Company number: 1003142

Rolls-Royce plc
Report of the directors, business review and financial statements

December 31, 2007

Contents

Board of directors
At February 6, 2008

Simon Robertson
Non-executive Chairman since 2005
Appointed to the Board in 2004 He is the founder member of Simon Robertson Associates LLP and a non-executive director of HSBC Holdings plc, Berry Bros & Rudd Ltd, and The Economist Newspaper Limited He is a director of The Royal Opera House Covent Garden Limited, a Trustee of The Eden Project and the Royal Opera House Endowment Fund He is the former President of Goldman Sachs Europe Limited Age 66

Sir John Rose
Chief Executive since 1996
Appointed to the Board in 1992 having joined Rolls-Royce in 1984 He is a Trustee of The Eden Project Age 55

Helen Alexander CBE
Non-executive director
Appointed to the Board in September 2007 Helen Alexander was appointed Chief Executive of The Economist Group in January 1997, having joined the company in 1984 She was Managing Director of The Economist Intelligence Unit from 1993 until the end of 1996 She is a non-executive director of Centrica plc, a Trustee of the Tate Gallery and a governor of St Paul's Girls' School She was awarded a CBE for services to publishing in 2004 She has an MBA from INSEAD She is currently Chairman of PPA, the magazine industry trade association Age 50

Peter J Byrom BSc, FCA
Non-executive director
Appointed to the Board in 1997 He is Chairman of Domino Printing Sciences plc and Molins PLC, and a non-executive director of AMEC plc. He is a Fellow of the Royal Aeronautical Society He was a director of N M Rothschild & Sons Limited from 1977 to 1996 Age 63

Iain C Conn
Non-executive director, Senior Independent Director
Appointed to the Board in 2005 He is an executive director of BP p l c having held a range of executive positions within the BP Group worldwide He is Chairman of the Advisory Board of The Imperial College London Tanaka Business School Age 45

Professor Peter Gregson
Non-executive director
Appointed to the Board in March 2007 He is President and Vice-Chancellor of Queen's University Belfast and serves on the Northern Ireland Economic Development Forum, the Council of CBI Northern Ireland and the Steering Group of the US – Ireland Research and Development Partnership He is a Fellow and Council Member of the Royal Academy of Engineering, a member of the Royal Irish Academy, and Deputy Lieutenant of Belfast. He was formerly Professor of Aerospace Materials and Deputy Vice-Chancellor of the University of Southampton and has served on the Council for the Central Laboratory of the Research Councils (CCLRC) Age 50

James M Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Appointed to the Board in 1998 having joined Rolls-Royce in 1997 He is a director of the Private Bank and Trust Company of Chicago, Illinois and of priceline com Inc. Until 1995 he was Executive Vice President, Marketing and Planning of United Airlines Age 62

John Rishton
Non-executive director
Appointed to the Board in March 2007 He is Chief Executive Officer of Royal Ahold He began his career in 1979 at Ford Motor Company and held a variety of positions both in the UK and in Europe In 1994 he joined British Airways plc where he was Chief Financial Officer from 2001 to 2005 He is a former non-executive director of Allied Domecq Age 49

Andrew B Shilston MA, ACA, MCT
Finance Director
Appointed to the Board in 2003 having joined Rolls-Royce in 2002 He is a non-executive director of Cairn Energy PLC and was Finance Director of Enterprise Oil plc from 1993 until 2002 Age 52

Colin P Smith BSc Hons, FREng, FRAeS, FIMechE
Director – Engineering and Technology
Appointed to the Board in 2005 having joined Rolls-Royce in 1974 He has held a variety of key positions within Engineering, including Director – Research and Technology and Director of Engineering and Technology – Civil Aerospace He is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers Age 52

Ian C Strachan
Non-executive director
Appointed to the Board in 2003 He is a non-executive director of Reuters Group plc, Johnson Matthey plc, Xstrata plc and Transocean Inc. He was Chief Executive of BTR plc, Deputy Chief Executive and Chief Financial Officer of Rio Tinto plc and non-executive Chairman of Instinet Group Inc Age 64

Carl G Symon BSc, MSc
Non-executive director
Appointed to the Board in 1999 He is Chairman of HMV Group plc and Clearswift Systems Ltd He is also a non-executive director of BT Group plc and Chairman of the BT Group Equality of Access Board, Senior Independent Director of Rexam plc and an Advisory Board member of Cross Atlantic Capital Partners He was previously Chairman and Chief Executive Officer, IBM UK and held numerous executive positions with IBM Corp in Canada, USA, Latin America, Asia and Europe during a 32 year international career Age 61

Mike J Terrett
Chief Operating Officer
Appointed to the Board in September 2007, having joined Rolls-Royce in 1978 He has held a variety of senior positions in the development of new aero engine programmes, including Managing Director of Airlines and President and Chief Executive Officer of International Aero Engines (IAE) based in the United States Prior to his appointment as Chief Operating Officer, he was President – Civil Aerospace He is a member of the Institute of Mechanical Engineers and a Fellow of the Royal Aeronautical Society Age 51

Tim Rayner
General Counsel and Company Secretary
He joined Rolls-Royce in 2007 having previously been General Counsel and Company Secretary at United Utilities PLC Age 47

Report of the directors

The directors present their report and the audited financial statements of Rolls-Royce plc (the Company) and its subsidiaries (together referred to as the Group) for the year ended December 31, 2007

Business review
A review of the business can be found on pages 4 to 27

Share capital
No new shares were issued during the year

Going concern
After making enquiries, the directors have a reasonable expectation that the Company 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

Political donations
In line with its established policy, the Group made no political donations during 2007

Directors
The directors' biographical details, including their other significant commitments, are set out on page 2 During the year there were a number of Board changes Professor Peter Gregson and John Rishton were appointed as non-executive directors on March 1, 2007, Sir John Taylor retired as a non-executive director on May 1, 2007 On September 1, 2007 Helen Alexander was appointed as a non-executive director and Mike Terrett was appointed as an executive director John Cheffins retired as an executive director on September 30, 2007 and Carl Symon will retire as a non-executive director on May 7, 2008

As at December 31, 2007 all the directors were also directors of Rolls-Royce Group plc, the ultimate parent company As directors of the ultimate parent company, there is no requirement to disclose their individual remuneration or their interests in the shares of companies in the Rolls-Royce group in this report, as they are disclosed in the Annual report of Rolls-Royce Group plc.

The Company has entered into separate Deeds of Indemnity in favour of its directors. The deeds provide substantially the same protection as that already provided to directors under the indemnity in Article 142 of the Company's Articles of Association The Company has also arranged appropriate insurance cover for any legal action taken against its directors

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

The Company had the equivalent of 47 days purchases outstanding at December 31, 2007, based on the average daily amount invoiced by suppliers during the year

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

Statement of directors' responsibilities in respect of the Report of the directors and the financial statements
The directors are responsible for preparing the Report of the directors and the Group and parent company financial statements, in accordance with applicable law and regulations

Company law requires the directors to prepare Group and parent company financial statements for each financial year Under that law the directors are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards

The Group financial statements are required by law and IFRS as adopted by the EU to present fairly the financial position and performance of the Group, the Companies Act 1985 (the 'Act') provides in relation to such financial statements that references in the relevant part of the Act to financial statements giving a true and fair view are references to their achieving a fair presentation

The parent company financial statements are required by law to give a true and fair view of the state of affairs of the parent company

In preparing each of the Group and parent company financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and estimates that are reasonable and prudent,
- for the Group financial statements, state whether they have been prepared in accordance with IFRS as adopted by the EU,
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements, and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Act. 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

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Rolls-Royce website Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions

Disclosure of information to auditors
Each of the persons who is a director at the date of approval of this report confirms that

i) so far as the director is aware, there is no relevant information of which the Company's auditors are unaware

ii) the director has taken all steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information

This confirmation is given and should be interpreted in accordance with the provisions of Section 234ZA of the Act.

By order of the Board

Tim Rayner, General Counsel and Company Secretary
February 6, 2008

Chief Executive's review

Sir John Rose

2007 was another year of significant progress for Rolls-Royce. We have over many years pursued a consistent strategy which has enabled us to build a robust business.

The strength of our technology gives us unusually good access to growing global markets, as well as creating high barriers to entry The size of our order book, the longevity of our programmes and the scale of our services activity give us clearer visibility of future revenues We face inevitable challenges but we will continue to invest in the technologies and capability to ensure that our business is run efficiently and with a strong global footprint.

Our financial results reflect this progress We increased sales to £7,435 million (2006 £7,156 million), with underlying sales growth of six per cent Underlying profit before tax was £845 million (2006 £851 million) We ended the year with a net cash balance of £887 million, after making a payment of £500 million into our UK pension funds as part of our strategy to reduce overall deficits and reduce volatility

Looking to the future, it is particularly encouraging that our success in global markets has strengthened our order book which ended the year at a record £45 9 billion (2006 £26 1 billion)

Ours is a long-term business and it is important not to look at one year in isolation We therefore highlight the progress made since Rolls-Royce returned to the Stock Exchange 20 years ago

Addressing four global markets

In 1987, Rolls-Royce was in many respects a very different company The business was, of course, centred on the gas turbine but here the similarities stop

Twenty years ago, Rolls-Royce was predominantly a UK company, with over 90 per cent of its employees based in this country If you look at the Group's sales at the time, two points jump out at you the extent to which revenue was dominated by UK sales and the relative narrowness of the Group's global penetration, with Europe and North America accounting for over 70 per cent of turnover We were primarily a defence and civil aerospace business, with the marine and energy sectors in the early stages of development

Now, by contrast, we are a genuinely global company Over 40 per cent of our workforce is based outside the UK and our employees include 50 different nationalities. We manufacture in 20 countries and have customer support facilities in 50

The increasingly global nature of our markets is illustrated by the composition of our record order book, which is now balanced between the Americas, Europe and Asia The rapid increase in our business in Asia and the Middle East was particularly striking in 2007, with the order book for these regions at the same level as the total value of the order book just four years ago Almost 50 per cent of our order book is from outside the traditional markets of Europe and North America

In 2007, we significantly expanded our international presence in all four of our business sectors. We won new customers in the Americas, Europe and Asia, often in countries in which previously we had little or no presence

Investing in technology, capability and infrastructure

Twenty years ago, almost all our research and technology (R&T) activity took place in the UK By 2007, 32 per cent was conducted outside this country, with our centres of engineering excellence spread across the world We have developed a global network of University Technology Centres (UTCs), with nine of our 29 UTCs located outside the UK.

Some things, however, have not changed Our commitment to improving the environmental performance of our products is as strong today as it was in 1987 We believe that technology, applied on an industrial scale, is central to developing an effective response to climate change

In 2007, we continued to work with customers, governments and other stakeholders to help develop solutions Central to our approach is our contribution to international research programmes aimed at halving aircraft noise and carbon dioxide emissions by 2020 from their 2000 levels

Our manufacturing capabilities, like our R&T activity, have become far less UK-centric since 1987 In the past year we have continued to invest globally in new manufacturing capability Our priorities have been to modernise our facilities, introduce more efficient working practices, improve our business processes and simplify our supply chain In September, we announced plans to open a major new assembly facility in Singapore to build and test large civil aero engines. We will also be further increasing our already strong presence in the US by building a facility in Virginia to assemble and test our new RB282 engine for the next generation of corporate jets

Over the past five years we have invested around £850 million in new capital projects in the UK as part of our programme to improve the operational performance of our manufacturing facilities

We clearly intend to maintain a strong UK manufacturing presence However, as the Group continues to grow, our investments and capability will reflect the global spread of our activities

Developing a competitive product portfolio

The Group has successfully broadened its product portfolio by investing in technology and product development and by acquiring products and capability

Although Rolls-Royce competed in aerospace, marine and energy markets 20 years ago, it was with a much smaller product portfolio, across a more limited power range Our research and development approach of 'invent once and use many times' has since allowed us to maximise technology across each of our markets We now have a wide range of modern, efficient gas turbines in each of our key sectors The way we have developed the Trent family for aero, marine and energy markets is the best example of this approach

Our marine business now has an extensive product range, which provides a range of capabilities from ship design to power systems and controls Our energy business provides gas turbines, compressors and reciprocating engines for the power generation and oil and gas markets

Our defence business produces engines for all the major military aviation markets These engines power around a quarter of the world's military fleet

In 1987, our civil aero-engine product portfolio was limited to just four principal engines, one of which, the V2500, was still in development Today, Rolls-Royce has the most extensive product portfolio of any of the gas turbine manufacturers, powering more than 30 applications The breadth of the portfolio makes the business model far more robust as we are not as dependent on the success of individual applications

We continue to see significant opportunities for the introduction of new products in each of our market sectors Our strategy is to ensure that we have 'on the shelf' innovative technologies for future generations of product For Rolls-Royce, product development is at the heart of our competitive advantage and in many ways is our equivalent of acquisition activity For that reason, each product investment involves a rigorous examination of the risks and rewards – in effect the equivalent of due diligence – to ensure that only business cases that we believe will create shareholder value are pursued

