remaining service lives of the pensionable employees.

Prepayments of **£73m** (1996 £64m) are included in debtors and accruals of **£15m** (1996 £9m) 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 76 retired employees currently benefit from these provisions and it is estimated that 3,200 current employees will be eligible on retirement.

The cost of post-retirement benefits other than pensions for the Group was **£12m** (1996 £10m). Provisions for the benefit obligations at December 31, 1997 amounted to **£63m** (1996 £51m) and are included in provisions for liabilities and charges. There were no plan assets at either December 31, 1997 or December 31, 1996. 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 8.3% reducing to 5% per annum by the year 2007.

Notes to the financial statements

continued

27 ACQUISITIONS

On June 17, 1997 the Group purchased the net assets of Gear Systems Inc. (a USA aerospace business).

	1997 £m
Tangible fixed assets	2
Stocks	5
Debtors	3
Creditors	(3)
Provisions	(4)
	3
Goodwill written off to reserves	—
Cash consideration in 1997	3

On August 25, 1997 the Group acquired, for £1m, the 50% of Orca Energy, Inc. which it did not already own. At the date of acquisition the share of net assets acquired was £nil (being fixed assets of £9m less debt due to the Group of £9m) giving rise to goodwill of £1m, which has been written off to reserves.

The results of these businesses are not separately disclosed because they are not material to the Group's results.

Additionally the Group has redeemed the 'non-equity minority interest' preference shares of its subsidiary undertaking Rolls-Royce Power Engineering plc. The cash consideration of £4m exceeded the book value by £1m, which has been written off to reserves.

During 1996 the Group acquired Caillard SA (a French crane company) and included provisional fair valuations of its net liabilities in the 1996 Group financial statements. In 1997 the provisional net liabilities have been increased by £1m and the corresponding increase in purchased goodwill has been incorporated in the 1997 Group financial statements. This practice is in accordance with Financial Reporting Standard 7 'Fair values in acquisition accounting'.

28 DISPOSALS OF BUSINESSES

During the year the Group has disposed of Bristol Aerospace Limited (Canada), Kennicott Water Systems, Parsons (excepting some major turnkey contracts) and International Combustion's service business.

	Continuing operations £m	Discontinued operations £m	1997 £m
Tangible fixed assets	14	34	48
Stocks	13	8	21
Debtors	10	29	39
Creditors	(7)	(19)	(26)
Bank overdraft [1]	(3)	—	(3)
Loan	(2)	—	(2)
Provisions	—	(7)	(7)
	25	45	70
Write-back of purchased goodwill	—	3	3
Profit/(loss) on disposals	1	(9)	(8)
Cash consideration in 1997 [1]	26	39	65
[1] Net inflow of cash – Group cash flow statement			68

In accordance with Financial Reporting Standard 3 'Reporting financial performance', immaterial disposals cannot be classified as discontinued operations.

Principal subsidiary undertakings

AT DECEMBER 31, 1997

REGISTERED IN ENGLAND

Aerospace businesses	
Rolls E.L. Turbofans Limited	– FJ44 engine support services/holding company
Rolls-Royce Aero Engine Services Limited [1]	– Repair and overhaul
Rolls-Royce Commercial Aero Engines Limited [1]	– Sale and support of aero gas turbine engines and parts
Rolls-Royce Military Aero Engines Limited [1]	– Sale and support of aero gas turbine engines and parts
Sawley Packaging Company Limited	– Specialised packaging
Industrial businesses	
Allen Power Engineering Limited [2]	– Diesel engines, small steam turbines and valves
Clarke Chapman Limited [2]	– Cranes and mechanical handling equipment
Cochran Boilers Limited [2]	– Shell boilers
Derby Specialist Fabrications Limited [2]	– High integrity pressure vessels and fabrications
Exeter Power Limited [3]	– Development, construction and ownership of power plant
Heartlands Power Limited [3]	– Development, construction and ownership of power plant
NEI Overseas Holdings Limited [4]	– Holding company
Peebles Electric Limited [2]	– Transformers and electric motors
Reyrolle Limited [2]	– Electrical switchgear and protection equipment
Reyrolle Projects Limited [2]	– Electrical transmission and distribution project management
Rolls-Royce and Associates Limited	– Nuclear submarine propulsion systems
Rolls-Royce Industrial & Marine Gas Turbines Limited [1]	– Aero-derived gas turbines
Rolls-Royce Industrial & Marine Power Limited [4]	– Management company
Rolls-Royce Industrial Power (India) Limited [4]	– Power station construction
Rolls-Royce Industrial Power (Overseas Projects) Limited [4]	– Project management of engineering contracts
Rolls-Royce Industrial Power Systems Limited [1]	– Aero-derived power generation
Rolls-Royce Materials Handling Limited [4]	– Management company
Rolls-Royce Nuclear Engineering Limited [5]	– Management company
Rolls-Royce Nuclear Engineering Services Limited [2]	– Refurbishment and modification of nuclear power plant
Rolls-Royce Power Engineering plc	– Holding company
Rolls-Royce Transmission & Distribution Limited [4]	– Management company
R-R Industrial Controls Limited [2]	– Control systems for power stations and industrial applications
Corporate	
Middle East Equity Partners Limited	– Holding company
Rolls-Royce & Partners Finance Limited	– Financial services
Rolls-Royce Capital Limited [1]	– Sales finance and other financial services
Rolls-Royce International Limited	– Support and commercial information services in Australia, Belgium, Brazil, China, Czech Republic, Dubai, France, Germany, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Pakistan, Saudi Arabia, Singapore, South Africa, Thailand and Turkey
Rolls-Royce Leasing Limited	– Leasing of engines
Rolls-Royce Overseas Holdings Limited	– Holding company
Rolls-Royce Power Ventures Limited	– Provision of project development capabilities
RRPF Engine Leasing Limited [6]	– Leasing of engines
RRPF Engine Leasing (No. 2) Limited [6]	– Leasing of engines
Sourcerer Limited [1]	– Supply of goods, services and utilities to the engineering sector

[1] These subsidiaries act as agents of Rolls-Royce plc.
[2] The interests are held by Rolls-Royce Power Engineering plc and these companies act as agents of that company.
[3] The interests are held by Rolls-Royce Power Ventures Limited.
[4] The interests are held by Rolls-Royce Power Engineering plc.
[5] This subsidiary acts as agent of Rolls-Royce Power Engineering plc.
[6] The interests are held by Rolls-Royce & Partners Finance Limited.

Except where otherwise stated, the above companies operate principally in Great Britain and the effective Group interest is 100%.

Principal subsidiary undertakings

continued

INCORPORATED OVERSEAS

Aerospace businesses		
Brazil	Motores Rolls-Royce Limitada	– Repair and overhaul
France	Rolls-Royce Technical Support SARL[1]	– Project support
USA	Allison Engine Company, Inc.[2]	– Manufacture, sale and support of gas turbine engines
	Gear Systems Inc.[2]	– Design and manufacture of accessory gearbox systems
Industrial businesses		
Australia	Rolls-Royce Industrial Power (Pacific) Limited[3]	– Electrical, mechanical and construction engineering
Canada	Ferranti-Packard Transformers Limited[4]	– Power transformers
	Rolls-Royce Canada Limited[4]	– Industrial gas turbines and aero engine sales, service and overhaul
	Rolls-Royce Gas Turbine Engines (Canada) Inc.[4]	– Industrial gas turbines
	Rolls-Royce Holdings Canada Inc.	– Holding company
	Rolls-Royce Industries Canada Inc.[5]	– Holding company
China	Fushun & Reyrolle Bushing Co Limited (50.4%)[6]	– Manufacture of electrical bushings
France	Caillard SA[3]	– Cranes and plant handling equipment
Mexico	Ferranti-Packard de Mexico SA De CV[7]	– Power transformers
New Zealand	Rolls-Royce Industrial Power (New Zealand) Limited[8]	– Electrical switchgear and industrial engineering
Philippines	Orca Energy, Inc.[9]	– Development, construction and ownership of power plant
South Africa	NEI Africa Holdings Limited (60.44%)[3]	– Holding company
	Northern Engineering Industries Africa Limited (55.93%)[10]	– Energy conversion and distribution equipment
	(The effective interest in South African companies is 34.99%)	
USA	Rolls-Royce Industrial & Marine Power Inc.[2]	– Production of packaged power generation sets
	Syncrolift Inc.[2]	– Shiplift systems
Zambia	Cutler Hammer Zambia Limited[3]	– Low voltage motor control equipment
	NEI Zambia Limited[3]	– Diesel engines, distribution switchgear
Zimbabwe	NEI Holdings Zimbabwe (Private) Limited[3]	– Boilers, distribution switchgear
Corporate		
Guernsey	Nightingale Insurance Limited[1]	– Insurance services
Netherlands	Rolls-Royce & Partners Finance (Netherlands) BV[11]	– Holding company
Saudi Arabia	Rolls-Royce International Turbines (Saudi Arabia) Limited (51%)	– Operation and maintenance of electrical generating plant
USA	Rolls-Royce North America Inc.[1]	– Holding company for US operations
	Rolls-Royce Inc.[2]	– Engineering research, marketing and support
	Rolls-Royce Capital Inc.[2]	– Financial services

[1] The interests are held by Rolls-Royce Overseas Holdings Limited.
[2] The interests are held by Rolls-Royce North America Inc.
[3] The interests are held by NEI Overseas Holdings Limited.
[4] The interests are held by Rolls-Royce Industries Canada Inc.
[5] The interests are held by Rolls-Royce Holdings Canada Inc.
[6] The interest is held by Rolls-Royce Power Engineering plc.
[7] The interest is held as follows: 37% by Rolls-Royce Industries Canada Inc., 63% by NEI Overseas Holdings Limited.
[8] The interest is held by Rolls-Royce Industrial Power (Pacific) Limited.
[9] The interest is held by Rolls-Royce Power Ventures Limited.
[10] The interest is held as follows: 52.93% by NEI Africa Holdings Limited, 3% by NEI Overseas Holdings Limited.
[11] The interest is held by Rolls-Royce & Partners Finance Limited.