Growing market share and our installed product base

Since 1987, we have been successfully growing our market share in each of our businesses

Our share of the market for large civil aero engines is nearly 40 per cent and we are Europe's number one, and the world's number two, defence aero-engine producer

We are also pre-eminent in capabilities which 20 years ago either did not exist or were at a very early stage of development For example, our marine propulsion business is the market leader in its field and we have one of the world's most successful offshore vessel ship-design businesses

In the energy market, we are a world leader in the supply of power and compression equipment to the offshore oil and gas markets We are also developing our power generation business with new products such as the low emissions Bergen series of gas engines

Developing aftermarket services that add value

In 1987, we supported our engines in service by offering repair and overhaul arrangements which often failed to align our interests with those of our customers

Today, we have comprehensive through-life service arrangements in place in each of our business sectors. These align our interests with those of our customers and enable us to add value through the application of our skills and knowledge of the product

In 2007, underlying aftermarket service revenues grew by nine per cent and represented 55 per cent of Group sales This growth has been achieved partly as a result of the introduction of new products, but also because our ownership of intellectual property enables us to turn data into information that adds value to our customer

Future prospects

Our consistent strategy has created a business that is increasingly global in terms of its operational footprint and has access to a broad range of growing markets worldwide

This access to markets is distinctive It has profoundly influenced the nature of our order book, which has increased in line with our greater geographical spread and also reflects the growing economic significance of Asia and the Middle East

Our strong order book, together with the long product life cycle and our ability to provide valuable services to customers, has greatly increased the predictability of our business

Responding to these opportunities will inevitably see the Company continue to change at an equivalent or faster pace than that of the past two decades

Our strong focus on productivity and efficiency, our broad product and service portfolio and our access to global markets give us confidence that in 2008, Rolls-Royce will continue to deliver profitable growth and a positive cash flow

Sir John Rose
Chief Executive
February 6, 2008

Business review
Our business

Market outlook

The Group operates in four long-term global markets – civil and defence aerospace, marine and energy These markets present, in aggregate, an opportunity of some two trillion US dollars over the next 20 years and have common characteristics All these markets have very high entry barriers and

- offer the opportunity for organic growth,
- feature extraordinarily long programme lives, usually measured in decades,
- can only be addressed through significant investments in technology, infrastructure and capability, and
- create a significant opportunity for extended customer relationships, with revenues from aftermarket services similar in size to original equipment revenues

The size of these markets is generally related to world Gross Domestic Product (GDP) growth, or in the case of the defence markets, global security and the scale of defence budgets

Civil aerospace

The Group publishes a 20 year global market outlook, which covers passenger and cargo jets, corporate and regional aircraft We predict that over the next 20 years 131,000 engines, worth over US$700 billion, will be required, for more than 60,000 commercial aircraft and business jets

The forecast predicts faster growth rates for long-haul markets and those markets to, from and within Asia These markets will continue to benefit from more liberal air service agreements, which boost demand

Factors affecting demand include GDP growth, aircraft productivity, operating costs, environmental issues and the number of old aircraft retirements

While the market can be temporarily disrupted by external events, such as war or acts of terrorism, it has, in the past, always returned to its long-term growth trend

In addition to the demand for engines, the Group forecasts a market opportunity worth US$550 billion for the provision of product related aftermarket services

Defence aerospace

The Group forecasts that demand for military engines will be worth US$180 billion over the next 20 years The largest single market is expected to be the US, followed by Europe and the Far East Within Asia, demand will be dominated by Japan, South Korea and India Trends are driven by the scale of defence budgets and geopolitical developments around the world

As in the Group's other business sectors, programme lives are long and there is a significant opportunity to support equipment with aftermarket services Customers' budget constraints and their need to increase the value they derive from their assets have accelerated the move in this direction The Group estimates the value of services revenues over the next 20 years to be US$300 billion

Marine

The Group forecasts demand for marine power and propulsion systems of US$230 billion over the next 20 years Demand will be greatest in the commercial sector, where the merchant market represents 50 per cent of the total and the offshore market, 30 per cent

Commercial shipping plays a crucial role in the world economy The need to transport raw materials, finished goods, people, and oil and gas requires a large fleet which has to be renewed progressively

The expansion of trade and technological advances mean more ship construction for growth and for replacement as older designs become obsolete Finding and extracting oil and gas offshore requires a large number of floating drilling and production units which, in turn, are supported by a variety of service craft Merchant and offshore markets are rarely at the same stage of the business cycle, which helps to reduce overall volatility

In naval markets, the Group expects surface vessels to represent 15 per cent of the total demand, and submarines five per cent

Naval markets are driven by different considerations, with customers looking to get more for their budgets, leading to increasing demand for integrated systems and through-life servicing arrangements

As in the Group's other markets, marine aftermarket services are expected to generate significant demand, forecast at US$120 billion over the next 20 years

Energy

The International Energy Agency has forecast that over the next 20 years, the worldwide demand for oil will grow by 40 per cent, for gas by more than 50 per cent and for power generation by nearly 60 per cent.

To satisfy this demand, there will be a growing requirement for aero-derived gas turbines The Group's 20 year forecast values the total aero-derivative gas turbine sales in the oil and gas and power generation sectors at US$70 billion Over this period, demand for associated aftermarket services is expected to be around US$50 billion

While the oil and gas market is large and growing, demand for aero derivatives in the power generation segment is four times that of oil and gas

Group financial highlights

The Group delivered underlying organic sales growth across all businesses, growth in underlying profits and a further year of positive cash flow

Business review continued
Our business continued

Strategy

We have followed a consistent strategy over many years to grow the business profitably based on five key elements

Address four global markets

We are a leading power systems company operating in the civil and defence aerospace, marine and energy markets

Invest in technology, capability and infrastructure

Over the past five years, we have invested £3.5 billion in research and development We invest approximately £30 million annually on training and some £300 million a year on capital projects

Develop a competitive portfolio of products and services

We have more than 50 current product programmes and we are involved in many of the major future projects in the markets we serve These key projects will define the power systems market for many years

Grow market share and installed product base

Across the Group, the installed base of engines in service is expected throughout their long product lives to generate attractive returns over several decades

Add value for our customers through the provision of product-related services

We seek to add value for our customers with aftermarket services that will enhance the performance and reliability of our products.

Key performance indicators

The Board uses a range of financial and non-financial indicators to monitor Group and segmental performance in line with the strategy described These indicators are chosen to monitor both current performance and the success of investments that will sustain and enhance future performance

Key performance indicators are included in the appropriate sections of the business review and are as follows

Underlying revenue

Monitoring of revenues provides a measure of business growth Underlying revenues are used in order to eliminate the effect of the decision not to adopt hedge accounting and to provide a clearer year-on-year measure The Group measures foreign currency sales at the actual exchange rate achieved as a result of settling foreign exchange contracts from forward cover

Underlying revenue grew by six per cent in 2007 and has grown by eight per cent compound over the past five years

Underlying profit before financing

Underlying profit before financing is presented on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements In particular, (a) revenues and costs denominated in US dollars and Euros are presented on the basis of the exchange rates achieved during the year, (b) similar adjustments are made in respect of commodity derivatives, and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis The derivation of underlying profit before financing is shown in note 2 on page 39 of the consolidated financial statements

Underlying profit before financing grew by 10 per cent in 2007 and has grown by 22 per cent compound over the past five years.

Cash flow

In a business requiring significant investment, the Board monitors cash flow to ensure that profitability is converted into cash generation, both for future investment and as a reward for shareholders The Group measures cash flow as the movement in net funds/debt during the year, after taking into account the value of derivatives held to hedge the value of balances denominated in foreign currencies

Research and development

Investment in research and development underpins all the elements of the Group's strategy Programme expenditure is monitored in conjunction with a gated review process on each programme and progress is reviewed at key milestones

Gross research and development expenditure

The Group's research and development activities comprise both self-funded and customer funded programmes Gross expenditure measures the total research and development activity and is an indicator of the effectiveness of the actions taken to improve continuously the Group's intellectual property

Research and development as a proportion of underlying sales

Research and development is measured as the self-funded expenditure before both amounts capitalised in the year and amortisation of previously capitalised balances The Group expects to spend approximately five per cent of revenues on research and development although this proportion will fluctuate year-by-year depending on the stage of development of current programmes This measure reflects the need to generate current returns as well as to invest for the future

Capital expenditure
To deliver on its commitments to customers, the Group invests significant amounts in its infrastructure All investments are subject to rigorous review to ensure that they are consistent with forecast activity and will provide value for money Annual capital expenditure is measured as the cost of property, plant and equipment acquired during the period

New product launches
As discussed in the Chief Executive's review on page 5, the Group has broadened its product portfolio over the past 20 years. This portfolio is subject to continuous review and new programmes are launched only after rigorous review, where the business case confirms that the programme will create shareholder value

Order book
The order book provides an indicator of future business and is measured at constant exchange rates and list prices and includes both firm and announced orders In civil aerospace, it is common for a customer to take options for future orders in addition to firm orders placed Such options are excluded from the order book. In defence aerospace, long-term programmes are often ordered for only one year at a time In such circumstances, even though there may be no alternative engine choice available to the customer, only the contracted business is included in the order book. Only the first seven years' revenue of long-term aftermarket contracts is included

Training expenditure
Training is a core element of the Group's investment in its capability and is measured as the expenditure on the training and development of employees, customers and suppliers Effectiveness is ensured by using a range of external and internal sources, and by gathering user feedback.

Employee engagement surveys
Regular surveys are undertaken to identify and address emerging issues

Training and employee engagement surveys are discussed further in the corporate responsibility section of this review

Product cost index
Unit costs are a key determinant of the Group's ability to deliver its commitments on a profitable basis The Group monitors the year-on-year change in the actual average unit product cost of its gas turbine operations and seeks over time to improve productivity in all owned facilities and suppliers

Engine deliveries
The Group's installed engine base represents an opportunity to generate future aftermarket business Within each business segment (except marine as its products do not lend themselves to this measure due to their diversity), this is measured as the number of Group products delivered during the year

Underlying services revenue
Underlying services revenue shows the amount of business during the year that has been generated from the installed engine base This is measured as the revenue derived from spare parts, overhaul services and long-term service arrangements

Percentage of fleet under management
Long-term contracts are an important way of generating value for customers The percentage of fleet under management gives a measure of the proportion of the installed base where the future aftermarket arrangements are agreed under long-term contracts. This is measured as the percentage of gas turbines and submarine propulsion units where the Group has contracted a long-term service arrangement In civil aerospace, marine and energy, the percentage is weighted to reflect the value of the equipment under management The amounts shown for civil aerospace for 2003 and 2004 differ from those disclosed in Annual reports for those years as a result of reflecting this weighting

Emissions
Much of the research and development expenditure is focused on reducing emissions of the Group's products.

The Group measures both the emissions of its products and the emissions of its manufacturing operations These measures are described in detail in the environment report, 'Powering a better world' which is available on the Rolls-Royce website at www rolls-royce com

Business review continued
Our business continued

Principal risks and uncertainties

The Group continues to be exposed to a number of risks and has an established, structured approach to identifying, assessing and managing those risks The risk committee has accountability for the system of risk management and regularly reports to the Board on the key risks facing the business and the mitigating actions the Group has put in place to deal with them The Group has a consistent strategy and long performance cycles and consequently the risks faced by the Group have not changed significantly over the past year

The principal risks reflect the global growth of the business, and the competitive and challenging business environment in which it operates Risks are considered under four broad headings

Business environment risks

Environmental impact of products and operations
The Group recognises that its activities have an impact on the environment and the approach taken is to be part of the solution to resolving the challenges faced by climate change A high priority is given to responding to the challenge of reducing the environmental impact of the Group's products and business activities It is recognised that the solutions are not straightforward and that novel developments represent both significant threats and opportunities

Our Environment report was published in 2007 and shared with key stakeholders This details our global strategy to address the risks and reports on our approach to working towards achieving challenging performance improvement targets for noise and carbon dioxide emissions by 2020 Technology acquisition programmes for more fuel-efficient products form a major part of the management of these risks

External events which might affect demand for air travel or cause the business to be disrupted
Civil aerospace is an important contributor to Group revenues and profits The willingness of passengers to travel by air is influenced by a range of factors, including economic, health and security issues. Exposure to this risk is mitigated by the Group's business strategy, which has enabled it to develop a broader, global business base, with the defence, marine and energy businesses being less susceptible to this type of risk. In addition, the civil aerospace business model, with its emphasis on increasing aftermarket services revenues, continues to be resilient, providing a high degree of protection against any shortfall in demand The Group's ability to respond rapidly to changes in demand through the adjustment of its cost base is a key mitigation

Disruption to the Group's business operations and the ability to respond to and recover from disruption, for example, from an outbreak of pandemic flu, is recognised as a key element of, and risk to, both financial performance and the Company's reputation The Group's operations strategy aims to deliver world-class manufacturing capabilities with an increasing global footprint, providing flexibility and ability to respond to disruption A Group Crisis Management framework and plan is in place as part of the wider business continuity and risk management activities

Strategic risks

Aftermarket
The Group's business model is balanced between original equipment delivery and aftermarket services The growth in product sales has provided a larger base from which to generate aftermarket revenues These continue to contribute over half of annual sales and are an essential element of the returns the Group expects to make from its investments The ability to deliver the operational service to the satisfaction of its customers while managing the costs of the service, will determine the Group's profitability The Group is focused on working in partnership with all of its global customers and driving improvement through the supply chain to provide a high standard of service to all its customers The Group has made investments in service delivery capabilities and works closely with its customers to understand better their requirements, with a continued focus on standardisation and processes to manage cost

Competitive pressures
The markets in which Rolls-Royce operates are highly competitive The majority of its programmes are long term in nature and access to key platforms is critical to the success of the business. This requires sustained investment in technology, capability and infrastructure, which presents a high barrier to entry However, these factors alone do not protect the Group from competition, including pricing and technical advances made by competitors which could adversely affect the Group's results

The Group has developed a balanced business portfolio and maintained a steady improvement in operational performance This, together with the establishment of long-term customer relationships and sustained investment in technology acquisition, allows the Group to respond to competitive pressure

Financial risks

These are risks that arise as a result of movements in financial markets. Principal risks are movements in foreign currency exchange rates, interest rates, commodity prices and counterparty credit risk.

A description of these risks and details of the Group's risk mitigation actions in this area are provided in the Finance Director's review on pages 23 to 27

Operational risks

Performance of supply chain
A significant element of the Group's risk profile is the delivery performance of its supply chain The Group manufactures approximately 30 per cent by value of its gas turbine products, the remainder being provided through external supply chains Strong growth in order intake has been experienced and any failure of the supply chain would present a risk to the delivery of products to meet customer requirements and achieve financial goals The Group's supply chain strategy is to seek opportunities to simplify and globalise the external supply chain by forging deeper, strategic relationships with fewer but stronger global suppliers, working together on design and manufacture

The Group is close to completing the modernisation of its production facilities, which will improve productivity and reduce costs Investment in developing world-class manufacturing processes continues in Asia, North America and the UK. In addition, the Group has an established global business continuity programme, to manage the risk of a loss of a major capability or facility

IT security
Continuing globalisation of the business and advances in technology have resulted in more data being transmitted across global communication links, posing an increased security risk Security systems operate with the latest technology and Rolls-Royce maintains effective communications with other industrial companies and the appropriate government agencies to share information on potential threats

Ethics
The Group recognises the benefit that is derived from conducting business in an ethically and socially responsible manner This approach extends from the supply of raw materials and components to the manufacture and delivery of end products and services It applies to the provision of a safe and healthy place of work and investment in technologies to reduce the environmental impact of the Group's products and operations A failure in any of these areas could damage the Group's reputation and disrupt its business

The Group is committed to embedding high ethical standards and a new Global Code of Business Ethics was issued to all employees during 2007 A training and engagement programme for employees will be completed during 2008 to strengthen employee awareness of the Group's values. The Group communicates its standards to its first-tier supply base through a supplier code of conduct

Programme risk
The Group manages complex product programmes with demanding technical requirements against stringent customer schedules This requires the co-ordination of the external supply chain, manufacturing operations, partners and engineering functions Failure to achieve programme goals would have significant financial implications for the Group

The Group employs project management controls on a routine basis. All major programmes are subject to Board approval and are regularly reviewed by the Board with a particular focus on any emerging risks

Business review continued

Review of operations

Civil aerospace

The civil aerospace business powers over 30 types of commercial aircraft from business jets to the largest widebody airliners A fleet of over 12,000 engines is in service

The business has performed strongly, increasing underlying revenue by three per cent and underlying profit before financing by nine per cent despite the headwinds of a further weakening of the US dollar and increased unit costs Flying hours continued to grow at approximately five per cent, with services revenues representing 63 per cent of underlying sales The Rolls-Royce TotalCare® and CorporateCare® service products were again chosen by the vast majority of new operators

The business continued to benefit from its strong position on new programmes and its broad portfolio, as orders for new aircraft and engines rose to unprecedented levels The total order book for civil aerospace was £35 9 billion, with record orders for Trent engines in the widebody sector and for V2500 engines in the single-aisle market

Orders for Trent engines covered all six variants, contributing to an overall total of 1,182 Emerging markets, including South America, China, Russia and India, accounted for 17 per cent of Trent orders while 45 per cent were won in our established markets in the US, Europe and Asia

Significant milestones were reached by the Trent engine family this year The Airbus A380 successfully entered service in November with Singapore Airlines, powered by the Trent 900 as its launch engine In July, the first Boeing 787 was rolled out with its launch engine, the Trent 1000, which received Federal Aviation Authority and Joint Aviation Authority certification as scheduled in August

The 787 aircraft will enter service with All Nippon Airlines and continues to sell well, with the firm order book for Trent 1000 engines exceeding 600 engines at the end of 2007

The Trent family continues to attract strong demand The Trent is the only engine currently available for the Airbus A350XWB, for which Airbus received approximately 300 orders during 2007 An upgraded version of the Trent 700 will enter service in 2009, and during 2007, almost 70 per cent of customers who ordered the Airbus A330 chose the Trent 700, representing business to us of US$3 8 billion

Civil aerospace – 2007 highlights

Operational highlights

Almost 1,200 Trents ordered in the year covering all six variants

Trent 900 successfully entered service on the Airbus A380

Trent 1000 received certification on schedule

Dassault selected Rolls-Royce to power its new super mid-sized business jet

11 customers selected the Trent XWB for a total of more than 600 engines

Key financial data	2007	2006	2005	2004	2003
Underlying revenue £m	**4,038**	3,907	3,406	3,072	2,715
	+3%	+15%	+11%	+13%	-1%
Underlying profit before financing £m	**564**	523	441	208	168
	+8%	+19%	+112%	+24%	-10%
Net assets £m	**2,260**	1,889	1,315	1,257	1,338
Other key performance indicators					
Order book £bn	**35 9**	20 0	19 0	16 2	14 4
	+80%	+5%	+17%	+13%	+14%
Engine deliveries	**851**	856	881	824	746
Underlying services revenues £m	**2,554**	2,310	2,016	1,838	1,460
Underlying services revenues %	**63**	59	59	60	54
% of fleet under management	**55**	48	45	45	43

International Aero Engines (IAE), in which Rolls-Royce is a major shareholder, certified its SelectOne upgrade of the successful V2500 engine on time in December The improved engine saw another record year for new orders, reflecting the competitive advantage achieved by its low fuel consumption and maintenance cost benefits More than 660 IAE V2500 engines were selected to power over 300 Airbus A320 family aircraft during 2007, including a follow-on order from US Airways for 78 V2500 powered aircraft

The Group's leadership in the business jet sector was reinforced by Dassault's selection of a new Rolls-Royce engine to power its next generation, super mid-sized business jet Our business jet sector continued to perform strongly with almost 400 engines delivered for corporate and regional applications to Bombardier, Cessna, Embraer and Gulfstream

In October, the Group announced plans to invest in two significant new facilities to help meet growth A new facility in Singapore, to be completed in 2009, will provide Rolls-Royce with a dual-sourcing capability for the assembly and test of large civil engines, including future new versions of the Trent engine In addition, a new facility in Virginia, US, will assemble and test the new engine for the Dassault programme

Defence aerospace

The defence aerospace business has over 20,000 engines in service and is Europe's largest aero-engine manufacturer in the defence sector We power aircraft in all the major categories including transport, helicopters, trainers, combat, tactical and unmanned aerial vehicles

2007 marked another year of progress in all sectors EJ200 engine business and support for the fleet of 72 Eurofighter Typhoon aircraft for the Royal Saudi Air Force will be worth up to £1 billion to Rolls-Royce We are the prime contractor for EJ200 on behalf of the Eurojet consortium

The F136 engine, which we are jointly developing with GE to power the F-35 Lightning II, has been fully funded for 2008 by the US Department of Defense (DoD) at US$480 million The engine continues to perform exceptionally well in both testing and milestone delivery The LiftSystem for the STOVL variant of the F-35 has been installed in the aircraft and is expected to make its first flight in the first half of 2008

The selection of the AE 2100-powered C-27J for the Joint Cargo Aircraft programme in the US further enhanced the Group's position as the leader in the transport aircraft engine market The supply of the engines and aftermarket services is worth more than US$500 million over the life of the programme For the collaborative TP400 engine programme, a challenging year culminated in the delivery of the first engine for the flight test programme Incremental development costs of £40 million associated with the programme have been provided for in the year

In the tactical sector, the Advanced Hawkeye programme, with the T56-A-427A powered E-2D aircraft, achieved its first flight in August 2007 The programme has a potential contract value of US$500 million Initial production for the programme commences in 2008

The launch of the RR300 engine represents a major step forward in the helicopter sector with the engine providing 300 shaft horsepower at take off, excellent hot and high performance and outstanding value Federal Aviation Authority type certification was achieved ahead of schedule in December 2007, with full-rate production to follow in 2008 Under the agreement with Robinson Helicopter, Rolls-Royce will provide several hundred RR300 engines in forthcoming years Elsewhere in the helicopter sector, additional RTM322 orders were secured from Belgium and Australia, while the T800 was selected by Turkey to power the ATAK helicopter

Defence aerospace – 2007 highlights

Operational highlights

EJ200 engine and support contract signed for Royal Saudi Air Force Eurofighter Typhoon aircraft

F136 programme received US$480 million development funding for 2008

Rolls-Royce selected as propulsion system provider for the US forces Joint Cargo Aircraft programme

V-22 Osprey engine contract for US$700 million gained

RR300 launched to power the Robinson R66

Service contracts worth over US$500 million signed

Key financial data	2007	2006	2005	2004	2003
Underlying revenue £m	**1,673** +4%	1,601 +13%	1,420 +3%	1,374 -2%	1,398 +2%
Underlying profit before financing £m	**199** +2%	195 +11%	175 -2%	179 +22%	147 -20%
Net assets £m	**(247)**	(83)	(56)	(48)	81
Other key performance indicators					
Order book £bn	**4 4** +38%	3 2 -3%	3 3 0%	3 3 +22%	2 7 +4%
Engine deliveries	**495**	514	565	548	510
Underlying services revenues £m	**877**	853	787	768	789
Underlying services revenues %	**52**	53	55	56	56
% of fleet under management	**11**	11	8	5	5

2007 marked a significant year for the AE 1107C-Liberty engine with the award of a five-year production contract from the US DoD worth US$700 million for the V-22 Osprey tiltrotor aircraft

Aftermarket support continued to develop, both in terms of new contracts and the scope of services being offered to customers Rolls-Royce signed its first contract with the US Air Force to support its fleet of AE 2100 engines on the C-130J aircraft, worth US$235 million Adour engine support contracts were also signed with the US Navy and the UK Ministry of Defence (MoD) A Memorandum of Understanding was signed with BAE Systems to work together to improve support to the UK MoD and other worldwide customers, building on two successful availability contracts for the UK's RB199-powered Tornado fleet

Business review continued
Review of operations continued

Marine

Rolls-Royce provides a range of capabilities and expertise in the marine sector for naval surface ships, submarines, offshore and merchant vessels The business has installed equipment on over 20,000 vessels, including those of 70 navies

The marine business has enjoyed another successful year with a strong increase in sales and good order book growth Key sectors of the business saw record order intakes, and we made progress on some important new marine programmes

The offshore sector performed strongly during the year In June 2007, we announced an £83 million contract to deliver designs and equipment for six new Rolls-Royce offshore service vessels to Nordcapital, which will be operated on their behalf by OSM Schiffahrt This is the largest single marine offshore contract ever won by Rolls-Royce In December 2007, a £72 million contract was signed with the same company covering a further four ships taking the total to £155 million

Our merchant sector also contracted major new business We signed our largest contract so far with Chinese shipbuilder Sinopacific, to provide steering gear and deck machinery worth US$42 million The order marked a record year in China for the merchant sector with contracts for more than 700 ship sets of steering gear and 300 ship sets of deck machinery China now presents the biggest single market opportunity for Rolls-Royce equipment in commercial merchant ships

In the naval business, a major milestone was achieved when Rolls-Royce was selected to supply the US Navy's most advanced surface combatant ship with the world's most powerful marine gas turbine Four MT30 gas turbine generator sets are being supplied to power two DDG-1000 Zumwalt Class destroyers, with deliveries to begin in 2009 Also in North America, the US naval architecture and engineering firm, Seaworthy Systems Inc, was acquired and added to the marine portfolio to boost support services Its work is now part of a TotalCare service Rolls-Royce is developing for naval customers, offering long-term guaranteed power availability and complete propulsion plant support for ships.