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

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

Principal associated undertakings

AT DECEMBER 31, 1997

REGISTERED IN ENGLAND (OR SCOTLAND*)	Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Aerospace businesses			
Rolls-Royce Turbomeca Limited (England & France)	A Shares	—	50
– Adour and RTM 322 engines collaboration	B Shares	100	
Rolls Smiths Engine Controls Limited [1]	A Ordinary	—	50
– Digital engine controls	B Ordinary	100	
Turbo-Union Limited (England, Germany & Italy)	Ordinary	40	40
– RB199 engine collaboration	A Shares	37.5	
Industrial businesses			
Clarke Chapman Portia Port Services Limited [2]	A Ordinary	—	50
– Port development and port management	B Ordinary	100	
Cooper Rolls Limited [3]	Ordinary	50	50
– Sale and marketing of mechanical drive units			
Derby Cogeneration Limited [4]	Ordinary	50	50
– Development, construction and ownership of power plant			
Rolls Laval Heat Exchangers Limited	A Ordinary	100	50
– Design, development and manufacture of heat exchangers	B Ordinary	—	
Rolls Wood Group (Repair & Overhauls) Limited*	A Ordinary	100	50
– Repair and overhaul	B Ordinary	—	
Viking Power Limited [4]	Ordinary	50	50
– Development, construction and ownership of power plant			

INCORPORATED OVERSEAS	Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Aerospace businesses			
China			
Xian XR Aero Components Co Limited	Ordinary	49	49
– Manufacturing facility for aero engine parts			
Germany			
BMW Rolls-Royce GmbH (England & Germany)	Ordinary	49.5	49.5
– BR700 series engine development			
EUROJET Turbo GmbH (England, Germany, Italy & Spain)	Ordinary	33	33
– EJ200 engine collaboration			
MTU, Turbomeca, Rolls-Royce GmbH (England, France & Germany)	Ordinary	33.3	33.3
– MTR 390 engine collaboration			
Hong Kong			
Hong Kong Aero Engine Services Limited [5]	Ordinary	50	50
– Overhaul facility for Rolls-Royce aero engines			
Singapore			
International Engine Component Overhaul Pte Limited	Common	50	50
– Repair and overhaul of engine components			
Spain			
Industria de Turbo Propulsores SA	Ordinary	45	45
– Manufacture and maintenance of aero engines			
Switzerland			
IAE International Aero Engines AG (England, Germany, Japan & USA)	A Shares	100	32.45
– V2500 series engine collaboration	B Shares	—	
	C Shares	—	
	D Shares	—	
USA			
Williams-Rolls Inc.[6] (Europe & North America)	Common	15	15
– FJ44 engine collaboration			

Principal associated undertakings

continued

INCORPORATED OVERSEAS CONTINUED	Class	% of class held by Rolls-Royce plc	% of total equity held by Rolls-Royce plc
Industrial businesses			
Canada			
Cooper, Rolls Corporation [7] – Sale and marketing of mechanical drive units	Common	50	50
India			
Belliss India Limited [8] – Manufacture of steam turbines	Ordinary	40	40
Easun Reyrolle Limited [2] – Protection systems, power supplies and relays	Ordinary	25	25
Malaysia			
EPE Reyrolle (Malaysia) Sdn Bhd [5] – Manufacture of electrical switchgear	Ordinary	50	50
USA			
Cooper Rolls Incorporated (Europe & North America) – Sale and marketing of mechanical drive units	Common	50	50
Corporate			
Cayman Islands			
Sama Leasing Company Limited [9] – Aircraft leasing	A Ordinary B Ordinary	— 100	50
Jersey			
RS Leasing Limited [10] – Aircraft leasing	A Ordinary B Ordinary	100 —	50
Netherlands			
Aircraft Financing and Trading Holdings BV [11] – Financial services	Ordinary	50	50
Saudi Arabia			
Middle East Propulsion Company Limited [12] – Repair and overhaul	Ordinary	16.6	16.6
USA			
R-H Component Technologies, L.C. [13] – Component refurbishment	Ordinary	50	50

UNINCORPORATED OVERSEAS

Aerospace businesses

USA

Allison Engine Company, Inc. has a 50% interest in an unincorporated partnership, Light Helicopter Turbine Engine Company (LHTEC), formed to jointly develop and market the T800 engine.

[1] The interest is held by Rolls-Royce Engine Controls Limited.
[2] The interests are held by Rolls-Royce Power Engineering plc.
[3] The interest is held by Cooper Rolls Incorporated.
[4] The interests are held by Rolls-Royce Power Ventures Limited
[5] The interests are held by Rolls-Royce Overseas Holdings Limited.
[6] The interest is held by Rolls E.L. Turbofans Limited.
[7] The interest is held by Rolls-Royce Industries Canada Inc.
[8] The interest is held by Allen Power Holdings Limited.
[9] The interest is held by Rolls-Royce & Partners Finance Limited.
[10] The interest is held by Rolls-Royce Leasing Limited.
[11] The interest is held by Rolls-Royce & Partners Finance (Netherlands) BV.
[12] The interest is held by Middle East Equity Partners Limited.
[13] The interest is held by Rolls-Royce Inc.

The countries of principal operations, if other than the country of registration, are stated in brackets after the name of the company.

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 auditors to the members of Rolls-Royce plc

KPMG

We have audited the financial statements on pages 38 to 64. We have also examined the amounts disclosed relating to emoluments, share options, long-term incentive scheme interests and directors' pension entitlements which form part of the remuneration committee report on page 31.

Respective responsibilities of directors and auditors

As described above, the Company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of 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, 1997 and of the profit for the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc
Chartered Accountants, Registered Auditor

KPMG Audit Plc

London
March 4, 1998

Group five year review

FOR THE YEARS ENDED DECEMBER 31

Profit and loss account	1997 £m	1996 £m	1995 £m	1994 £m	1993 £m
Turnover [1]	4,334	3,902	3,226	2,781	3,162
Trading profit [2]	479	418	352	309	329
Operating exceptional items	—	(101)	—	—	—
Research and development (net)*	(216)	(199)	(206)	(218)	(253)
Share of profits of associated undertakings	13	8	9	9	12
Operating profit/(loss) [1]	276	126	155	100	88
Non-operating exceptional/other items	1	(147)	32	—	—
Net interest (payable)/receivable	(1)	(7)	(12)	1	(12)
Profit/(loss) on ordinary activities before taxation	276	(28)	175	101	76
Taxation	(51)	(16)	(31)	(20)	(18)
Profit/(loss) on ordinary activities after taxation	225	(44)	144	81	58
Equity minority interests in subsidiary undertakings	(1)	(3)	(2)	—	5
Profit/(loss) attributable to ordinary shareholders	224	(47)	142	81	63
Dividends	(88)	(78)	(73)	(61)	(56)
Transferred to/(from) reserves	136	(125)	69	20	7
*Research and development (gross)	(595)	(527)	(492)	(452)	(451)
[1] **Turnover**					
Continuing operations	4,216	3,656	2,971	2,538	2,964
Discontinued operations	118	246	255	243	198
[1] **Operating profit/(loss)**					
Continuing operations	276	242	178	117	97
Discontinued operations	—	(116)	(23)	(17)	(9)
Earnings/(loss) per ordinary share					
Net basis	15.16p	(3.19)p	10.25p	6.56p	5.90p
Net basis before exceptional items	15.16p	12.70p	7.94p	6.56p	5.90p
Dividends per ordinary share	5.90p	5.30p	5.00p	5.00p	5.00p

[2] Trading profit represents gross profit less commercial, marketing, product support, general and administration costs but is stated before operating exceptional items.

The turnover figures for 1993 to 1996 have been restated to reflect the amended accounting policy for sales discounts adopted for 1997.

Balance sheet

	1997 £m	1996 £m	1995 £m	1994 £m	1993 £m
Fixed assets	1,157	1,047	1,037	907	950
Current assets	3,245	2,882	2,618	2,195	2,392
	4,402	3,929	3,655	3,102	3,342
Liabilities and provisions	(2,940)	(2,604)	(2,295)	(1,847)	(2,107)
	1,462	1,325	1,360	1,255	1,235
Share capital	296	295	292	245	244
Reserves	1,147	1,008	1,053	997	981
Equity shareholders' funds	1,443	1,303	1,345	1,242	1,225
Minority interests in subsidiary undertakings	19	22	15	13	10
	1,462	1,325	1,360	1,255	1,235

Cash flow

	1997 £m	1996 £m	1995 £m	1994 £m	1993 £m
Cash inflow from operating activities	308	166	114	11	275
Interest, dividends and taxation	(110)	(100)	(87)	(66)	(79)
Capital expenditure and financial investment	(203)	(96)	19	(81)	(114)
Acquisitions and disposals	42	(21)	(180)	18	18
	37	(51)	(134)	(118)	100
Cash inflow/(outflow) from financing	23	71	194	(69)	341
Increase/(decrease) in cash and liquid resources	60	20	60	(187)	441

Shareholders' information

FINANCIAL CALENDAR

Ex dividend date for final dividend	April 27, 1998
Calculation period for scrip dividend	April 27-May 1, 1998
Qualifying (record) date for final dividend	May 1, 1998
Last date for new scrip dividend instructions	May 27, 1998
Annual General Meeting, The Queen Elizabeth II Conference Centre, Broad Sanctuary, London SW1, 11.00am	May 28, 1998
Payment of final/scrip dividend	July 6, 1998
Press advertisement of 1998 interim results*	August 28, 1998
Ex dividend date for interim dividend	October 26, 1998
Calculation period for scrip dividend	October 26-30, 1998
Qualifying (record) date for interim dividend	October 30, 1998
Last date for new scrip dividend instructions	November 25, 1998
Financial year end	December 31, 1998
Payment of interim/scrip dividend	January 11, 1999
Press advertisement of 1998 preliminary results*	March, 1999
1998 Annual Report published	April, 1999

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

ANALYSIS OF ORDINARY SHAREHOLDERS AT DECEMBER 31, 1997

Size of holding	Number of holdings	% of total holdings	% of total shares
1 – 150	133,240	37.41	1.21
151 – 500	189,151	53.12	3.14
501 – 10,000	32,020	8.99	3.51
10,001 – 100,000	931	0.26	2.10
100,001 – 1,000,000	553	0.16	13.08
1,000,001 and over	212	0.06	76.96
	356,107	100.00	100.00

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.

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 about your shareholding, please write to or telephone the Registrar at the following address:

Computershare Services PLC
PO Box 82
Caxton House
Redcliffe Way
Bristol BS99 7NH
Telephone: 0117 930 6600

The Royal Bank of Scotland transfered its registration business to Computershare Services PLC on March 12, 1998.

Details of special low cost dealing services in the Company's shares may be obtained from Hoare Govett Corporate Finance Limited (telephone 0171 601 0101) and from NatWest Stockbrokers Limited (telephone 0171 895 5489). Both are members of the Securities and Futures Authority and NatWest Stockbrokers Limited is a member of the London Stock Exchange.

You can obtain the current market price of the Company's shares by telephoning 0839 500 232 (currently charged at 11p per call) or alternatively by viewing teletext and similar services.

Rolls-Royce®

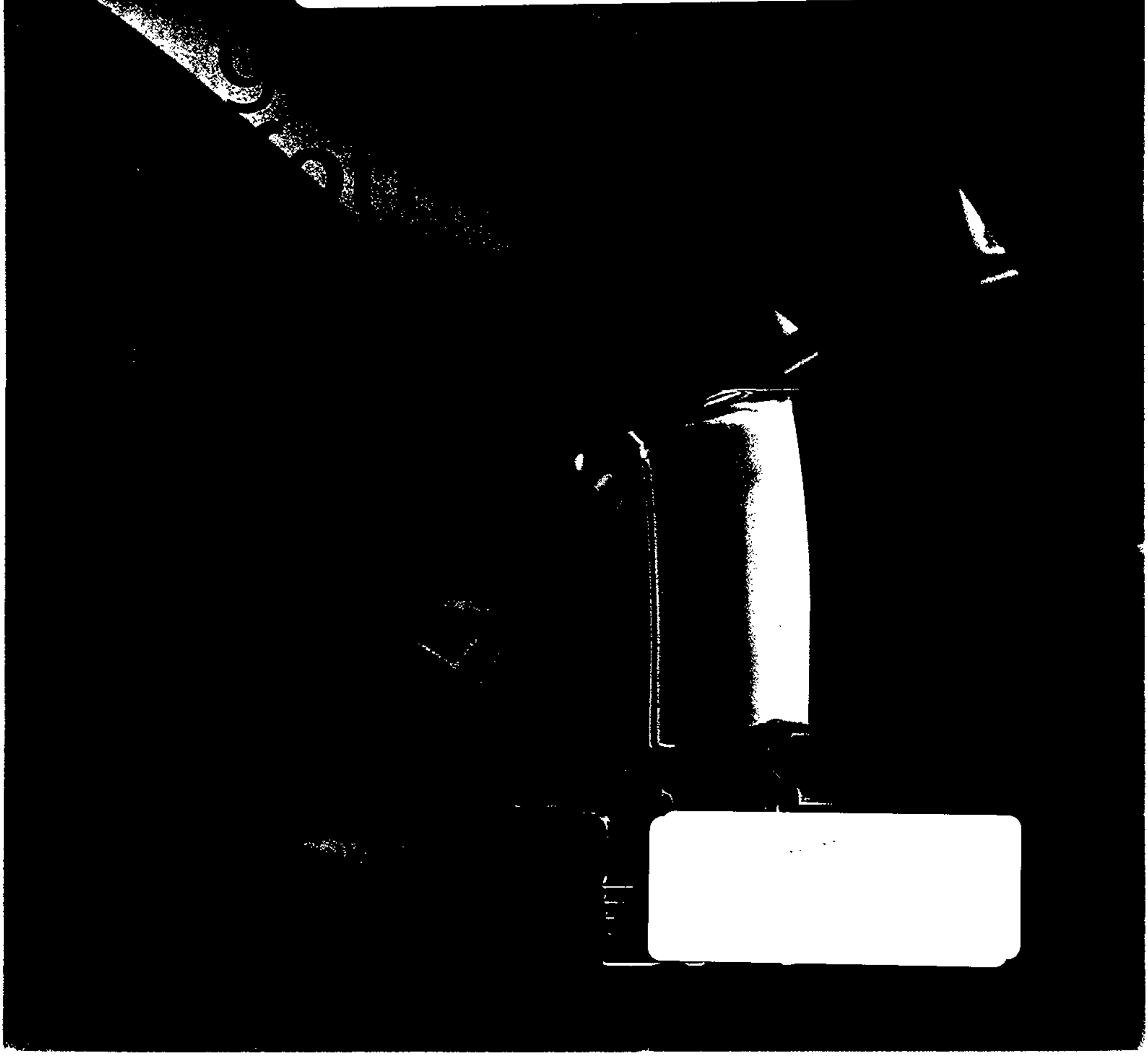
Rolls-Royce plc
65 Buckingham Gate
London SW1E 6AT

www.rolls-royce.com

Rolls-Royce

Annual Review and Summary Financial Statement 1997

COMPANY NUMBER
1003142



Group financial highlights

FOR THE YEAR ENDED DECEMBER 31, 1997

		1996 £m
Turnover	4,334	3,902
Research and development (net)	(216)	(199)
Profit before exceptional items and taxation	276	220
Exceptional and non-operating items	—	(248)
Profit/(loss) before taxation	276	(28)
Profit/(loss) attributable to ordinary shareholders	224	(47)
Equity shareholders' funds	1,443	1,303
Earnings/(loss) per ordinary share		
– net basis	15.16p	(3.19)p
– net basis before exceptional items	15.16p	12.70p
Dividend per ordinary share	5.90p	5.30p

Contents

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Registered office:

65 Buckingham Gate

London SW1E 6AT

Telephone: 0171 222 9020

Company number: 1003142

Rolls-Royce

Corporate profile:

Our objective is to deliver shareholder value through a strategy of continuously improving our performance, investing to secure leading positions in growth markets and becoming the most efficient supplier to the industry.

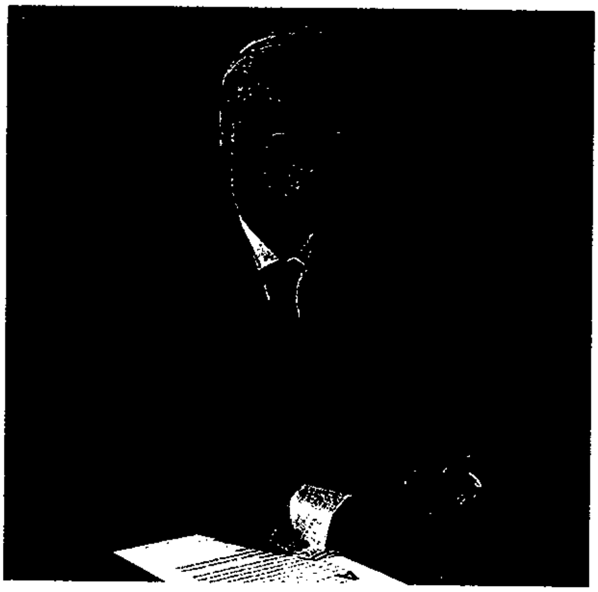
Rolls-Royce is one of the world's foremost engineering companies, supplying aero engines and power systems to customers in international markets. The Group is focused upon understanding the individual needs of customers to ensure we deliver the best products and services.

By providing customers with solutions that encompass the Rolls-Royce core values of reliability, integrity and innovation, the Group will be successful in growing its position in chosen markets and be recognised by customers as 'Trusted to deliver excellence'.

The market sectors served by our customer facing businesses are: airlines, corporate operators and regional airlines, helicopter, military, power generation, marine power, oil and gas, electrical transmission and distribution and materials handling.

With world-class people, products and services we are well placed to build on our success in these markets.

Building on success



Chairman of Rolls-Royce plc Sir Ralph Robins

We intend to demonstrate to our customers that we are the most efficient and responsive in our industry.

ROLLS-ROYCE ESTABLISHED a firm platform for better business performance and growing profitability in 1997.

We achieved record profits and sales and our best ever share of the commercial aero-engine market. At the same time we continued to manage the business efficiently, resulting in a strong balance sheet and further improvements in sales per employee and return on capital employed.

This success has been built upon the strong foundations of our core gas turbine technology and the pursuit of consistent strategies over a number of years to establish leading positions in growth markets.

We substantially completed the withdrawal from the large steam power generation business during the year, within the provisions established in 1996. As a result, more than 90 per cent of all of our business activities are built around our gas turbine products.

Aerospace activities have dominated the growth of the Group. We won a 34 per cent share of the available world market for civil turbofans and more than 80 per cent of the market for new large twin-engined aircraft, where the Trent has established a strong position. We see more than half the future civil engine market requiring engines of this size.

Our strategy to offer a broad and competitive product range has led to new developments across the whole of the range – from the excellent order intake of the AE3007, which has established a strong position in the emerging 50-seat regional jet market, the confirmation of the BR715 as sole powerplant on the Boeing 717 and the choice of the Trent 500 to power the Airbus Industrie A340-500 and 600.

In the defence sector we continue to see a stable future. In particular, the commitment of the European partner governments to the production programme for the Eurofighter 2000 was an important step, paving the way for production of 1,500 engines. In addition, we anticipate that there will be opportunities to export the EJ200 engine to other countries.

We are also well placed in the next major international military programme, the United States' Joint Strike Fighter, which takes us into the heavy combat sector for the first time.

The restructuring of the industrial businesses continues. In addition to the sale of the large steam power generation businesses, we made a number of smaller disposals, aimed at improving the focus of the Group on those businesses which can develop strong and profitable positions in growing markets.

Through a company-wide initiative, 'Better Performance *Faster*', we are developing improved ways of working so that we obtain maximum value from our investment in systems, plant and equipment. Our objective is to ensure that we are the most efficient producer in our target market sectors.

Clearly, our people are crucial to our success and we continue to invest heavily in education and training at all levels. We have enhanced the element of performance related pay for all employees. While our demanding targets mean that not everybody will benefit directly, the majority of employees will do so for the second successive year.

I would like to take this opportunity to thank all our workforce for their personal contributions to our success and congratulate Jerry Lewis who received an OBE in the Birthday Honours and Alan Westaway who received an MBE in the New Year's Honours List.

I would particularly like to thank Harold Mourgue and John Sandford, who, on their retirement from the Board, will have completed 12 years and eight years service respectively. I welcome to the Board Jim Guyette, who is responsible for Rolls-Royce in North America.

Prospects

We are confident of our continuing success. There has been much speculation about the economic problems in Asia and the possible impact upon the aerospace industry. We have built a robust business which is not over-dependent upon any sector or any single economy: therefore we do not expect significant adverse impact, other than a slowdown in the rate of new orders from Asia. The strength of our business in other sectors, particularly the recent growth of order intake in North America and Europe will allow us to offset any effect of such a slowdown.

Furthermore, our success in gaining market share in Asia will be profoundly important in the long-term as we believe that this area will continue to be one of the most important growth sectors over the next 20 years.

We described last November how our growing market share has led to a change in the mix of aero engine sales, with a higher proportion of new engine deliveries leading to a dilution of trading margins. We expect this trend to continue as we further increase market share and exploit new opportunities. Each new engine delivered develops a future embedded value in the form of profitable aftermarket business.

We are confident that our continued investment in new products and capability will create enhanced value for our shareholders. Based upon our current industry projections we are targeting to achieve annual double-digit earnings growth.

Dividend

Your Board has recommended a final dividend payment of 3.70p per share, making a total for the year of 5.90p, an increase of 11 per cent on 1996, reflecting its confidence in the long-term prospects of the Group.

Ralph Robins

Sir Ralph Robins, Chairman, March 4, 1998

Better all-round performance

Chief Executive John Rose

Using our products and expertise to help our customers operate more efficiently and cost-effectively is the best way of meeting the needs and expectations of our shareholders and employees.

OUR PROGRESS IN 1997 REPRESENTS another important stage in the Group's development.

We have always prided ourselves on the technical excellence that has earned us a place among the top three aero-engine manufacturers in the world. In recent years we have built on this reputation by turning ourselves from a British company with overseas operations into one that is truly global.

At the same time, we have made our products available to more customers by broadening our engine portfolio. Our core business is the gas turbine and our strength in this technology generates more than 90 per cent of our business in the growing markets for civil and military aero engines, power generation, oil and gas power systems and marine power.

Today we power more types of civil aircraft than any other manufacturer (32 in all, from helicopters and business jets to the largest airliners) and offer the widest range of military engines.

Technical quality, global reach and a wide portfolio have all contributed to our strong sales and rising market share. Our success in winning new orders has resulted in a 50 per cent increase in manufacturing output during 1997 and our engineering productivity has increased by 17 per cent over the last two years.