Marine – 2007 highlights

Operational highlights

Largest ever order won by the offshore sector at £155 million

New service centres announced for Singapore, Rio de Janeiro, Mumbai, Galveston, Fort Lauderdale and Rotterdam

MT30 selected by the US Navy to power two DDG-1000 destroyers

£1 billion service contract won for Royal Navy nuclear power plants for the UK's submarine fleet

Key financial data	2007	2006	2005	2004	2003
Underlying revenue £m	**1,548** +19%	1,299 +18%	1,097 +14%	963 -4%	1,003 +2%
Underlying profit before financing £m	**113** +11%	102 +17%	87 +12%	78 0%	78 -5%
Net assets £m	**508**	543	595	523	554
Other key performance indicators					
Order book £bn	**4.7** +96%	2 4 +41%	1 7 +21%	1 4 +17%	1 2 -8%
Underlying services revenues £m	**545**	487	435	397	380
Underlying services revenues %	**35**	37	40	41	38
% of fleet under management	**33**	3	3	0	0

An innovative 10-year contract with the UK MoD worth £1 billion was secured for Rolls-Royce to manage the support of the reactor powerplants of the Royal Navy's nuclear submarine fleet Rolls-Royce and the UK MoD formed a joint team setting agreed service levels, and both parties are now sharing the savings made through improved business efficiency and effectiveness

The business has been undertaking a review of the efficiency of our supply chain in 2007 in order to meet the challenge of higher levels of production activity

Marine is creating a fully integrated global operations business which will help realise economies of scale, improve efficiency and thereby reduce the unit cost of production This is being achieved through improvements in manufacturing plant and production facilities which are aimed at building capacity to respond to our existing workload and manage greater volumes in the future

A good example is the £14 million investment in our diesels facility in Bergen, Norway, where we are installing state-of-the-art machining equipment which will significantly improve levels of production

Our large base of installed equipment provides a platform from which to grow our services business To meet this global opportunity we are upgrading our service facilities in places as diverse as Singapore, Rio de Janeiro, Mumbai, Galveston, Fort Lauderdale and Rotterdam and, at the same time, recruiting more service engineers to provide better customer service

Energy

The energy business has customers in over 120 countries. It is a leading supplier of power systems to the oil and gas industries and has a growing presence in the electrical power generation sector

In 2007, the energy business won a record number of contracts in both the oil & gas and power generation sectors Services also had a strong year and now accounts for over 50 per cent of total sales

With record demand driving a strong oil and gas market, we continued to expand our global footprint with orders from customers in the Americas, Europe, the Middle East and Asia

The Caspian region proved particularly active In Azerbaijan, the energy business secured its largest single contract to date, a TotalCare service agreement with British Petroleum (BP) worth £120 million for the maintenance of 28 industrial RB211 gas turbines operating onshore and offshore As part of our strategy to work more closely with customers, this contract will be managed from our service centre in Baku We also won our first order for the installation of RB211 units in Turkmenistan This order continues the expansion of our footprint in the central Asia/Caspian region

Our growing presence in the power generation sector continues. Momentum is building as the industrial Trent attracts a broader customer base, particularly in a recovering North American market In 2007, we received a record number of orders for the industrial Trent, including five units for installation in the US Commitments were also received from customers in South America, Europe and Australia

We continue to focus on becoming a service solutions provider, with the services segment having doubled its order intake over the past three years We now have dedicated customer service centres in Scotland, Brazil and Azerbaijan, with plans under way for an additional site in West Africa These centres position the skills and knowledge of our services team closer to our customers

Energy – 2007 highlights

Operational highlights

Record orders received totalling £856 million

Services now represent 52 per cent of sales

Largest ever order won at £120 million for maintaining RB211s for BP

Record number of contracts for the industrial Trent

Avon 200 upgrade well received by market in first year

Key financial data	**2007**	2006	2005	2004	2003
Underlying revenue £m	**558** **+2%**	546 +2%	535 -1%	538 2%	529 -17%
Underlying profit/(loss) before financing £m	**5** **+128%**	(18) -1 700%	(1) +86%	(7) +61%	(18) +80%
Net assets £m	**346**	355	353	395	546
Other key performance indicators					
Order book £bn	**0.9** **+80%**	0.5 +25%	0 4 0%	0 4 0%	0 4 -33%
Engine deliveries	**32**	44	61	47	54
Underlying services revenues £m	**289**	251	219	248	214
Underlying services revenues %	**52**	46	41	46	40
% of fleet under management	**7**	6	5	5	4

Our product upgrades business also delivered a record year Demonstrating our commitment to the existing Rolls-Royce installed gas turbine fleet, this business applies new technology into existing products to extend their service life by enhancing power and performance Of particular note is our Avon 200 programme, which provides Avon gas turbine users with increased efficiency and power for their installed units The market response to this programme has been extremely positive, with orders for 19 unit upgrades received in the first year

Business review continued
Review of operations continued

Engineering and Technology

In 2007, Rolls-Royce invested a total of £824 million in research and development, of which £454 million was funded from Group resources The net charge to the income statement was £381 million

Over the past year, we have continued investing in technology demonstration programmes aimed at reducing the environmental impact of our products The seven year European 'Clean Sky' Joint Technology Initiative has now been successfully launched with Rolls-Royce leading three of the five engine demonstrator programmes. This European initiative is aiming to reduce radically the impact of civil aviation on the environment

In the UK, we are members of the newly formed Energy Technologies Institute (ETI) whose remit is to invest in research and development to accelerate the development of secure, reliable and cost-effective low-carbon energy technologies towards commercial deployment We have also successfully been awarded funding from the UK Government's Technology Strategy Board for a number of low carbon/renewable projects

Development of the innovative Rolls-Royce fuel cell system continues This technology will deliver significant reductions in carbon dioxide with negligible oxides of nitrogen emissions relative to existing fossil fuel power generation technology

In 2007, we continued the expansion of our global network of University Technology Centres (UTCs) with two new UTCs at the University of Bristol, to focus on composite materials and at Karlsruhe in Germany, to focus on cooling in turbines and combustors We also launched a new Advanced Research Centre to develop forming technologies with industry partners and Strathclyde University

Building on our research successes of previous years we filed a record 400 patent applications.

Engineering and Technology – 2007 highlights

Operational highlights

The Trent 1000, V2500 SelectOne and RR300 helicopter engine all achieved certification on plan

The JSF LiftFan completed ground testing prior to first flight

The revolutionary Rim Driven Tunnel Thruster started sea trials

Two new University Technology Centres and an Advanced Research Centre were opened

A record 400 patent applications were submitted

US$315 million of contracts received for US Air Force work on advanced propulsion concepts

Key performance indicators	2007	2006	2005	2004	2003
Gross research and development expenditure £m	**824**	747	663	601	619
Net research and development expenditure £m	**454**	395	339	282	281
Net research and development charge £m	**381**	370	282	288	281
Net research and development expenditure % of underlying revenue	**5 8**	5 4	5 2	4 7	5 0

The US Air Force laboratory awarded Rolls-Royce two contracts within the Versatile Affordable Advanced Turbine Engines (VAATE) programme with a total value of US$315 million The Adaptive Versatile Engine Technology (ADVENT) programme will demonstrate adaptive cycles technologies, while the Highly Efficient Embedded Turbine Engine (HEETE) will develop high-pressure ratio compressor and high temperature cycles technologies

In the defence sector, the LiftFan for the Joint Strike Fighter completed ground testing prior to its flight test in 2008 The T56-A-427A engine for the E-2D Advanced Hawkeye successfully started flight-testing This latest version of the T56 family incorporates a new sensor suite plus state-of-the-art integrated electronic propulsion system control, monitoring, and maintenance system The new RR300 helicopter engine was certified ahead of schedule and is now undergoing flight testing

In the civil aerospace sector, the Trent 1000 achieved certification on schedule in August and successfully completed a flight test programme on the Rolls-Royce Flying Test Bed The V2500 SelectOne engine, which offers improved fuel consumption and lower life-cycle costs was also certified

In the marine propulsion sector, we have started sea trials of a full-scale prototype of the Rim Driven Tunnel Thruster, which delivers a step change in technology for tunnel thrusters and dynamic positioning The new lean-burn Bergen KV gas reciprocated engine made its entry into service, setting new standards in low emissions for commercial marine applications

In 2007, the WR-21-powered Royal Navy Type 45 destroyer completed initial sea trials The WR-21 is developed from the RB211 aero engine and features an advanced intercooled recuperated cycle that makes it the world's most efficient marine gas turbine

Operations

The supply chain in 2007 continued to evolve, meeting strong demand from all markets and managing the introduction of several new products

A mixture of material costs, factory disruption and supplier pressures all contributed to a unit cost increase in the year of almost seven per cent

The Trent 900 production line was successfully restarted and the engine's application, the Airbus A380, entered service successfully The Trent 1000 engine for the Boeing 787 entered production Boeing's decision to re-schedule the entry into service of the 787 means that we will re-plan production of the engine in line with the requirements of the aircraft programme

Other new products entering production include the V2500Select upgrade, TP400, RR300 and WR-21

As part of managing the introduction of a number of new programmes we maintained our focus on simplifying our supply chain, resulting in a reduction in the number of external suppliers.

The drive to improve our productivity continued with the final exit from our older UK factories and with the introduction of our planning system to more of our facilities Our SAP system has now been embedded in 32 sites, and was introduced in 2007 to sites in the US, Canada and the UK The smooth and quick implementation of SAP into our new repair and overhaul joint venture in Germany, N3, also took place

Modern Working Practices were fully embedded in all our operational facilities in the UK, including civil aerospace assembly and test

Our Process Excellence programme continued to supply both wide scale and local improvements, complementing the benefits from our major process systems such as SAP and PLM

Worldwide, our engineers can now work simultaneously on the same live computer model, improving lead times and productivity as a result of upgrading key engineering design tools such as PLM

Operations – 2007 highlights

Operational highlights

Trent 900 production line successfully restarted

V2500 SelectOne, TP400, RR300 and WR-21 all entered production

New facilities opened in Derby and Bristol

New outdoor test facility commissioned in Mississippi

Future assembly plants in US and Singapore announced

Key performance indicators	2007	2006	2005	2004	2003
Capital expenditure £m	**304**	303	232	191	186
Product cost index – year-on-year (increase)/decrease %	**(7)**	(5)	0	5	4
Sales per employee (£k)	**193**	192	186	169	156

The availability of these and other improved systems and processes will allow us to reduce the number of employees in management and support roles by 2,300 worldwide We continue to recruit graduates, apprentices and employees involved directly in delivering growth for the Group Consequently the overall productivity will improve through 2008

Our plans to become more productive, global and less exposed to the volatility of the US dollar exchange rate have continued There were several facilities opened around the world including the new Rotatives plant and a new test bed for large civil engines in Derby, UK, and a new facility in Bristol, UK. Our outdoor test facility in Mississippi, US, was also commissioned

We selected the locations for two new facilities, one in Asia and the other in the US Our new advanced assembly and test plant for Trent engines will be built in Singapore and in Virginia we will build a new manufacturing plant for the assembly and test of the RB282 engine Both facilities will be operational by the end of 2009

We entered 2008 with an increase in load and we have visibility of load over several years as a result of our strong order book Raw materials have been secured and strategic hedging is in place to manage supply and cost risks

The increase in load, allied to our supply chain simplification and improvement, gives us an opportunity to continue cost reduction and to reduce further our exposure to the US dollar Continuing investment in IT, facilities, processes and people will allow us to grow our business and better manage the cost of overheads

We would like to thank all employees, suppliers and partners for their commitment during the year

Business review continued
Review of operations continued

Services

The Group's underlying service revenues continued to grow strongly in 2007, increasing nine per cent to £4.3 billion Services account for 55 per cent of Group revenues, with long-term TotalCare agreements now representing the majority of our business in the civil aerospace sector

Our services range from the provision of field support, shop maintenance and logistics solutions to data management and engine leasing, delivered through a global network of service providers, wholly owned, and joint venture facilities Rolls-Royce and joint venture facilities employ over 8,000 people with major locations in the UK, Europe, the Americas and Asia The service delivery organisations are managed through our operations centres which plan the flow of work and manage the day-to-day activities

Our relationships with our customers are at the heart of our services strategy TotalCare, our preferred contracting model, aligns our interests with those of our customers and provides an incentive for Rolls-Royce to build and drive improvement in the services supply chain

We frequently work closely with our customers in building service delivery capability and we have recorded a number of milestones this year HAESL, our joint venture in Hong Kong with HAECO of the Swire Group, celebrated its tenth year of operations and the opening of its latest facility extension in December 2007, SAESL, our joint venture with Singapore Airlines, delivered its 500th engine, and TAESL, our joint venture with American Airlines, its 1,500th engine We continue to build on this successful model and N3, which is a joint venture with Lufthansa Technik in Germany, and our newest repair and overhaul centre, opened for business in March 2007

One of the ways we measure our progress in implementing our service strategy is by reference to the percentage of the installed base of delivered engines subject to TotalCare or similar agreements During 2007, Singapore Airlines and Emirates converted their Trent service contracts to TotalCare Such decisions and deliveries of new engines subject to TotalCare have increased the civil engine fleet under management to 55 per cent, up from 48 per cent last year This trend is set to continue, with 77 per cent of future Trent civil deliveries subject to TotalCare agreements.