A step change in performance

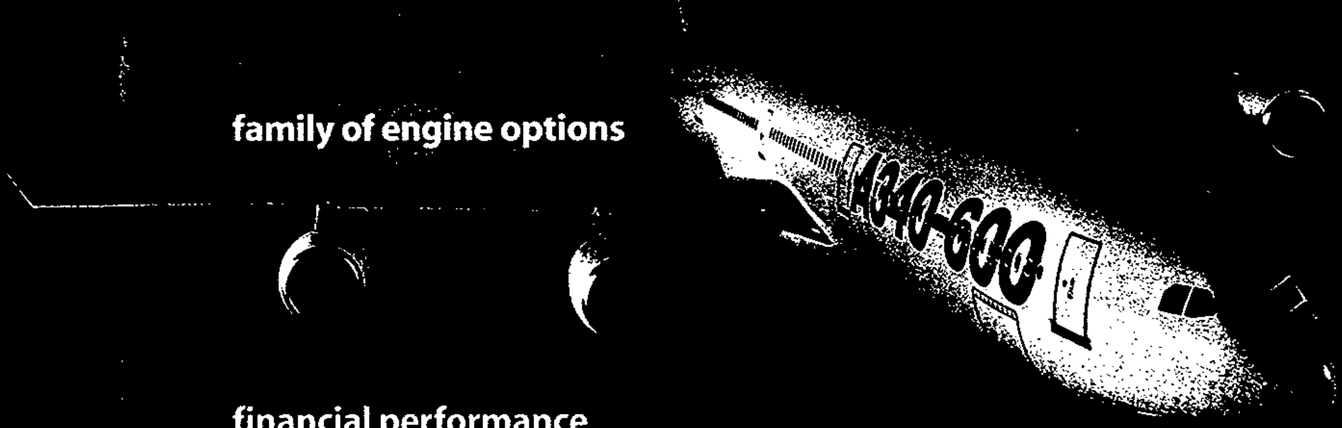
It is a fundamental element of our strategy that the quality of engineering is matched by commercial and business excellence. Our priority is to generate value for our customers, the Company and shareholders, and we are committed to a continued improvement in

The Trent 500 engine has been selected by Airbus Industrie to power its new four engined A340 500 600 long range wide bodied airliner.

cost efficiencies

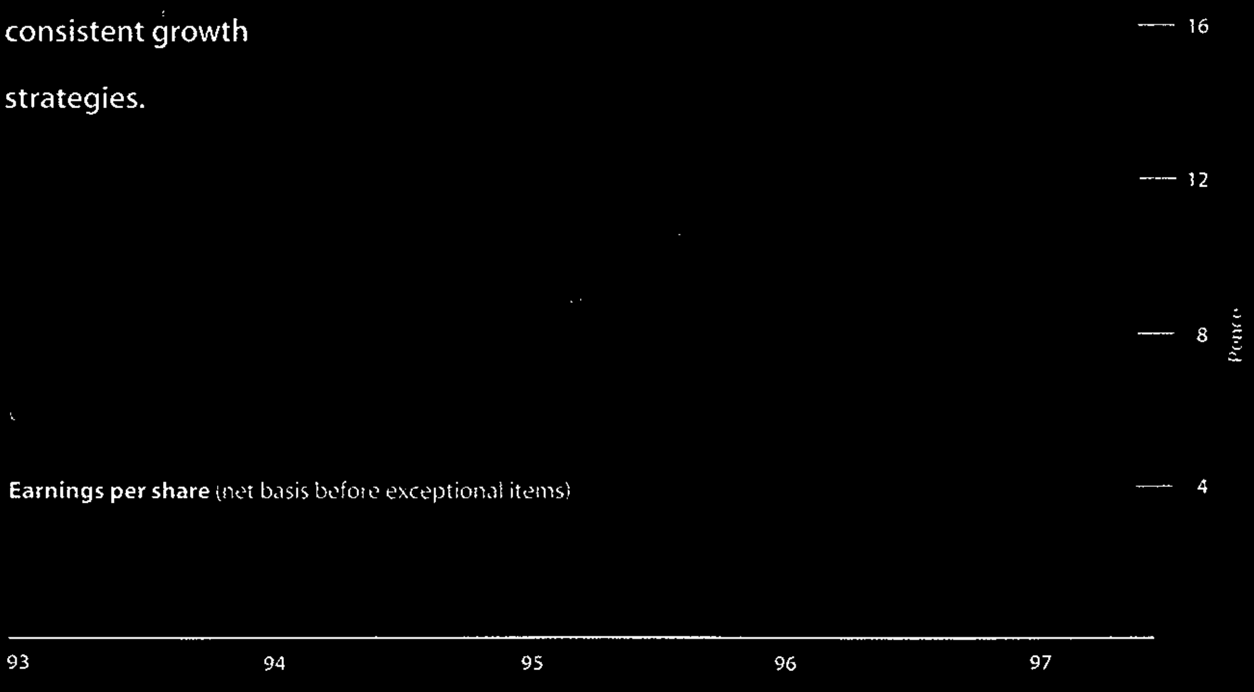
market share

family of engine options



financial performance

We are seeing the benefits of pursuing consistent growth strategies.



Earnings per share (net basis before exceptional items) financial performance. This will be achieved by improving our market position and therefore revenue and by ensuring that our operational efficiency is world-class.

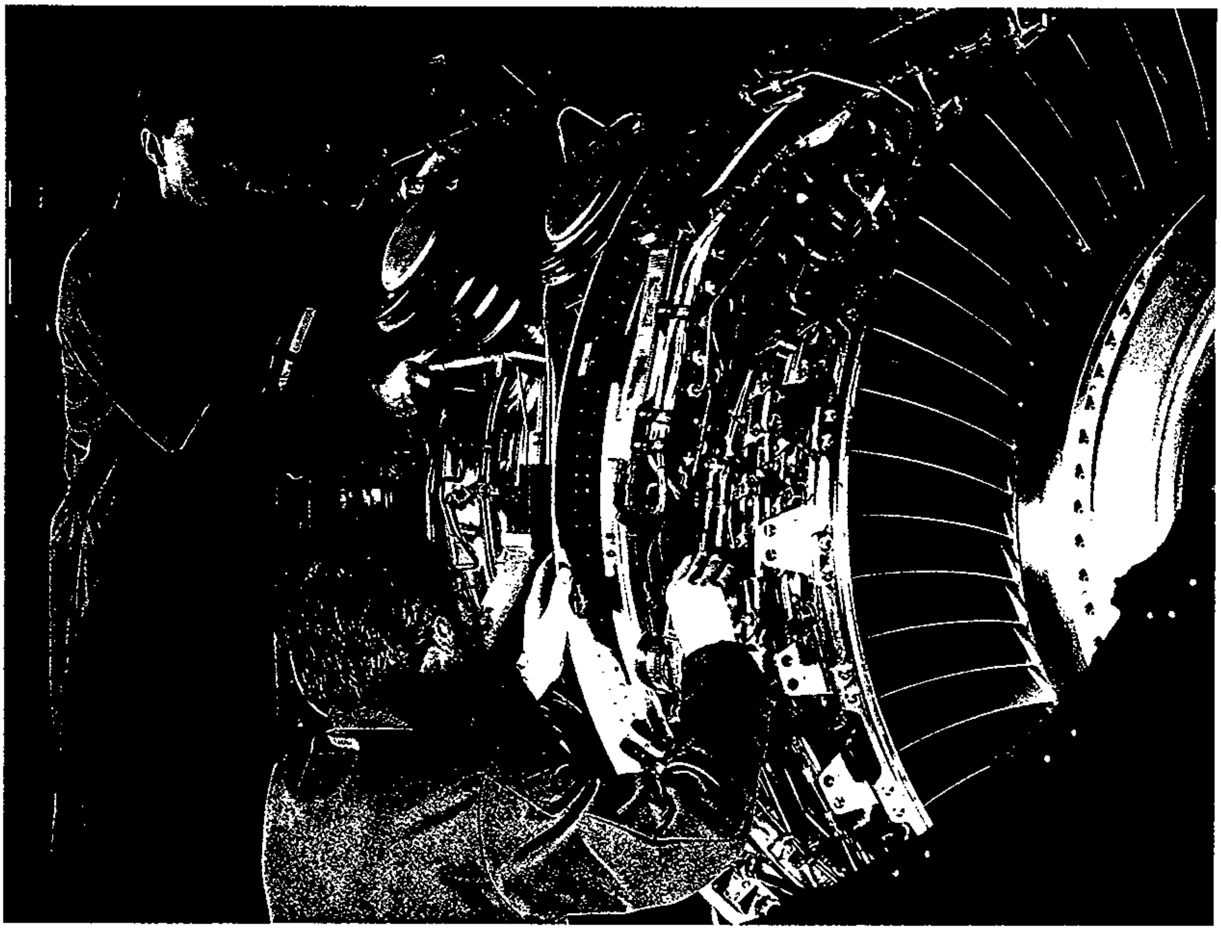
We recognise that we need to develop products and services better and faster in order to stay competitive and improve our profitability. At the beginning of 1996, we began a programme to transform our business performance by streamlining our processes and beating our competitors on cost, quality and delivery. Known as 'Better Performance *Faster*', the programme was launched in our aerospace businesses in 1996 and extended to the rest of the Group in 1997.

To emphasise the importance of the present changes, we increasingly reward our people according to their progress in implementing 'Better Performance *Faster*' initiatives.

'Better Performance *Faster*' covers everything we do from procurement and product development to supporting our customers in the marketplace.

One project, for example, is helping us to develop new products more efficiently through the use of multi-disciplinary teams with faster access to more data. Another is improving our sourcing by forging closer relationships with fewer suppliers who can then work alongside us to satisfy our customers. Others are streamlining our production, integrating our systems, introducing lean manufacture and improving our programme management.

Further initiatives not only enhance our own performance but also help our customers and



'Better Performance *Faster*' is improving efficiency throughout the Group. Above: engine-build fitters Andy Bould and Graham Holmes are part of a team that has helped to reduce engine-build time to 15 days.

suppliers to operate more effectively. The re-engineering of processes in the repair and overhaul business is reducing the time it takes to overhaul engines. Supplying information to our customers on CD-ROM gives them instant access to technical data and makes their engineering functions more efficient.

The underlying principles are focus and integration. We are concentrating more rigorously on the skills, products and activities that offer the greatest potential rewards. At the same time, we are sharpening our manufacturing performance by integrating our processes and ensuring that nothing is done twice that need only be done once.

Combined with further investment of around £200 million in fixed assets in 1997, 'Better Performance *Faster*' is producing tangible benefits. For example, a new production cell for the V2500 engine took just 12 weeks from concept to producing components and has reduced lead times from six weeks to ten days. We are also installing the latest technology for machining turbine blades and developing a world-class production centre for compressor aerofoils.

Investments such as these in capital and improved ways of working have had a considerable impact. It used to take 12 weeks to make a compressor disc: now it takes four and the target is two. We have reduced the lead time for manufacturing shafts from 104 days in 1996 to 48 days at the end of 1997 and are now in sight of our target of 15 days. In the last two years the lead time for Trent and V2500 compressor blades has fallen by 50 per cent and the engine-build time for the RB211-535 by 25 per cent.

Sales per employee have risen nearly 60 per cent over the last five years.

While these improvements are encouraging, they are only a start and we remain committed to further improving operational performance.

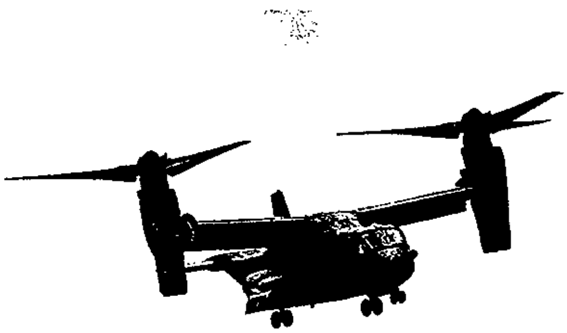
Steve Jones, general manager at Hong Kong Aero Engine Services Limited, and K M Pang, engine overhaul manager, are part of our expanding worldwide repair and overhaul business.

It is our ability to keep costs down that ensures the viability and competitive position of the Group.

High technology, low costs

The RB211-535 is the power for the Russian-built Tu-204. The engine is the most reliable in its class.

Rolls-Royce is a significant supplier wherever cost-effective engineering solutions are required.



The T406 engine is making a significant contribution to the development programme for the V-22 Osprey tilt-rotor aircraft.

FUTURE GROWTH is based on the strength of our product portfolio and the ability to meet the future needs of our customers. By focusing on our gas turbine technology we are developing our position in a number of growth markets.