Services – 2007 highlights

Operational highlights

Service revenues increased nine per cent to £4,265 million
55 per cent of civil fleet under TotalCare
HAESL celebrates tenth year of operation and expands its operations
N3, our Trent overhaul centre in Germany, opened on time
£1 billion ten year submarine support contract with UK MoD
TotalCare agreement with BP for RB211s in Azerbaijan

Key performance indicators	2007	2006	2005	2004	2003
Underlying services revenue £m	**4,265**	3,901	3,457	3,251	2,843
Underlying services revenue %	**55**	53	54	55	50

In our other sectors the penetration of TotalCare is lower but we continue to record significant wins The UK MoD and US DoD are committed to through-life contracting as the means by which they intend to secure service support from industry Of particular note last year was the award by the UK MoD of a £1 billion contract covering the support of powerplant systems for the UK's nuclear submarines

In the energy sector, BP has entered into a second TotalCare contract Following on from the success of the North Sea contract, Rolls-Royce will now manage the 28 RB211s operated by BP in Azerbaijan

We continue to invest in upgrading and expanding our service capability During 2007, we opened an Operations Centre in Dahlewitz, Germany, to support our corporate and regional aircraft operators and a new flow line in Ansty, UK, to repair RB199 and EJ200 modules We also implemented a new spare parts forecasting system

Standardised tools and processes are one of the ways in which we seek to control costs We are deploying SAP across the repair and overhaul network, successfully migrating our parts service centres, Rolls-Royce Canada and N3 to our global template during 2007

In the marine sector, new service workshops have been opened and we acquired Seaworthy Systems Inc. to enable us to develop a new TotalCare service for naval customers, which will guarantee complete propulsion plant support and power availability

Corporate responsibility

The business case for corporate responsibility

Corporate responsibility is a fundamental part of the Group's business strategy It is not conducted as a separate and self-contained activity, but is integral to the business This is because we see corporate responsibility as making a key contribution to the success of Rolls-Royce in the markets in which we operate We believe that conducting business in an ethical and responsible way brings us competitive advantage, because it helps us to

- attract and retain the best people,
- build goodwill and maintain successful working relationships with customers, suppliers and governments, and
- support the global communities in which our employees live and work.

The Group's values of reliability, integrity and innovation are embedded in our Global Code of Business Ethics This provides a framework for our stakeholder relationships worldwide, the strength of which helps to shape the Group's reputation

With around 39,500 employees in 50 countries, our strongest contribution to society is the wealth generated by the thousands of highly skilled jobs we provide worldwide

Governance

Each area of corporate responsibility has its own governance process or managing committee, and each is led by a member of the Board or Group Executive These include

- the Environmental Council, chaired by the Director – Engineering and Technology,
- the HS&E committee, chaired by the Chief Executive,
- the Global Council, chaired by the Director – Human Resources, and
- the Group Community Investment and Sponsorship committee, chaired by the Chief Executive

Individual subject matter expertise is reviewed by the Corporate Responsibility Steering Group, which reports regularly to the Board This group comprises the Director – Human Resources, Director of Public Affairs, Director of Risk, the General Counsel and Company Secretary In addition, the corporate responsibility risk register uses the Company risk process to identify the potential risks and opportunities, as well as mitigation plans to address these risks Additional information can be found in the Principal risks and uncertainties section on pages 10 and 11

External recognition

Rolls-Royce is ranked in a number of external indexes which benchmark corporate responsibility performance During 2007, we retained our position in both the Dow Jones World and European Sustainability Indexes and retained our Platinum position in Business in the Community's voluntary Corporate Responsibility and Business in the Environment Indexes

Rolls-Royce has a long history of being a responsible business In the coming years the world will continue to change, along with the needs and expectations of all of our stakeholders We are committed to build on our track record and our obligation to continue to behave responsibly

Health, safety and the environment (HS&E)

Performance against targets

The Group believes that good HS&E performance is synonymous with good business performance Our stated vision is to be recognised widely for the excellence of our HS&E performance To achieve that vision we continue to implement robust processes in order to deliver against a number of key objectives by the end of 2009 These are detailed in our report 'Responsible Operations', published in April 2007

In summary, our 2007-2009 objectives are to

Protect health

-10%

Target: Reduce the incident rate of occupational diseases and other work-related ill health by ten per cent by the end of 2009

Prevent injury

-15%

Target Achieve a 15 per cent reduction in the lost-time injury rate (over one day) by the end of 2009

Reduce environmental impact

-10%

Target 1. Achieve a ten per cent reduction in energy consumed (normalised by financial revenues) by the end of 2009

-10%

Target 2: Achieve a ten per cent reduction in solid waste (normalised by financial revenues) by the end of 2009

58%

Target 3 Achieve a 58 per cent recycle rate of solid waste by the end of 2009

We will report on progress against these objectives in April 2008

Business review continued
Corporate responsibility continued

To ensure that we continue to make rapid progress, we have updated our HS&E training for all employees and developed targeted training plans across our businesses These are being implemented currently, with risk management training completed during 2007 as part of this programme

All the Group's businesses have third party certification to the environmental management system standard ISO 14001, and our comprehensive Corporate HS&E audit programme assesses the implementation of the HS&E management system across all businesses on a rolling audit basis This year, audits took place in the UK and US, across our civil aerospace, energy, fuel cells, marine services and submarines businesses, and the combustions and casings, component services and turbine systems supply chain units Audit reviews were also undertaken at four sites on the management and effective control of major hazards as part of an ongoing programme

We operate three sites in the UK which together manufacture, test and support nuclear reactor cores for Royal Navy submarines The Company Nuclear Propulsion Assurance Committee monitors the performance of these sites regularly to ensure that the highest standards of health and safety are maintained and processes are robust and fit for purpose

Our annual Company HS&E awards recognise outstanding initiatives and improvements worldwide This year's winners were the Civil Aerospace Customer Delivery Centre for state-of-the-art equipment to allow colleagues to work safely on an engine at any height. Six safety performance certificates were awarded to sites achieving a full year with no lost-time injury incidents In addition, nine sites each achieved over one million man hours lost-time injury free

The Group's contribution to developing best practice through third party collaboration continues to grow We are taking a leading industry role in REACH, the latest EU chemicals regulation, and have appointed a REACH executive dedicated to this programme during 2008

We are working closely with other companies, trade bodies, sectors and regulators in preparing for the implementation of REACH Efforts have been focused on raising awareness within our manufacturing operations and supply chains, in order that appropriate arrangements for compliance and business continuity, and the targeting of any future 'substances of very high concern', are introduced well ahead of deadlines Within the aviation sector, we are helping to develop international standards for the declaration of substances in 'articles' supplied to us to facilitate future REACH compliance and, where required, substitution programmes

We continue to take part in the UK's voluntary carbon dioxide emissions trading scheme and the Chicago Climate Exchange Programmes we have implemented to reduce carbon dioxide emissions include an initiative at Inchinnan, Scotland, where a reduction in furnace temperatures will reduce annual emissions by around 1,200 tonnes of carbon dioxide and will achieve cost savings of £140,000 a year

Environment: technology and climate change

Rolls-Royce believes that technology, applied on an industrial scale, lies at the heart of society's response to climate change

The scale of this challenge should not be underestimated The development and application of such technologies is, in itself, a formidable task, and must be accompanied by a step change in consumer behaviour We are committed to applying our science and engineering skills to help overcome the challenges

The Group is in a unique position to address these difficult issues, due to its long history of optimising the environmental performance of its products For example, since the 1950s our engineering expertise has helped to reduce aircraft noise by 75 per cent and fuel burn by 70 per cent on a passenger per kilometre basis We are therefore well placed to contribute to the search for technological solutions to climate change

In 2007, Rolls-Royce was announced as the leading member of the Environmentally Friendly Engine programme, a UK government and industry initiative to develop technologies which will halve the amount of aviation fuel used per passenger The Group was also awarded a contract by the US Air Force Research Laboratory to develop a technology demonstrator for high-thrust, reduced fuel consumption military aerospace platforms We also continue to play a leading role in aiming to achieve, by 2020, the environmental goals set by the Advisory Council for Aeronautics Research in Europe (ACARE) The ACARE targets, which are broadly in line with the US research goals set by NASA, are to reduce carbon dioxide emissions by 50 per cent per passenger kilometre, noise by50 per cent and NOx by 80 per cent, all from a 2000 baseline

The drive to improve our products' environmental performance spans all of our businesses. For example, in the marine sector our latest Bergen K gas engine, which is certified to power the world's first major car and passenger ferries running on liquefied natural gas, produces up to 90 per cent less NOx and 20 per cent less carbon dioxide than traditional diesel engines

The Group is developing megawatt-scale, solid oxide fuel cell systems that will deliver significant reduction in carbon dioxide emissions, relative to existing fossil fuel power generation A 250 kilowatt unit is planned to be tested in 2008 Other product developments include exploring the feasibility of renewable power sources, such as tidal stream and offshore wind

The Group published 'Powering a better world', a report on the environmental performance of our products and our Group, in April 2007 This is available on the Rolls-Royce website at www rolls-royce com

Employees

At the end of 2007, Rolls-Royce employed 39,529 permanent staff in over 50 countries

The long life cycle associated with the Group's products makes it imperative that we have a skilled workforce which is committed to delivering excellence to customers over the long term To achieve this, we aim to create a working environment that attracts and retains the best people, enhances their flexibility, capability and motivation and encourages them to be involved, resulting in improving performance

Upholding our values

During the year we launched the Rolls-Royce Global Code of Business Ethics This sets out principles and guidelines concerning interaction with our stakeholders The Code is available in 16 languages and its distribution is being supported by a Group-wide training programme which is being rolled out in 2008

Engaging employees

In 2005, we formed a Global Council to improve consultation and employee engagement This meets twice a year and involves over 40 employee representatives from around the world plus senior managers from each business and function In 2007, full Council meetings were held in Indianapolis, US and Bristol, UK and included consultation on global policy implementation

The year saw the launch of the Strategy Storyboard, an interactive Group-wide briefing on corporate strategy and performance, which was delivered via facilitated sessions to all employees worldwide

The bi-annual Global Employee Engagement Survey, which will next be conducted in 2008, provides valuable feedback on which we act in consultation with employees and their representatives Response to the survey results is handled locally by the Group's businesses through action planning and feedback sessions

Rolls-Royce provides competitive pay and benefits in all its locations and actively encourages share ownership by offering ShareSave plans to all employees. Our employees currently commit around £105 million to these plans In the UK, statutory arrangements enable employees to receive part of their annual bonus in shares and to make monthly share purchases from their salary

Encouraging diversity

The Group is committed to developing a diverse workforce and equal opportunities for all, with a Global Diversity Steering Group that shapes diversity policies One example of our approach focuses on encouraging more women and people from minority backgrounds to pursue engineering careers

In Asia, we made good progress in attracting leadership talent through the Asian Future Leaders Programme, attracting several high calibre early to mid-career managers to Rolls-Royce A number of senior managers were also recruited locally into key roles Together they will form the nucleus of the Group's evolving regional senior management team

The third Women's Leadership Forum was held in North America and the UK Women's Network was fully established

Our policy is to provide, wherever possible, employment training and development opportunities for disabled people We are committed to supporting employees who become disabled and to helping disabled employees make the best possible use of their skills and potential

Learning and development

The Group reviewed its learning and development strategy in 2007, realigning its training provision to global business priorities with the help of new Governance Boards which are now accountable for training standards worldwide This activity was strengthened with the selection of new supplier partners in the UK, North America and Asia to ensure consistency and the highest possible standards

Expenditure on the education, training and professional development of employees during the year totalled around £30 million Training schemes to support future competitiveness are developed continually Our quality programmes, for example, were deployed globally to ensure consistent performance standards across the Group During the year, we again increased our use of online learning, delivering over 50,000 hours of training to over 11,000 users

During 2007, we recruited 166 graduates and 220 apprentices and technicians worldwide An additional 642 undergraduate students were employed for short-term training programmes of two months to a year's duration At the end of the year there were 323 graduates and 550 apprentices and technicians on formal training programmes worldwide As a measure of our dedication to graduate training, we were ranked 24th overall in The Times newspaper's Top 100 Graduate Employers of 2007, coming 2nd in the Engineering sector

We also continued to invest in customer training, an important factor in strengthening our competitive position, delivering over 21,500 person days of training in our dedicated facilities or at customers' own premises

Health and wellbeing

The primary objective of the Group's occupational health strategy is to create a culture of prevention rather than cure The strategy has four key areas of focus

- screening and surveillance,
- rehabilitation,
- health promotion, and
- education

Progress against our screening and surveillance targets will be reported in April 2008 A Health Risk assessment pilot programme to identify and work with people at risk was launched in 2007 among employees in operations functions in the UK and will run until mid 2008

The importance of managing rehabilitation effectively was reinforced during the year with an ongoing training programme New training modules were also launched to help managers assess their own understanding and delivery of occupational health principles

A major health promotion campaign, 'Know Your Numbers', was held during the year, providing workstations where nearly 2,000 employees measured their vital health statistics such as blood pressure, weight and blood cholesterol An 'owners handbook' health manual will be issued to all employees in 2008