Airline customers

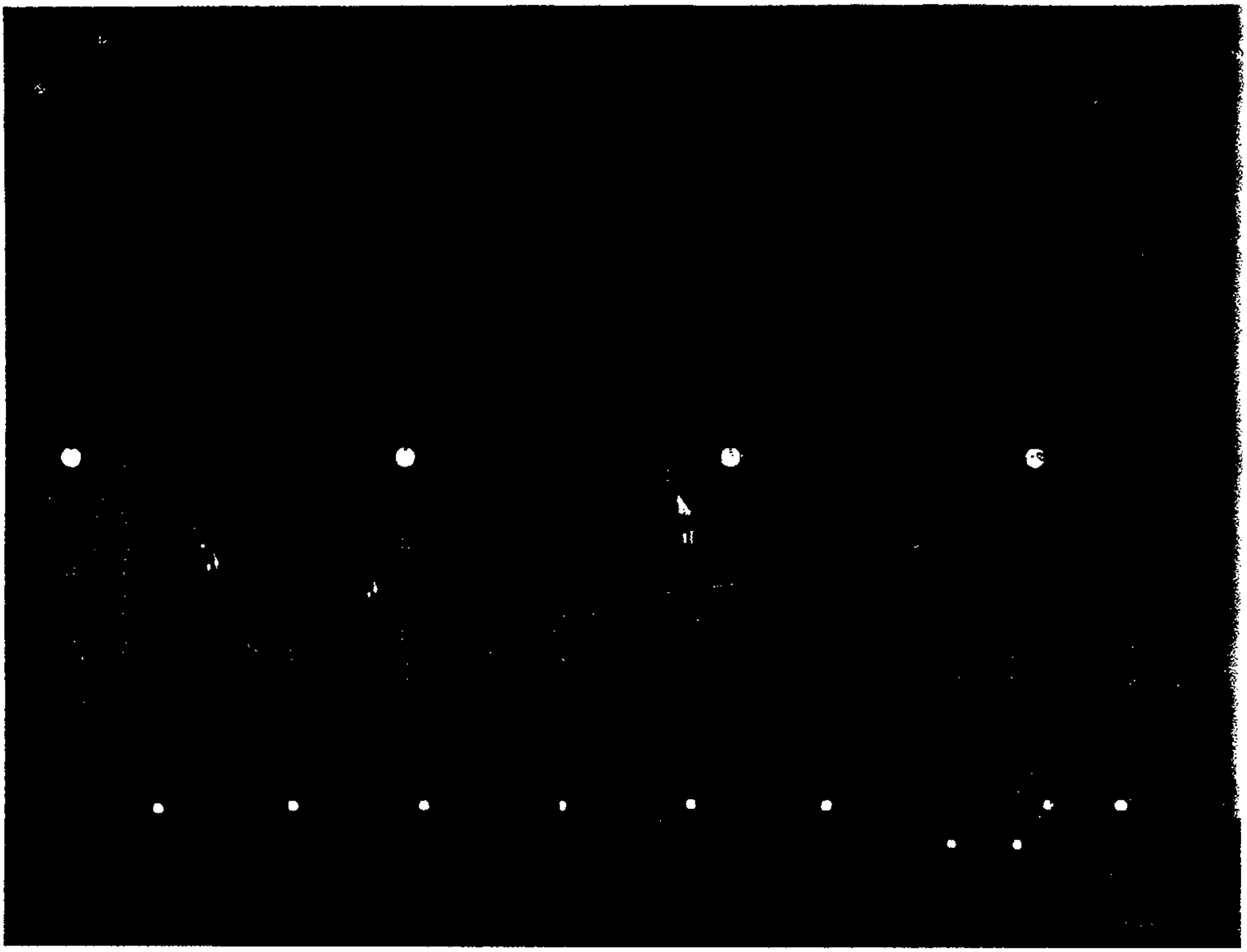
The market for aero engines and spare parts for airline customers will be worth $380 billion over the next 20 years. We have established a very competitive engine range to address this opportunity.

The Trent family of engines has established a 40 per cent share of the world market for the new generation of wide-bodied, high capacity aircraft. Ranging in thrust from 53,000lb to over 100,000lb, the Trent is the only engine family able to power every large airliner, existing or planned. This offers clear advantages to the customer through commonality of product and support arrangements.

The Trent owes much of its success to a development philosophy that bases new engines on proven technology. This reduces cost and risk and the time it takes to bring new products to market.

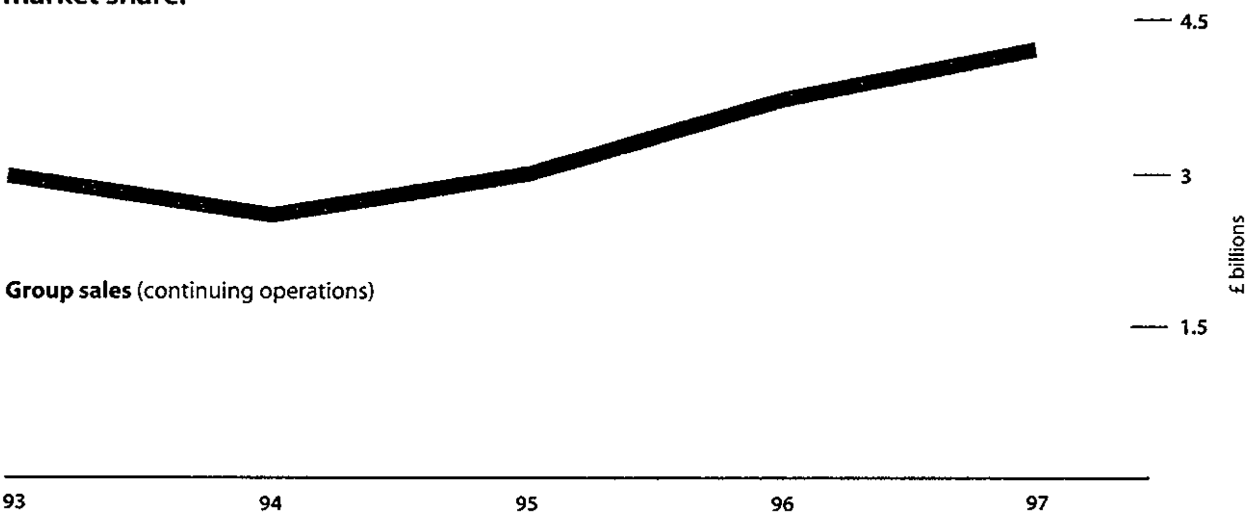
The Trent 700 for the Airbus A330 won further orders from Emirates, Monarch and Air Canada and now has a market share of 40 per cent.

The larger Trent 800 also had a good year. Delta Air Lines became the first customer in the USA to select the Trent 800 for its Boeing 777s, followed by American Airlines' selection of 11 firm and 39 option Trent-powered Boeing 777s. The Trent 800 achieved a market share of 41 per cent while the Trent family



An RB211-powered Boeing 747 landing at Heathrow Airport, London. Trent technology is being incorporated into the latest RB211-524G/H-T engine for the 747-400 version, making it the most fuel-efficient on the aircraft.

Our broad product range has led to increased sales and an improved market share.



Group sales (continuing operations)

achieved a market share of 80 per cent of new wide-bodied twin-engined aircraft ordered in 1997.

In November the latest members of the Trent family were announced – the Trent 500, 600 and 8104. The UK government will participate in these programmes with an investment similar to a risk and revenue sharing partner.

The Trent 500 secured the launch position on the new A340-500 and 600 aircraft. Airbus Industrie confirmed this programme with orders for 100 aircraft from seven customers. This represents engine business worth up to $4 billion, the strongest launch platform for an engine achieved by Rolls-Royce.

Trent technology is being applied to other Rolls-Royce engines. The RB211-524G/H-T combines Trent and RB211 technology to create a lighter, more fuel-efficient engine for the Boeing 747-400 and the Boeing 767. South African Airways, Cathay Pacific and the air freight carrier Cargolux, have all placed orders for this engine.

The RB211-535 and the International Aero Engines' (IAE) V2500 continue to perform well in their respective markets. The 1000th RB211-535 was delivered last year and 80 per cent of Boeing 757 operators have chosen this engine. The IAE order intake for the V2500 amounted to $1.6 billion.

Regional airlines and corporate operators

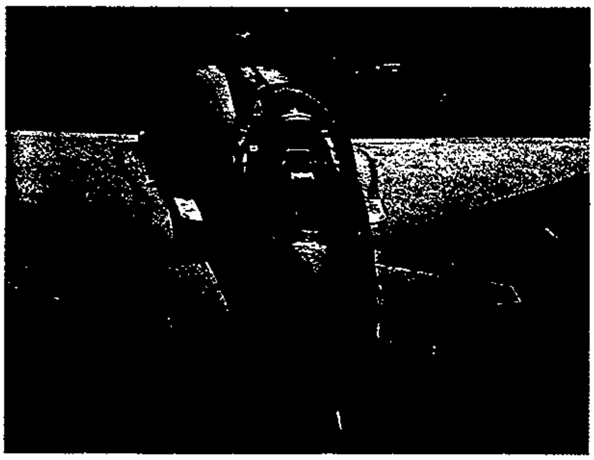
The strength of Rolls-Royce is its ability to serve customers in each sector. We estimate the aero-engine market in regional airlines and for corporate aircraft operators to be worth $40 billion over the next 20 years.

A highlight was the continuation of the Boeing 717 programme (formerly the McDonnell Douglas MD-95). This new 100-seat aircraft addresses a market requiring 2,500 such aircraft over the next 20 years. The BMW Rolls-Royce BR715 is the only powerplant offered on this aircraft.

In the market for 35 to 50-seat regional jets, the AE3007-powered Embraer RJ145 took substantial orders from a number of international customers. The 37-seat Embraer RJ135 was also launched, with the AE3007 offered as the exclusive powerplant. Orders for the two jets totalled 145 aircraft during 1997.

The AE3007 powers the Citation X corporate jet which had a successful entry into service. The Tay engine benefited from the continuing strong demand for the Gulfstream IV, and the BMW Rolls-Royce BR710 entered service on the Gulfstream V. The BR710 engine will enter service in 1998 on the other new long-range executive jet, the Bombardier Global Express. In all of these applications Rolls-Royce is the only choice of engine on the aircraft.

Lufthansa already operates the V2500-powered A321 aircraft (above) and has now selected the A340-600 with Trent engines.



The Eurofighter 2000 development programme is well advanced and the production contracts are now in place.

Defence

Rolls-Royce has a comprehensive range of engines available for more than 30 different military applications from helicopters to combat aircraft, a market worth $190 billion over the next 20 years.

We are involved in two of the world's new combat aircraft programmes. Rolls-Royce is a major partner in the programme to develop the EJ200 engine for the Eurofighter 2000. With five EJ200-powered prototype Eurofighters now flying, the defence ministers of the four participating nations signed a production contract for 620 Eurofighter aircraft and 1,500 EJ200 engines. The aircraft is due to enter service in 2001 and offers enormous export potential.

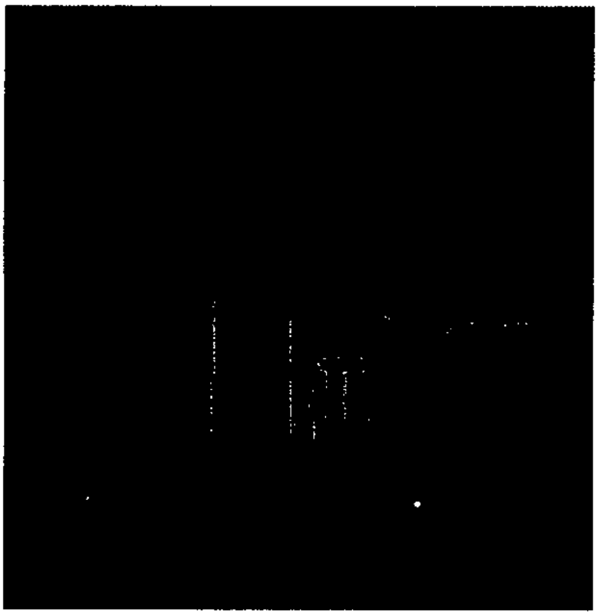
In the United States, Rolls-Royce is involved in the Joint Strike Fighter (JSF) programme. We are working with General Electric to develop the F120 engine – one of two proposed powerplants for JSF and, in addition, we are working with both Boeing and Lockheed Martin, on the short take-off and vertical landing technology to be incorporated in one of the versions of JSF. These contracts give the Group an important stake in the next generation of fighter aircraft, some 3,000 of which will be built over the next 15 years.

For trainer aircraft, Rolls-Royce launched the Adour 900. Embodying the latest technology, the engine sets new standards of cost and reliability. It is a member of the Adour family which powers the Hawk, Jaguar and the US Navy's T-45A Goshawk. In 1997 the Adour won orders in Australia and Canada.

In the market for transport aircraft, engine contracts were signed for 32 AE2100-powered C-130J aircraft for the United States and Italy. These contracts were worth more than $250 million to Rolls-Royce.

The helicopter engine business also achieved notable successes in 1997, including a $189 million contract with the US Army for Model 250 engines to be used in Kiowa Warrior helicopters.

Gas turbines are our core business. Through this technology we have developed strengths and leading positions across a number of markets.



Efficient power with minimal environmental impact: the benefits of aero-derived gas turbines are now widely recognised in the power industry.

Our transmission and distribution business has been successful in providing expertise and equipment to customers worldwide.

Developments in our industrial businesses follow our intent to focus on activities where Rolls-Royce can develop a significant position and create value.

Power generation

The growing market for distributed power is served by our range of aero-derived gas turbines which covers power requirements from 3-50 megawatt (MW). With a new family of small gas turbines, the 601K and 701K series, improvements to the existing RB211 and the development of the industrial Trent at 50MW, our enhanced range satisfies power needs up to 150MW in combined cycle. The Trent will enter service later than planned as we have extended the programme to overcome difficult technical challenges associated with emissions control. Similar challenges are faced by all manufacturers in this market. We are confident that the engine will meet its original targets.

Transmission and distribution products complement the power generation activities. In 1997 new joint ventures were announced in Saudi Arabia, Jordan and Indonesia.

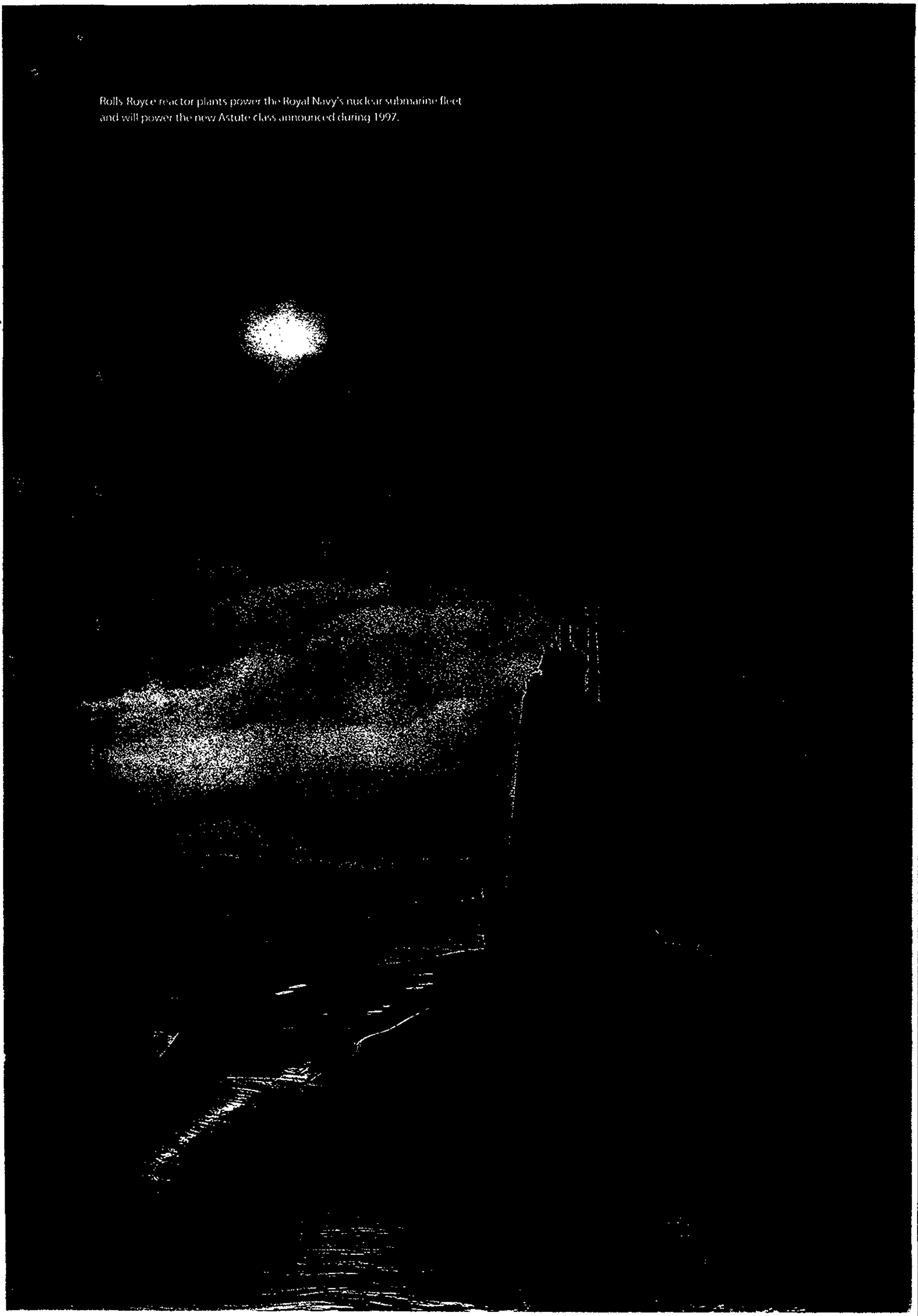
Marine power

Rolls-Royce is at the forefront of two major naval developments. The WR-21 large marine gas turbine, a joint venture with Northrop Grumman, successfully completed its 500-hour endurance test, leaving us well placed to offer a unique product to the world's navies. Rolls-Royce has been nominated to design and supply the reactor plants for the Royal Navy's next generation of nuclear submarines and we also serve marine customers through our materials handling business.

Oil and gas

For the oil and gas market we, again, exploit our gas turbine technology for pumping and compression. Together with our diesel engines, we have a full product range from 3MW to 50MW. In 1997 we announced an extension of this capability in the form of a joint venture with Russian design bureau, Lyulka Saturn.

Rolls-Royce reactor plants power the Royal Navy's nuclear submarine fleet and will power the new Astute class announced during 1997.



Expanding global presence

We have been successful in following strategies to improve our global market presence through the development of new products, joint ventures and international collaboration.

By concentrating on local needs we expand our global presence.

WE CONTINUE TO EXPAND internationally, building our presence and seeking business in markets that offer attractive returns to our shareholders. 1997 saw good progress in each of our major territories.

In North America substantial orders from leading airlines such as Delta Air Lines, American Airlines and Air Canada were secured, ensuring the continuation of long-term customer relationships in the North American marketplace.

We remain strong in Asia, which we expect to be a significant long-term growth market. In the developing Chinese market, our engines have been specified by ten local airlines and we now have a joint training centre with China's aviation authority. In Indonesia we are providing a £25 million substation with local partners.

In Europe we have benefited from our military contracts and further developments in the Airbus range. The new Rolls-Royce powered Airbus A340-500/600 has won orders from major European carriers including Lufthansa, Virgin Atlantic and Swissair, developing our business with these prominent airlines.

Ninety per cent of our order intake in 1997 was secured in Europe and North America.

A growing aftermarket business

Rolls-Royce has over 53,000 engines in service – one of the largest fleets in the world. To service this fleet we are developing a large and successful global repair and overhaul business. Our market share for the repair and overhaul of Rolls-Royce engines has more than doubled in the last three years and our target is to

Singapore Airlines began operating the first of its 61 Rolls Royce Trent powered Boeing 777s, during 1997.

We are pursuing a strategy of global market penetration through acquisitions, joint ventures and by developing our overseas manufacturing and customer support.

double sales within the next five years. We are growing this activity in association with key customers in order to provide capability across the world.

Last year we announced a joint venture with American Airlines to create a repair and overhaul base for Rolls-Royce engines in the Americas. The new company will work on a number of engine types, including RB211-535, Tay and Trent 800.

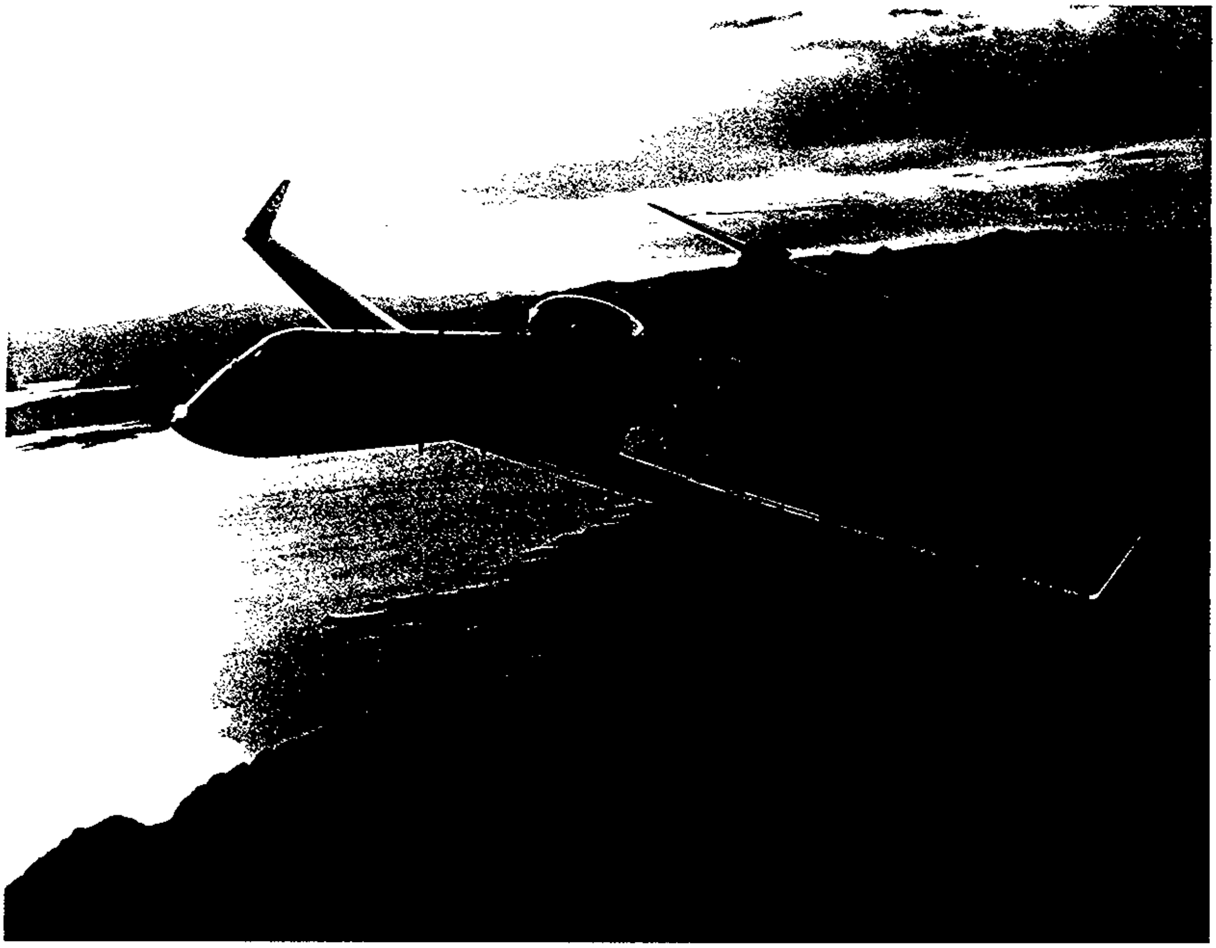
In Asia our new joint venture repair and overhaul business has opened in Hong Kong. We have also announced the formation of a base in Singapore for the repair and overhaul of Trent engines. The latter is a tri-party agreement between ourselves, Hong Kong Aero Engine Services Limited and Singapore Airlines Engineering Company, a subsidiary of Singapore Airlines.