The Group continued to promote best practice in health education by hosting a major conference on common health problems Leading experts spoke to an audience of employees about the importance of maintaining a healthy workforce

Business review continued
Corporate responsibility continued

Society

Suppliers

The Group sets and manages its rigorous performance standards for suppliers through its quality system, Supplier Advanced Business Relationships (SABRe) This includes a supplier code of conduct, which is complemented by the Group's purchasing code of conduct that ensures suppliers and employees work together consistently

As outlined in previous reports, the Group seeks to foster productive supplier relationships which

- deliver mutual business benefits,
- minimise the environmental impact of business operations,
- encourage the highest standards of ethical behaviour, and
- promote human rights

In 2007, we introduced an assessment of current and potential suppliers which includes a focus on their approach towards corporate responsibility, in particular their policies and their approach to HS&E

The establishment of local purchasing offices continues globally, with a new office opened in South East Asia Training of suppliers and the sharing of best practice, with an emphasis on 'lean' techniques and waste elimination, have resulted in productivity improvements among some suppliers of up to 40 per cent

A number of activities are helping to minimise environmental impacts An active programme to encourage suppliers to adopt the environmental standard ISO 14001 continued in 2007, along with guidance and support to help them achieve certification

The e-business system, Exostar, has encouraged virtual teamworking between the Group and its suppliers, significantly reducing the need to travel In addition, a drive to 'revert' – the equivalent of raw materials recycling – has resulted in an average of 83 per cent achieved globally

Local sourcing policies reflect government regulations, such as in the US where particular rules towards working with small and disadvantaged businesses apply

Community investment

The Group has a longstanding commitment to supporting its local communities Community investment is an intrinsic part of the way we do business, supporting the Group's strategy and future success, particularly in the areas of

- recruitment and retention of employees, particularly by investing in the science skills we need,
- employee engagement, by encouraging a sense of loyalty and pride and motivation about our organisation,
- development of professional and personal skills such as teamwork, leadership, adaptability and ethical behaviour, and
- reputation, by building proactive and mutually beneficial relationships in the communities in which we operate

During 2007, we conducted our fourth global survey of community contributions, including cash, employee time and gifts in kind, using the London Benchmarking Group model The Group's total contributions across all these areas amounted to approximately £6 6 million

Donations and sponsorship

The Group's charitable donations policy is to 'directly support causes primarily relating to educational, engineering and scientific objectives, as well as social objectives connected with the Group's business and place in the wider community' The Group's charitable donations amounted to £1 8 million, of which £1 1 million were made in the UK These included support for The Prince's Trust, Community Foundations and Duxford Airspace Elsewhere Rolls-Royce made charitable donations in other key regions of £700,000, with £267,000 donated in North America, including support for the work of United Way, £144,000 in Germany and £289,000 in other regions

A further £2 5 million was contributed in sponsorships and educational programmes, including support for the Smithsonian National Air and Space Museum in North America, the Brandenberg Summer Festival in Germany and the London Symphony Orchestra tour of China

The Group has a stated policy of working closely with governments and institutions to highlight the many career opportunities that science and engineering can offer

Our flagship programme, the Rolls-Royce Science Prize, recognises excellent and innovative science teaching in the UK and Northern Ireland This year's winner, St Stephen and All Martyrs' Primary School from Bolton, England, was awarded a total of £20,000 to invest in science education, with £120,000 awarded in prizes to 61 schools in all

Employee time

Employee time contributed during 2007 is estimated at a value of at least £2 million, with more than 5,000 employees participating in activities such as community projects and team building activities with societal benefits

A number of employees in the UK, North America, and Germany completed a substantial community project as a formal part of their training or personal development programme During 2007, over 100 employees took part in 13 projects, which are recognised at the Group's Annual Learning and Development Awards

Employee giving

In addition to the Group's own contributions, Rolls-Royce also finances the administration of a Payroll Giving Scheme for UK employees, enabling them to make tax-free donations to their chosen charities During 2007, employees gave almost £450,000 to more than 350 charitable causes of their choice The scheme was commended at the 2007 UK Payroll Giving Awards and is recognised as Gold Award standard by the UK Government's Payroll Giving Quality Mark. In North America, employees have contributed £125,000 directly from payroll to good causes through the United Way scheme, a percentage of which is matched by the Group

In-kind support

The Group also supports community and educational organisations with in-kind donations, including surplus computer equipment and office furniture, use of office accommodation, the loan of engines and components and places on Group training courses

Finance Director's review
Andrew Shilston

Results for the year

Underlying profit before tax was £845 million (2006 £851 million)

Summary

Underlying sales increased by six per cent

- Engine deliveries in the civil aerospace business were broadly flat at 851 in 2007 There was a change in the mix, a reduction in the deliveries of large Trent engines was balanced by increased deliveries of smaller engines for the corporate and regional sector As a consequence, new engine revenues reduced by seven per cent in 2007 Underlying civil aerospace services revenues grew by 11 per cent
- Underlying defence aerospace sales increased by four per cent, with a six per cent increase in original equipment sales and a three per cent increase in services revenues
- Underlying marine sales increased by 19 per cent, with continued strong growth in the offshore oil and gas support market sector
- Underlying energy sales were flat, with a 15 per cent increase in services revenues, offsetting a decline in original equipment sales

Underlying aftermarket services revenues grew by nine per cent to £4.3 billion and have grown by ten per cent per annum compound over the past ten years Service revenues accounted for 55 per cent of total revenues.

84 per cent of sales were to customers outside the UK.

Underlying profit margins before financing costs were relatively flat with improvement in original equipment demand, continuing growth in services sales and our focus on cost reduction mitigating headwinds caused by commodity price inflation and an adverse trend in our achieved US dollar exchange rate

Underlying financing income amounted to £13 million (2006 £96 million)

Restructuring charges of £52 million (2006 £47 million), which were incurred for ongoing operational improvements, were included within operating costs

On the basis described below, underlying profit before tax was £845 million (2006 £851 million) The adjustments are detailed in note 2 on page 39

The published profit before tax reduced to £778 million from £1,537 million in 2006 This is primarily due to reduced benefits from the unrealised fair value derivative contracts, lower benefit from foreign exchange hedge reserve release and finally the recognition of past service costs for UK pension schemes, all of which are excluded from the calculation of underlying performance

The Group is exposed to fluctuations in foreign currency exchange rates and commodity price movements. These exposures are mitigated through the use of currency and commodity derivatives for which the Group does not apply hedge accounting

As a result, reported earnings do not reflect the economic substance of derivatives that have been closed out in the financial year, but do include unrealised gains and losses on derivatives which will only affect cash flows when they are closed out at some point in the future

Underlying earnings are presented on a basis that shows the economic substance of the Group's hedging strategies in respect of transactional exchange rate and commodity price movements Further information is included within key performance indicators on pages 8 and 9 of this report

Order book

The order book at December 31, 2007, at constant exchange rates, was £45 9 billion (2006 £26 1 billion)

This included firm business that was announced but for which contracts had not yet been signed of £7 1 billion (2006 £1 7 billion)

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

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

Aftermarket services agreements, including TotalCare packages, represented 28 per cent of the order book having increased by £3 2 billion in the year These are long-term contracts where only the first seven years revenue is included in the order book.

Aftermarket services

The Group continues to be successful in developing its aftermarket services activities These grew by nine per cent on an underlying basis in 2007 and accounted for 55 per cent of Group revenue

In particular, TotalCare packages in the civil aerospace sector now cover 55 per cent, by value, of the installed fleet TotalCare packages cover long-term management of the maintenance and associated logistics for our engines and systems, monitoring the equipment in service to deliver the system availability our customers require with predictable costs The pricing of such contracts reflects their long-term nature Revenues and costs are recognised based on the stage of completion of the contract, generally measured by reference to flying hours The overall net position of assets and liabilities on the balance sheet for TotalCare packages was an asset of £550 million (2006 £393 million)

Cash

Cash inflow during the year was £562 million (2006 £491 million) before the special injection of £500 million in to the UK defined benefit pension schemes. Continued growth in underlying profits and good cash conversion was supported by further increases in customer deposits and progress payments in the year, increasing by £332 million, and a benefit of £41 million from year-end currency revaluations Total cash investments of £598 million in plant and equipment and intangible assets represent the major cash outflows in the period Tax payments increased in the year to £71 million (2006 £25 million)

As a consequence average net cash was £350 million (2006 £150 million) The net cash balance at the year-end was £887 million (2006 £825 million)

Business review continued
Finance Director's review continued

Taxation

The overall tax charge on the profit before tax was £133 million (2006 £397 million) a rate of 17 1 per cent (2006 25 8 per cent)

The tax charge was reduced by £35 million in respect of the adjustment of deferred tax balances to reflect future lower corporate tax rates in the UK and Germany and £22 million in respect of the expected benefit of the UK research and development tax credit In addition, £22 million of provisions for prior years' tax liabilities were written back following settlement of a number of outstanding tax issues

The tax charge on underlying profit was £193 million (2006 £190 million) a rate of 22 8 per cent (2006 22.3 per cent)

The operation of most tax systems, including the availability of specific tax deductions, means that there is often a delay between the Group tax charge and the related tax payments, to the benefit of cash flow

The Group operates internationally and is subject to tax in many differing jurisdictions As a consequence, the Group is routinely subject to tax audits and examinations which by their nature can take a considerable period to conclude Provision is made for known issues based on management's interpretation of country specific legislation and the likely outcome

The Group seeks to minimise its tax burden in a manner which is consistent with its commercial objectives and meets its legal obligations and ethical standards While every effort is made to maximise the tax efficiency of its business transactions, the Group does not use artificial structures in its tax planning The Group has regard for the intention of the legislation concerned rather than just the wording itself The Group is committed to building open relationships with tax authorities and to follow a policy of full disclosure in order to effect the timely settlement of its tax affairs and to remove uncertainty in its business transactions

Pensions

As for 2006, the charges for pensions are calculated in accordance with the requirements of IAS 19 *Employee Benefits*

As the Group had previously announced, during 2007 the trustees of each of the UK defined benefit schemes undertook a review of their investment strategies, in consultation with the Group As a result, revised investment strategies have been adopted that seek to reduce the economic risks arising from each scheme The impact on the asset allocation of each scheme from the implementation of the revised investment strategies has been to reduce the equity allocation and increase the fixed income allocation Each scheme has appointed a liability-driven investment asset manager to hedge the majority of the interest rate and inflation risks associated with the pension liabilities, using swap contracts backed by short-term money market assets Under the terms of the swap contracts, each scheme is committed to paying London Inter-Bank Offered Rate (LIBOR) to its counterparties in exchange for fixed or inflation-linked cash inflows to match in large part an actuarial projection of future benefit payments to scheme members

Following agreement of the revised investment strategies with the trustees of each scheme, the Group has paid additional contributions of £500 million to the principal UK pension schemes

Further information and details of the pensions' charge and the defined benefit schemes' assets and liabilities are shown in note 17 to the financial statements This shows a net deficit, after taking account of deferred tax, of £88 million (2006 £681 million) Changes in this net position are affected by the assumptions made in valuing the liabilities and the market performance of the assets

The change in investment strategies agreed with the trustees of the principal UK schemes is expected to lead to lower volatility of the Group's net pension position for the future

Investments

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

The Group has a portfolio of projects at different stages of their life cycles Discounted cash flow analysis of the remaining life of projects is performed on a regular basis Sales of engines in production are assessed against criteria in the original development programme to ensure that overall value is enhanced

Gross research and development investment amounted to £824 million (2006 £747 million) Net research and development charged to the income statement was £381 million (2006 £370 million) The level of self-funded investment in research and development is expected to remain at approximately five per cent of Group sales in the future The impact of this investment on the income statement will reflect the mix and maturity of individual development programmes and will result in a similar level of net research and development reported within the income statement in 2008 Investment in training was £30 million (2006 £30 million)

Capital expenditure on property, plant and equipment was £304 million (2006 £303 million)

Intangible assets

The Group carried forward £1,761 million (2006 £1,460 million) of intangible assets This comprised purchased goodwill of £801 million, engine certification costs and participation fees of £354 million, development costs of £364 million, recoverable engine costs of £162 million and other intangible assets of £80 million

Total capital expenditure on property, plant and equipment and intangible assets is expected to increase modestly in 2008

Partnerships

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

Joint ventures

Joint ventures are an integral part of our business They are involved in engineering, manufacturing, repair and overhaul, and financial services They are also normal business structures for companies participating in international, collaborative defence projects

They share risk and investment, bring expertise and access to markets, and provide external objectivity Some of our joint ventures have become substantial businesses A major proportion of the debt of the joint ventures is secured on the assets of the respective companies and is non-recourse to the Group

Risk and revenue sharing partners (RRSPs)

RRSPs have enabled the Group to build a broad portfolio of engines, thereby reducing the exposure of the business to individual product risk The primary financial benefit is a reduction of the burden of research and development (R&D) expenditure on new programmes

The related R&D expenditure is expensed through the income statement and the initial programme receipts from partners, which reimburse the Group for past R&D expenditure, are also recorded in the income statement, as other operating income

RRSP agreements are a standard form of co-operation in the civil aero-engine industry They bring benefits to the engine manufacturer and the partner Specifically, for the manufacturer they bring some or all of the following benefits additional financial and engineering resource, sharing of risk, and initial programme contribution As appropriate, the partner also supplies components and as consideration for these components, receives a share of the long-term revenues generated by the engine programme in proportion to its purchased programme share

The sharing of risk is fundamental to RRSP agreements In general, partners share financial investment in the programme, they share market risk as they receive their return from future sales, they share currency risk as their returns are denominated in US dollars, they share sales financing obligations, they share warranty costs, and, where they are manufacturing or development partners, they share technical and cost risk. Partners that do not undertake development work or supply components are referred to as financial RRSPs and are accounted for as financial instruments as described here

In 2007, the Group received other operating income of £50 million (2006 £57 million), primarily in respect of the Trent 1000 engine programme

Payments to RRSPs are recorded within cost of sales and increase as the related programme sales increase These payments amounted to £199 million (2006 £162 million)

The classification of financial RRSPs as financial instruments has resulted in a liability of £315 million (2006 £324 million) being recorded in the balance sheet and an associated underlying financing cost of £26 million (2006 £27 million) recorded in the income statement

In the past, the Group has also received government launch investment in respect of certain programmes The treatment of this investment is similar to non-financial RRSPs

Risk management

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

Financial risk

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

The principal economic and market risks continue to be movements in foreign currency exchange rates, interest rates and commodity prices The Board regularly reviews the Group's exposures and financial risk management and a specialist committee also considers these in detail

All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework.