In addition to the sale of spare parts and the repair and overhaul of engines, Rolls-Royce offers a comprehensive range of services to customers, including one of the world's largest engine leasing businesses.

The industrial businesses also present important aftermarket opportunities with similar characteristics to those of the aerospace businesses. The Group is pursuing these opportunities aggressively.

International manufacturing

As we expand we increasingly integrate our manufacturing across national boundaries. Our US operations now supply components for the RB211, Tay and Pegasus engines. Our new joint venture factory at Xian, in China will soon be making components for the RB211, Tay, BR710 and the BR715.



Our success in providing power for the corporate and business jet market continues. The new Gulfstream V long-range executive jet is powered by BR710 engines.

Investing for the future

Our long-term value demands first-class training and development of Rolls-Royce people. This investment has resulted in sales per employee improving by 60 per cent in the last five years.

THE STEP CHANGE that we intend to achieve depends crucially on the skills, attitude and flexibility of our people. That is why, along with streamlining our processes, we are devoting considerable effort to training and developing our employees and improving their awareness of creating customer and shareholder satisfaction. We require our people not only to do their jobs well but to understand the commercial imperatives and be motivated to make the greatest possible contribution.

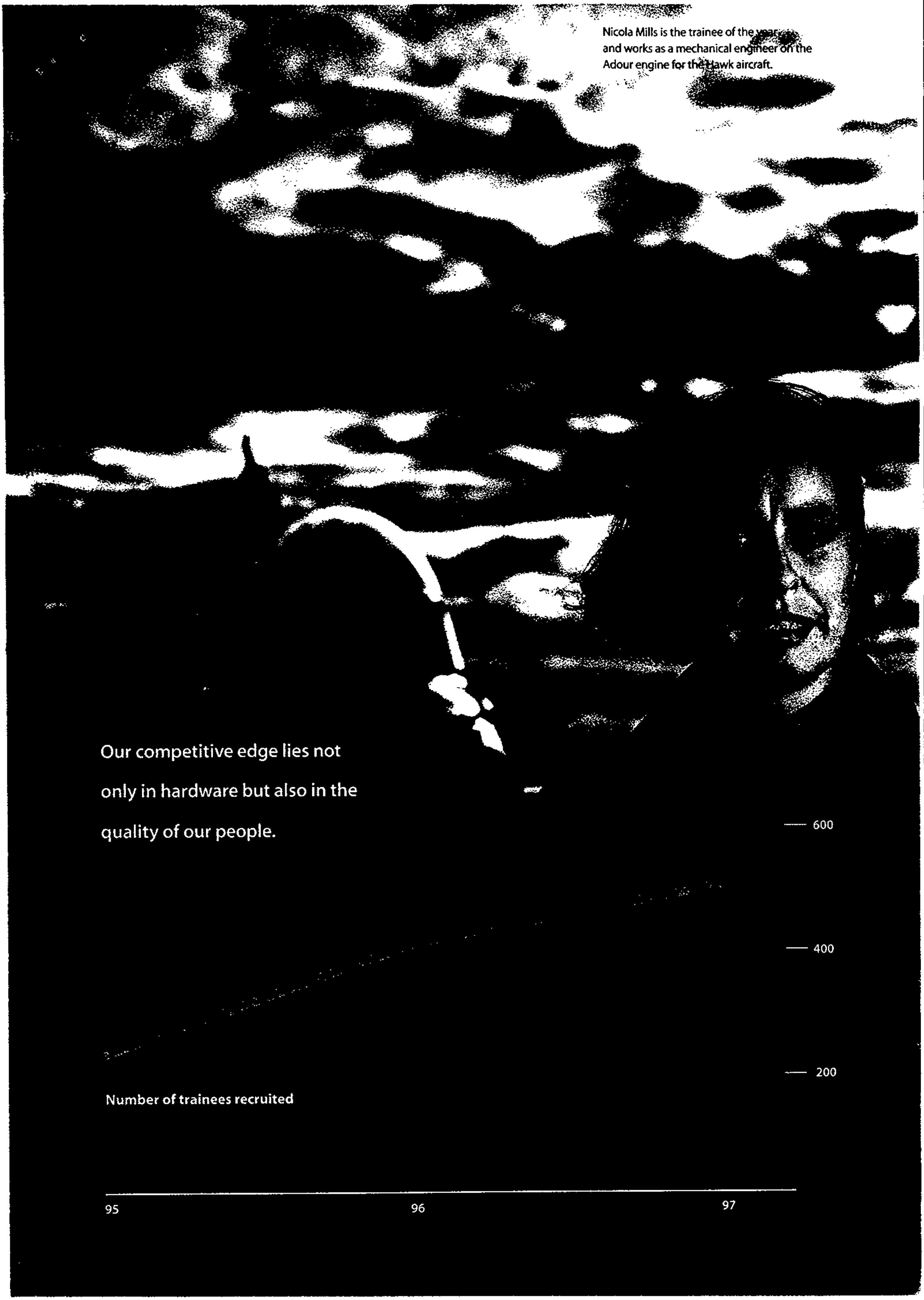
A new management development policy entitled, 'World Class People – World Class Business' (Management Development in Action) has been published and communicated through senior management meetings.

At all levels we are training people to operate in new ways and be more involved in affecting the performance of the Group. The aerospace businesses have already involved 14,000 employees in the 'One Small Step...' programme to encourage this contribution to improving our operational performance. This mechanism for encouraging dialogue will be used throughout the organisation.

We are changing processes and improving skills to create shareholder value. We develop our management skills on a company-wide basis and are thoroughly reviewing our policies and practices for developing these broad skills.

Our Business Leadership Programme ensures that our senior people are better equipped to operate in an innovative, competitive and global business. Additional courses are providing the same messages

Nicola Mills is the trainee of the year and works as a mechanical engineer on the Adour engine for the Hawk aircraft.



Our competitive edge lies not only in hardware but also in the quality of our people.

to all managers and first-time management appointees. A small number of high-potential younger managers also benefit from our new International Business Awareness Course which gives them a greater appreciation of the global nature of our business. To emphasise the point, this course has been successfully piloted and run at our joint venture training centre in Tianjin, China.

During 1997 these courses and programmes have helped some 250 senior individuals to further develop their management skills. Another 300 managers are expected to take part in 1998, providing significant business training and development for the Group's senior managers. In addition, around 200 managers have been trained in specific operational skills through our Management Development Curriculum. This provides training in subject areas such as managing money, people projects, information and operations. The modules cater for individual learning styles by offering a variety of learning methods to participants.

We are partnering China's aviation administration (CAAC) in developing extensive technical and management training programmes, which include a new training centre at Tianjin where training administrator Ma Miao (right) welcomes course delegate Shi Feng of China Xinjiang Airlines.

Looking ahead

Rolls-Royce has made enormous strides in recent years. We are now doing more business than we would have thought possible ten years ago. With 34 per cent of all civil turbofan orders placed in 1997 and a 19 per cent share of all engine deliveries during the year, we are making progress towards our goal of a third share of the world civil market. The future for our military business is encouraging, with contracts signed for the production of the new EJ200 and our increasing involvement in major North American defence programmes like the Joint Strike Fighter (JSF). In the industrial businesses our strategy of concentrating on activities where Rolls-Royce can establish market-leading positions is aimed at producing higher financial returns in the future.

Above all we have skilled and committed people who have embraced the opportunities and shown their enthusiasm for transforming Rolls-Royce, to satisfy our customers and generate greater rewards for our shareholders.

Board of directors

AT MARCH 4, 1998

Sir Ralph Robins
BSc, F Eng[3]
Chairman
Elected to the Board in 1982. He joined Rolls-Royce in 1955, became Managing Director in 1984 and was appointed Chairman in 1992. Age 65.

John E V Rose MA[3]
Chief Executive
Elected 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. Age 45.

Lord Moore of Lower Marsh PC, BSc[1,2,3]
Non-executive Deputy Chairman
Elected to the Board in 1994 and appointed Deputy Chairman in 1996. He is Chairman of Credit Suisse Asset Management Limited. Age 60.

Peter J Byrom
BSc, FCA[1,2,3]
Non-executive director
Elected to the Board with effect from January 1, 1997. He was a director of N M Rothschild & Sons Limited from 1977 to 1996. Age 53.

Colin H Green
BSc, C Eng
Managing Director – Aerospace Group
Elected to the Board in 1996. He joined Rolls-Royce in 1968, became Managing Director, Rolls-Royce Military Aero Engines in 1994, Vice President – Business Operations, Allison Engine Company Inc. in 1995 and Managing Director – Aerospace Group in 1996. Age 49.

James M Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Elected to the Board with effect from January 1, 1998. Until 1994 he was Executive Vice President Marketing and Planning of United Airlines. Age 52.

Paul Heiden
BSc, ARCS, ACA
Managing Director – Industrial Businesses
Elected to the Board with effect from July 1, 1997. He joined Rolls-Royce in 1992 and became Finance Director, Aerospace Group later that year and Managing Director – Industrial Businesses in 1997. Age 41.

Sir Gordon Higginson
BSc, PhD, F Eng[2,3]
Non-executive director
Elected to the Board in 1988. Until 1994 he was Vice Chancellor, University of Southampton. Age 68.

Harold G Mourgue
FCA[1,2,3,4]
Non-executive director
Elected to the Board in 1985. He was Chairman of Kenwood Appliances plc until 1996. He retires from the Board with effect from March 31, 1998. Age 70.

Sir Robin Nicholson
F Eng, FRS[2,3]
Non-executive director
Elected to the Board in 1986. He was an executive director of Pilkington plc until 1996. Age 63.

Philip C Ruffles BSc, F Eng
Director – Engineering and Technology
Elected to the Board with effect from January 1, 1997. He joined Rolls-Royce in 1961, became Director – Engineering, Aerospace Group in 1991 and Director – Engineering and Technology in 1997. Age 58.

Michael Townsend
MA, FCA
Finance Director
Elected to the Board in 1991. He joined Rolls-Royce in 1990 and was appointed Finance Director in 1991. Age 56.

Richard T Turner
OBE, BA
Group Marketing Director
Elected to the Board in 1992. He joined Rolls-Royce in 1991 having previously been with the Company from 1965 to 1988. Age 55.

Company Secretary
Charles Blundell MA
He joined Rolls-Royce in 1993 and was appointed Company Secretary in 1995. Age 46.