Counterparty credit risk

The Group has an established policy towards managing counterparty credit risk. A common framework exists to measure, report and control exposures to counterparties across the Group using Value at Risk and fair value techniques The Group assigns an internal credit rating to each counterparty, which is assessed with reference to publicly available credit information, such as that provided by Moody's, Standard & Poor's, and other recognised market sources and is reviewed regularly

Financial instruments are only transacted with counterparties that have a publicly assigned long-term credit rating from Standard & Poor's of 'A-' or better and from Moody's of 'A3' or better

Funding and liquidity

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

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

Short-term investments are generally held as bank deposits or in 'AAA' rated money market funds The Group operates a conservative investment policy which limits investments to high quality instruments with suitable counterparty diversification During 2007, the Group did not experience any losses related to its investments as a result of the US sub-prime crisis

Business review continued
Finance Director's review continued

No new borrowing facilities were entered into during 2007 and £340 million of borrowing facilities matured during 2007 As at December 31, 2007 the Group had total committed borrowing facilities of £1 5 billion (2006 £1 8 billion) There are no material debt facility maturities until 2011 The maturity profile of the borrowing facilities is staggered to ensure that refinancing levels are manageable in the context of the business and market conditions

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

The Group continues to have access to all the major global debt markets

Credit rating

The Group's parent company, Rolls-Royce Group plc, subscribes to both Moody's Investors Service and Standard & Poor's for its official publicised credit ratings As at December 31, 2007 the assigned long-term credit ratings were

Rating agency	Rating	Outlook	Category
Moody's	A3	Stable	Investment grade
Standard & Poor's	A-	Stable	Investment grade

As a long-term business, the Group attaches significant importance to maintaining this investment grade credit rating, which it views as necessary for the business to operate effectively

The Group's objective is to maintain this 'A' category investment grade credit rating from both agencies

Currency risk

The Group is exposed to movements in exchange rates for both foreign currency transactions and the translation of net assets and income statements of foreign subsidiaries

The Group regards its interests in overseas subsidiary companies as long-term investments. The Group has tended to manage its translational exposures through the currency matching of assets and liabilities where applicable The matching is reviewed regularly Appropriate risk mitigation is undertaken where material mismatches arise

The Group is exposed to a number of foreign currencies The most significant transactional currency exposures are US dollars to sterling and US dollars to Euros

The Group manages its exposure to movements in exchange rates at two levels

i) Revenues and costs are currency matched where it is economic to do so The Group actively seeks to source suppliers with the relevant currency cost base to avoid the risk or to flow down the risk to those suppliers that are capable of managing it Currency risk is also a prime consideration when deciding where to locate new facilities. US dollar income converted into Sterling represented 25 per cent of Group revenues in 2007 (2006 26 per cent) US dollar income converted into Euros represented four per cent of Group revenues in 2007 (2006 four per cent)

ii) Residual currency exposure is hedged via the financial markets The Group operates a hedging policy using a variety of financial instruments with the objective of minimising the impact of fluctuations in exchange rates on future transactions and cash flows

Market exchange rates

	2007	2006
US$ per £		
– Year-end spot rate	**1 991**	1 957
– Average spot rate	**2 001**	1 844
€ per £		
– Year-end spot rate	**1 362**	1 484
– Average spot rate	**1 461**	1 467

The permitted range of the amount of cover taken is determined by the written policies set by the Board, based on known and forecast income levels

The forward cover is managed within the parameters of these policies in order to achieve the Group's objectives, having regard to the Group's view of long-term exchange rates Forward cover is in the form of standard foreign exchange contracts and instruments on which the exchange rates achieved are dependent on future interest rates The Group may also write currency options against a portion of the unhedged dollar income at a rate which is consistent with the Group's long-term target rate At the end of 2007 the Group had US$9 4 billion of forward cover (2006 US$10 billion)

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates Note 15 includes the impact of revaluing forward currency contracts at market values on December 31, 2007, showing a value of £379 million (2006 £554 million) which will fluctuate with exchange rates over time The Group has entered into these forward contracts as part of the hedging policy, described above, in order to mitigate the impact of volatile exchange rates

Interest rate risk

The Group uses fixed rate bonds and floating rate debt as funding sources The Group's policy is to maintain a proportion of its debt at fixed rates of interest having regard to the prevailing interest rate outlook. To implement this policy the Group may utilise a combination of interest-rate swaps, forward-rate agreements and interest-rate caps to manage the exposure

Commodity risk

The Group has an ongoing exposure to the price of jet fuel and base metals arising from business operations The Group's objective is to minimise the impact of price fluctuations The exposure is hedged in accordance with parameters contained in written policies set by the Board

Sales financing

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

The Group manages and monitors its sales finance related exposures to customers and products within written policies approved by the Board and within the internal framework described in the Report of the directors. The contingent liabilities represent the maximum discounted aggregate gross and net exposure that the Group has in respect of delivered aircraft, regardless of the point in time at which such exposures may arise

The Group uses Ascend Worldwide Limited as an independent appraiser to value its security portfolio at both the half-year and year-end Ascend provides specific values (both current and forecast future values) for each asset in the security portfolio These values are then used to assess the Group's net exposure

The permitted levels of gross and net exposure are limited in aggregate, by counterparty, by product type and by calendar year The Group's gross exposures are divided approximately 55 45 between AVGs and credit guarantees They are spread over many years and relate to a number of customers and a broad product portfolio

The Board regularly reviews the Group's sales finance related exposures and risk management activities Each financing commitment is subject to a credit and asset review process and prior approval in accordance with Board delegations of authority

The Group operates a sophisticated risk-pricing model to assess risk and exposure

Costs and exposures associated with providing financing support are incorporated in any decision to secure new business

The Group seeks to minimise the level of exposure from sales finance commitments by

- the use of third-party non-recourse debt where appropriate,
- the transfer, sale, or reinsurance of risks, and
- ensuring the proportionate flow down of risk and exposure to relevant RRSPs

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

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

Note 22 to the financial statements describes the Group's contingent liabilities

There were no material changes to the Group's gross and net contingent liabilities in this respect in 2007

Accounting standards

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU In 2007, the Group has adopted IFRS 7 *Financial Instruments Disclosure* and the Amendment to IAS 1 *Presentation of Financial Statements* These changes both relate to disclosure and have no impact on the reported results Other new standards, amendments to standards and interpretations effective in 2007 do not have a significant effect on the Group's financial statements

A summary of other changes, which have not been adopted in 2007, is included within the accounting policies in note 1 to the financial statements

Andrew Shilston
Finance Director
February 6 2008

Consolidated income statement

For the year ended December 31, 2007

	Notes	2007 £m	Restated* 2006 £m
Revenue	2	**7,435**	7,156
Cost of sales		**(6,003)**	(5,566)
Gross profit		**1,432**	1,590
Other operating income	3	**50**	57
Commercial and administrative costs		**(653)**	(625)
Research and development costs		**(381)**	(370)
Share of profit of joint ventures	9	**66**	47
Operating profit		**514**	699
(Loss)/profit on sale of businesses	24	**(2)**	1
Profit before financing	2	**512**	700
Financing income	4	**762**	1,335
Financing costs	4	**(496)**	(498)
Net financing		**266**	837
Profit before taxation	3	**778**	1,537
Taxation	5	**(133)**	(397)
Profit for the year		**645**	1,140
Attributable to			
Equity holders of the parent		**651**	1,144
Minority interests	19	**(6)**	(4)
Profit for the year		**645**	1,140

* During the year the Group has reviewed the classification of costs. As a result, costs of £39m classified as commercial and administrative costs in 2006 have been reclassified as cost of sales.

Consolidated balance sheet

At December 31, 2007

	Notes	2007 £m	Restated* 2006 £m
ASSETS			
Non-current assets			
Intangible assets	7	**1,761**	1,460
Property, plant and equipment	8	**1,813**	1,706
Investments – joint ventures	9	**284**	240
Other investments	9	**89**	125
Deferred tax assets	5	**81**	141
Post-retirement scheme surpluses	17	**210**	22
		4,238	3,694
Current assets			
Inventory	10	**2,203**	1,845
Trade and other receivables	11	**2,585**	2,468
Taxation recoverable		**7**	5
Other financial assets	15	**514**	644
Short-term investments		**40**	34
Cash and cash equivalents	12	**1,896**	2,184
Assets held for sale		**7**	—
		7,252	7,180
Total assets		**11,490**	10,874
LIABILITIES			
Current liabilities			
Borrowings	13	**(34)**	(400)
Other financial liabilities	15	**(69)**	(24)
Trade and other payables	14	**(4,736)**	(4,265)
Current tax liabilities		**(188)**	(191)
Provisions	16	**(121)**	(146)
		(5,148)	(5,026)
Non-current liabilities			
Borrowings	13	**(1,030)**	(990)
Other financial liabilities	15	**(303)**	(336)
Trade and other payables	14	**(965)**	(827)
Deferred tax liabilities	5	**(345)**	(252)
Provisions	16	**(180)**	(189)
Post-retirement scheme deficits	17	**(333)**	(1,017)
		(3,156)	(3,611)
Total liabilities		**(8,304)**	(8,637)
Net assets		**3,186**	2,237
EQUITY			
Capital and reserves			
Called-up share capital	18	**326**	326
Share premium account	19	**631**	631
Transition hedging reserve	19	**77**	177
Translation reserve	19	**59**	(58)
Retained earnings	19	**2,081**	1 154
Equity attributable to equity holders of the parent		**3,174**	2,230
Minority interests	19	**12**	7
Total equity		**3,186**	2,237

* See notes 10 11, 14 17 and 19

The financial statements on pages 28 to 70 were approved by the Board on February 6, 2008 and signed on its behalf by

Simon Robertson Chairman

Andrew Shilston Finance Director

Consolidated cash flow statement

For the year ended December 31, 2007

	Notes	2007 £m	Restated* 2006 £m
Reconciliation of cash flows from operating activities			
Profit before taxation		**778**	1,537
Share of profit of joint ventures	9	**(66)**	(47)
Loss/(profit) on sale or termination of businesses	24	**2**	(1)
Loss/(profit) on sale of property, plant and equipment		**1**	(9)
Net interest payable	4	**5**	18
Net post-retirement scheme financing	4	**(30)**	(3)
Net other financing	4	**(241)**	(852)
Taxation paid		**(71)**	(25)
Amortisation of intangible assets	7	**63**	60
Depreciation of property, plant and equipment	8	**170**	161
Decrease in provisions		**(42)**	(36)
Increase in inventories		**(359)**	(226)
Increase in trade and other receivables		**(125)**	(400)
Increase in trade and other payables		**709**	793
Decrease in other financial assets and liabilities		**358**	250
Additional cash funding of post-retirement schemes		**(441)**	(21)
Share-based payments charge	20	**36**	36
Transfers of hedge reserves to income statement	15	**(149)**	(289)
Dividends received from joint ventures	9	**42**	44
Net cash inflow from operating activities		**640**	990
Cash flows from investing activities			
Additions of unlisted investments		**(5)**	—
Additions to intangible assets		**(294)**	(219)
Disposals of intangible assets		**—**	7
Purchases of property, plant and equipment		**(304)**	(298)
Disposals of property, plant and equipment		**47**	55
Acquisition of businesses	24	**(6)**	(5)
Disposals of businesses	24	**3**	1
Investments in joint ventures		**(13)**	(11)
Disposals of joint ventures		**—**	1
Additions to parent company shares		**(77)**	(44)
Disposals of parent company shares		**31**	76
Net cash outflow from investing activities		**(618)**	(437)
Cash flows from financing activities			
Borrowings due within one year – repayment of loans		**(350)**	(53)
Capital element of finance lease payments		**(5)**	(8)
Net cash outflow from decrease in borrowings		**(355)**	(61)
Interest received		**95**	84
Interest paid		**(93)**	(96)
Interest element of finance lease payments		**(3)**	(2)
(Increase)/decrease in government securities and corporate bonds		**(6)**	3
Net cash outflow from financing activities		**(362)**	(72)
(Decrease)/increase in cash and cash equivalents		**(340)**	481
Cash and cash equivalents at January 1		**2,170**	1,744
Foreign exchange		**41**	(60)
Net cash of businesses acquired/disposed		**—**	5
Cash and cash equivalents at December 31		**1,871**	2,170