[1] Member of the audit committee.
[2] Member of the remuneration committee.
[3] Member of the nomination committee.
[4] Chairman of the Trustees of The Rolls-Royce Pension Fund.

Note:
Committees 1 and 2 are made up entirely of non-executive directors.

1997 Summary financial statement

Summary report of the directors

The directors present the summary financial statement of the Group for the year ended December 31, 1997.

The auditors' report on the full financial statements of the Group was unqualified. It did not contain a statement under either S237(2) of the Companies Act 1985 (inadequate accounting records or returns, or accounts not agreeing with records and returns) or S237(3) (failure to obtain necessary information and explanations).

The Chairman's statement and the Chief Executive's review together give information relating to the year's operations and future prospects.

Directors who held office during 1997 are listed on page 20, apart from Mr R H Maudslay who resigned with effect from July 1, 1997 and Mr J W Sandford who retired on December 31, 1997. Mr P Heiden and Mr J M Guyette were appointed with effect from July 1, 1997 and January 1, 1998 respectively. Mr H G Mourgue will retire from the Board with effect from March 31, 1998.

The Group has complied throughout the financial year with the Code of Best Practice published by the Committee on the Financial Aspects of Corporate Governance.

During 1997 the Group made charitable donations amounting to £338,750. The Group's policy on donations is to direct its support primarily towards assisting military services' benevolent associations and charities with engineering, scientific or educational objectives, as well as objectives connected with the Group's business and place in the community.

A list of the principal donations made in 1997 is available on written request to the Company Secretary.

The Group made no political contributions in 1997.

This summary financial statement does not contain sufficient information to allow for a full understanding of the results of the Group and state of affairs of the Company or of the Group. For further information a full annual report, containing the full financial statements, the auditors' report on those financial statements and the directors' report, should be consulted. The Companies Act 1985 gives members the right to receive, free of charge, a copy of the full annual report. You may request a copy by filling in and posting the card attached to your proxy form.

Statement of the auditors to the members of Rolls-Royce plc

(in accordance with Section 251 of the Companies Act 1985)

KPMG

We have examined the summary financial statement set out on pages 21 to 23.

Respective responsibilities of directors and auditors

The summary financial statement is the responsibility of the directors. Our responsibility is to report to you our opinion on its preparation and consistency with the full financial statements and directors' report.

Basis of opinion

We conducted our examination in accordance with Auditing Guideline 'The auditor's statement on the summary financial statement' adopted by the Auditing Practices Board. Our report on the Group's full annual financial statements describes the basis of our audit opinion on those financial statements.

Opinion

In our opinion the summary financial statement is consistent with the full financial statements and directors' report of Rolls-Royce plc for the year ended December 31, 1997 and complies with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

KPMG Audit Plc
Chartered Accountants, Registered Auditor

London
March 4, 1998

KPMG Audit Plc

Summary Group profit and loss account

FOR THE YEAR ENDED DECEMBER 31, 1997

	Continuing operations £m	Discontinued operations £m	1997 £m	Restated[1] 1996 £m
Turnover	4,216	118	4,334	3,902
Cost of sales	(3,465)	(142)	(3,607)	(3,310)
Gross profit/(loss)	751	(24)	727	592
Commercial, marketing and product support costs	(142)	(2)	(144)	(143)
General and administrative costs	(131)	(13)	(144)	(132)
Research and development (net)*	(215)	(1)	(216)	(199)
Share of profits of associated undertakings	13	—	13	8
Utilisation of provision for loss on sale/termination of businesses	—	40	40	—
Operating profit	276	—	276	126
Profit/(loss) on sale of businesses	1	(9)	(8)	—
Utilisation/(creation) of provision for loss on sale/termination of businesses	—	9	9	(147)
Profit/(loss) on ordinary activities before interest	277	—	277	(21)
Net interest payable			(1)	(7)
Profit/(loss) on ordinary activities before taxation			276	(28)[2]
Taxation			(51)	(16)
Profit/(loss) on ordinary activities after taxation			225	(44)
Equity minority interests in subsidiary undertakings			(1)	(3)
Profit/(loss) attributable to ordinary shareholders			224	(47)
Dividends – interim 2.20p (1996 2.00p) per share			(33)	(29)
– final proposed 3.70p (1996 3.30p) per share			(55)	(49)
Transferred to/(from) reserves			136	(125)
*Research and development (gross)			(595)	(527)
Earnings/(loss) per ordinary share				
Net basis			15.16p	(3.19)p
Net basis before exceptional items			15.16p	12.70p

Analysis by business segment	Turnover 1997 £m	Turnover Restated[1] 1996 £m	Profit/(loss) before interest 1997 £m	Profit/(loss) before interest 1996 £m	Net assets[3] 1997 £m	Net assets[3] 1996 £m
Aerospace	3,071	2,570	241	185	846	778
Industrial	1,145	1,086	36	57	285	305
	4,216	3,656	277	242	1,131	1,083
Industrial Discontinued operations	118	246	—	(263)[2]	3	(42)
	4,334	3,902	277	(21)	1,134	1,041

[1] Turnover has been restated to reflect the amended accounting policy for sales discounts adopted for 1997.
[2] Included an exceptional loss of £248m.
[3] Net assets exclude net funds of £328m (1996 £284m).

Emoluments of directors	1997 £000	1996 £000
Salaries, benefits, fees and performance rewards	3,024	2,384
Compensation for loss of office	220	—
	3,244	2,384
Aggregate gains from exercising share options	261	609

Summary Group balance sheet

AT DECEMBER 31, 1997

	1997 £m	1996 £m
Fixed assets		
Tangible assets	1,055	962
Investments	102	85
	1,157	1,047
Current assets		
Stocks	959	798
Debtors – amounts falling due within one year	1,075	1,047
– amounts falling due after one year	332	262
Short-term deposits and investments	368	544
Cash at bank and in hand	511	231
	3,245	2,882
Creditors – amounts falling due within one year		
Borrowings	(302)	(88)
Other creditors	(1,898)	(1,571)
Net current assets	1,045	1,223
Total assets less current liabilities	2,202	2,270
Creditors – amounts falling due after one year		
Borrowings	(249)	(403)
Other creditors	(84)	(84)
Provisions for liabilities and charges	(407)	(458)
	1,462	1,325
Capital and reserves		
Called up share capital	296	295
Share premium account	522	519
Revaluation reserve	121	125
Other reserves	71	54
Profit and loss account	433	310
Equity shareholders' funds	1,443	1,303
Minority interests in subsidiary undertakings		
Equity interests	13	13
Non-equity interests	6	9
	1,462	1,325

The summary financial statement was approved by the Board on March 4, 1998 and signed on its behalf by:

Sir Ralph Robins
Chairman
M Townsend
Director

Group five year review

FOR THE YEARS ENDED DECEMBER 31

Profit and loss account	1997 £m	1996 £m	1995 £m	1994 £m	1993 £m
Turnover[1]	4,334	3,902	3,226	2,781	3,162
Trading profit[2]	479	418	352	309	329
Operating exceptional items	—	(101)	—	—	—
Research and development (net)*	(216)	(199)	(206)	(218)	(253)
Share of profits of associated undertakings	13	8	9	9	12
Operating profit/(loss)[1]	276	126	155	100	88
Non-operating exceptional/other items	1	(147)	32	—	—
Net interest (payable)/receivable	(1)	(7)	(12)	1	(12)
Profit/(loss) on ordinary activities before taxation	276	(28)	175	101	76
Taxation	(51)	(16)	(31)	(20)	(18)
Profit/(loss) on ordinary activities after taxation	225	(44)	144	81	58
Equity minority interests in subsidiary undertakings	(1)	(3)	(2)	—	5
Profit/(loss) attributable to ordinary shareholders	224	(47)	142	81	63
Dividends	(88)	(78)	(73)	(61)	(56)
Transferred to/(from) reserves	136	(125)	69	20	7
*Research and development (gross)	(595)	(527)	(492)	(452)	(451)
[1] Turnover					
Continuing operations	4,216	3,656	2,971	2,538	2,964
Discontinued operations	118	246	255	243	198
[1] Operating profit/(loss)					
Continuing operations	276	242	178	117	97
Discontinued operations	—	(116)	(23)	(17)	(9)
Earnings/(loss) per ordinary share					
Net basis	15.16p	(3.19)p	10.25p	6.56p	5.90p
Net basis before exceptional items	15.16p	12.70p	7.94p	6.56p	5.90p
Dividends per ordinary share	5.90p	5.30p	5.00p	5.00p	5.00p

[2] Trading profit represents gross profit less commercial, marketing, product support, general and administration costs but is stated before operating exceptional items.

The turnover figures for 1993 to 1996 have been restated to reflect the amended accounting policy for sales discounts adopted for 1997.

Balance sheet	1997 £m	1996 £m	1995 £m	1994 £m	1993 £m
Fixed assets	1,157	1,047	1,037	907	950
Current assets	3,245	2,882	2,618	2,195	2,392
	4,402	3,929	3,655	3,102	3,342
Liabilities and provisions	(2,940)	(2,604)	(2,295)	(1,847)	(2,107)
	1,462	1,325	1,360	1,255	1,235
Share capital	296	295	292	245	244
Reserves	1,147	1,008	1,053	997	981
Equity shareholders' funds	1,443	1,303	1,345	1,242	1,225
Minority interests in subsidiary undertakings	19	22	15	13	10
	1,462	1,325	1,360	1,255	1,235

Shareholders' information

FINANCIAL CALENDAR

Ex dividend date for final dividend	April 27, 1998
Calculation period for scrip dividend	April 27-May 1, 1998
Qualifying (record) date for final dividend	May 1, 1998
Last date for new scrip dividend instructions	May 27, 1998
Annual General Meeting, The Queen Elizabeth II Conference Centre, Broad Sanctuary, London SW1, 11.00am	May 28, 1998
Payment of final/scrip dividend	July 6, 1998
Press advertisement of 1998 interim results*	August 28, 1998
Ex dividend date for interim dividend	October 26, 1998
Calculation period for scrip dividend	October 26-30, 1998
Qualifying (record) date for interim dividend	October 30, 1998
Last date for new scrip dividend instructions	November 25, 1998
Financial year end	December 31, 1998
Payment of interim/scrip dividend	January 11, 1999
Press advertisement of 1998 preliminary results*	March, 1999
1998 Annual Report published	April, 1999

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

ANALYSIS OF ORDINARY SHAREHOLDERS AT DECEMBER 31, 1997

Size of holding	Number of holdings	% of total holdings	% of total shares
1 – 150	133,240	37.41	1.21
151 – 500	189,151	53.12	3.14
501 – 10,000	32,020	8.99	3.51
10,001 – 100,000	931	0.26	2.10
100,001 – 1,000,000	553	0.16	13.08
1,000,001 and over	212	0.06	76.96
	356,107	100.00	100.00

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.

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 about your shareholding, please write to or telephone the Registrar at the following address:

Computershare Services PLC
PO Box 82
Caxton House
Redcliffe Way
Bristol BS99 7NH
Telephone: 0117 930 6600

The Royal Bank of Scotland transfered its registration business to Computershare Services PLC on March 12, 1998.

Details of special low cost dealing services in the Company's shares may be obtained from Hoare Govett Corporate Finance Limited (telephone 0171 601 0101) and from NatWest Stockbrokers Limited (telephone 0171 895 5489). Both are members of the Securities and Futures Authority and NatWest Stockbrokers Limited is a member of the London Stock Exchange.

You can obtain the current market price of the Company's shares by telephoning 0839 500 232 (currently charged at 11p per call) or alternatively by viewing teletext and similar services.

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Rolls-Royce®

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