* See notes 10, 11 and 14

	2007 £m	2006 £m
Reconciliation of increase in cash and cash equivalents to movements in net funds		
(Decrease)/increase in cash and cash equivalents	**(340)**	481
Cash (inflow)/outflow from (decrease)/increase in government securities and corporate bonds	**6**	(3)
Net cash outflow from decrease in borrowings	**355**	61
Change in net funds resulting from cash flows	**21**	539
Net funds of businesses acquired	**—**	1
Exchange adjustments	**41**	(49)
Fair value adjustments	**(18)**	77
Movement in net funds	**44**	568
Net funds at January 1 excluding the fair value of swaps	**828**	260
Net funds at December 31 excluding the fair value of swaps	**872**	828
Fair value of swaps hedging fixed rate borrowings	**15**	(3)
Net funds at December 31	**887**	825

The movement in net funds (defined by the Group as including the items shown below) is as follows

	At January 1, 2007 £m	Cash flow £m	Exchange adjustments £m	Fair value adjustments £m	Reclassi-fications £m	At December 31, 2007 £m
Cash at bank and in hand	**756**	**465**	**43**	—	—	**1,264**
Overdrafts	**(14)**	**(11)**	—	—	—	**(25)**
Short-term deposits	**1,428**	**(794)**	**(2)**	—	—	**632**
Cash and cash equivalents	**2,170**	**(340)**	**41**	—	—	**1,871**
Investments	**34**	**6**	—	—	—	**40**
Other borrowings due within one year	**(379)**	**350**	—	**27**	**(2)**	**(4)**
Borrowings due after one year	**(983)**	—	—	**(45)**	**2**	**(1,026)**
Finance leases	**(14)**	**5**	—	—	—	**(9)**
	828	**21**	**41**	**(18)**	—	**872**
Fair value of swaps hedging fixed rate borrowings	**(3)**			**18**		**15**
	825	**21**	**41**	—	—	**887**

Consolidated statement of recognised income and expense

For the year ended December 31, 2007

	Notes	2007 £m	2006 £m
Foreign exchange translation differences from foreign operations		**117**	(75)
Net actuarial gains	17	**399**	602
Transfers from transition hedging reserve	15	**(149)**	(289)
Movement in fair value of available for sale assets		**(28)**	(126)
Related tax movements	5	**(86)**	(43)
Change in rates of corporation tax	5	**(9)**	—
Net income recognised directly in equity		**244**	69
Profit for the year		**645**	1,140
Total recognised income and expense for the year		**889**	1,209
Attributable to			
Equity holders of the parent		**895**	1,213
Minority interests		**(6)**	(4)
Total recognised income and expense for the year		**889**	1,209

Notes to the consolidated financial statements

1 Significant accounting policies

The Company

Rolls-Royce plc (the 'Company') is a company domiciled in the United Kingdom The consolidated financial statements of the Company for the year ended December 31, 2007 comprise the Company and its subsidiaries (together referred to as the 'Group') and the Group's interest in jointly controlled entities The financial statements were authorised for issue by the directors on February 6, 2008

Basis of preparation and statement of compliance

In accordance with European Union (EU) regulations, these financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), as adopted for use in the EU effective at December 31, 2007 (Adopted IFRS) The Company has elected to prepare its parent company accounts under UK Generally Accepted Accounting Practices (GAAP)

The financial statements have been prepared on the historical cost basis except where Adopted IFRS require an alternative treatment. The principal variations from the historical cost basis relate to pensions (IAS 19), monetary items (IAS 21), financial instruments (IAS 39) and share-based payments (IFRS 2)

The Group's significant accounting policies are set out below, together with the judgements made by management in applying these policies, which have the most significant effect on the amounts recognised in the financial statements, apart from those involving estimations, which are dealt with separately below These accounting policies have been applied consistently to all periods presented in these consolidated financial statements and by all Group entities

Restatements to comparative figures are set out in notes 10, 11, 14, 17 and 19 Some other small adjustments have been made to comparative figures to put them on a consistent basis with the current year

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 Groups share of the results of joint ventures up to December 31

A subsidiary is an entity controlled by the Company Control exists when the Company has the power, directly or indirectly to govern the financial and operating policies of the entity so as to derive benefits from its activities.

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

Any subsidiary undertakings and joint ventures sold or acquired during the year are included up to or from, the dates of change of control

All intra-group transactions, balances, income and expenses are eliminated on consolidation

Significant accounting policies and judgements applied

Revenue recognition

Revenues comprise sales to outside customers after discounts, excluding value added tax.

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured On occasion, the Group may participate in the financing of engines in conjunction with airframe manufacturers. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing whether significant risk and rewards of ownership have been transferred to the customer Where it is judged that sufficient risks and rewards are not transferred, the transaction is treated as a leasing transaction, resulting in an operating lease between the Group and the customer No deliveries of engines were treated as operating leases during 2007 Depending on the specific circumstances, where applicable, the financing arrangements may result in the consolidation of the entity established to facilitate the financing Such special purpose entities will be consolidated as required by IAS 27 *Consolidated and Separate Financial Statements* if it is considered that the Group controls the entity No such entities were consolidated at December 31, 2007

Sales of services are recognised by reference to the stage of completion based on services performed to date The assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on costs incurred to the extent these relate to services performed up to the reporting date, achievement of contractual milestones where appropriate, or flying hours or equivalent for long-term aftermarket arrangements

Linked sales of product and services are treated as a single contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single project with an overall profit margin Revenue is recognised on the same basis as for other sales of products and services as described above

Provided that the outcome of construction contracts can be assessed with reasonable certainty, the revenues and costs on such contracts are recognised based on stage of completion and the overall contract profitability

Full provision is made for any estimated losses to completion of contracts having regard to the overall substance of the arrangements.

Progress payments received on long-term contracts, when greater than recorded revenue 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 trade and other payables. The amount by which recorded revenue of long-term contracts is in excess of payments on account is classified as 'amounts recoverable on contracts' and is separately disclosed within trade and other receivables.

Risk and revenue sharing partnerships (RRSPs)

From time to time the Group enters into arrangements with partners who, in return for a share in future programme revenues or profits, make cash payments that are not refundable (except under certain remote circumstances) Cash sums received, which reimburse the Group for past expenditure, are credited to other operating income The arrangements also require partners to undertake development work and/or supply components for use in the programme at their own expense No accounting entries are recorded where partners undertake such development work or where programme components are supplied by partners because no obligation arises unless and until programme sales are made, instead, payments to partners for their share in the programme are charged to cost of sales as programme revenues arise

The Group has arrangements with partners who do not undertake development work or supply parts. Such arrangements are considered to be financial instruments as defined by IAS 32 *Financial Instruments Presentation* and are accounted for using the amortised cost method

Government investment

Where a government or similar body invests in a development programme, the Group treats such receipts as the sale of an interest in the programme Subsequent payments are royalty payments and are matched to related sales.

Interest

Interest receivable/payable is credited/charged to the income statement using the effective interest method The Group does not capitalise any borrowing costs

Taxation

The tax charge on the profit or loss for the year comprises current and deferred tax.

Current tax is the expected tax payable for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future Deferred tax is not recognised on taxable temporary differences arising on the initial recognition of goodwill or for temporary differences arising from the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit.

Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled Deferred tax is charged or credited in the income statement or statement of recognised income and expense as appropriate, except when it relates to items credited or charged directly to equity in which case the deferred tax is also dealt with in equity

Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be utilised

Segmental reporting
A segment is a distinguishable component of the Group that is engaged in providing products and services As the risks and rates of return are predominantly affected by differences in these products and services, the primary format for reporting segment information is based on business segments

Foreign currency translation
Transactions in overseas currencies are translated into local currency at the exchange rates ruling on the date of the transaction Monetary assets and liabilities denominated in foreign currencies are translated into local currency at the rate ruling at the year-end Exchange differences arising on foreign exchange transactions and the retranslation of assets and liabilities into sterling at the rate ruling at the year-end are taken into account in determining profit before taxation

The trading results of overseas undertakings are translated at the average exchange rates for the year The assets and liabilities of overseas undertakings, including goodwill and fair value adjustments arising on acquisition, are translated at the exchange rates ruling at the year-end Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are taken to equity

Financial instruments
IAS 39 *Financial Instruments Recognition and Measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different Rolls-Royce has classified its financial instruments as follows
- Fixed deposits, principally comprising funds held with banks and other financial institutions and trade receivables, are classified as loans and receivables
- Investments (other than interests in joint ventures and fixed deposits) and short-term deposits (other than fixed deposits) are classified as available for sale
- Borrowings, trade payables and financial RRSPs are classified as other liabilities
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading

Financial instruments are recognised at the contract date and initially measured at fair value Their subsequent measurement depends on their classification
- Loans and receivables and other liabilities are held at amortised cost and not revalued unless they are included in a fair value hedge accounting relationship Where such a relationship exists, the instruments are revalued in respect of the risk being hedged If instruments held at amortised cost are hedged, generally by interest rate swaps, and the hedges are effective, the carrying values are adjusted for changes in fair value, which are included in the income statement.
- Available for sale assets are held at fair value Changes in fair value arising from changes in exchange rates are included in the income statement. All other changes in fair value are taken to equity On disposal, the accumulated changes in value recorded in equity are included in the gain or loss recorded in the income statement.
- Held for trading instruments are held at fair value Changes in fair value are included in the income statement unless the instrument is included in a cash flow hedge If the instruments are included in a cash flow hedging relationship, which is effective, changes in value are taken to equity When the hedged forecast transaction occurs, amounts previously recorded in equity are recognised in the income statement.
- Foreign exchange gains and losses arising on transactions are recognised in the income statement

Financial instruments are derecognised on expiry or when all contractual rights and obligations are transferred

Hedge accounting
The Group does not apply hedge accounting in respect of forward foreign exchange contracts held to manage the cash flow exposures of forecast transactions denominated in foreign currencies.

The Group does not apply hedge accounting in respect of commodity swaps held to manage the cash flow exposures of forecast transactions in those commodities

The Group applies hedge accounting in respect of transactions entered into to manage the fair value and cash flow exposures of its borrowings Forward foreign exchange contracts are held to manage the fair value exposures of borrowings denominated in foreign currencies and are designated as fair value hedges Interest rate swaps are held to manage the interest rate exposures and are designated as fair value or cash flow hedges of fixed and floating rate borrowings respectively

Changes in the fair values of derivatives designated as fair value hedges and changes in fair value of the related hedged item are recognised directly in the income statement.

Changes in the fair values of derivatives that are designated as cash flow hedges and are effective are recognised directly in equity Any ineffectiveness in the hedging relationships is included in the income statement The amounts deferred in equity are recognised in the income statement to match the recognition of the hedged item

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting At that time, for cash flow hedges, any cumulative gain or loss on the hedging instrument recognised in equity, is retained in equity until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement.

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in equity The ineffective portion is recognised immediately in the income statement.

Until December 31, 2004, and as allowed by IFRS 1 *First-time Adoption of International Financial Reporting Standards*, the Group applied hedge accounting for forecast foreign exchange transactions and commodity exposures in accordance with UK GAAP On January 1, 2005, the fair values of derivatives used for hedging these exposures were included in the transition hedging reserve This reserve is released to the income statement based on the designation of the hedges on January 1, 2005

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

i) To December 31, 1997 Goodwill was written off to reserves in the year of acquisition

ii) From January 1, 1998 Goodwill was recognised within intangible assets in the year in which it arose and amortised on a straight line basis over its useful economic life, up to a maximum of 20 years

iii) From January 1, 2004, in accordance with IFRS 3 *Business Combinations*, goodwill is recognised as per (ii) above but is no longer amortised

Certification costs and participation fees
Costs incurred in respect of meeting regulatory certification requirements for new civil aero-engine/aircraft combinations and payments made to airframe manufacturers for this, and participation fees, are carried forward in intangible assets to the extent that they can be recovered out of future sales and are charged to the income statement over the programme life, up to a maximum of 15 years from the entry-into-service of the product.

Research and development
In accordance with IAS 38 *Intangible Assets*, expenditure incurred on research and development, excluding known recoverable amounts on contracts, and

Notes to the consolidated financial statements continued

contributions to shared engineering programmes, is distinguished as relating either to a research phase or to a development phase

All research phase expenditure is charged to the income statement. For development expenditure, this is capitalised as an internally generated intangible asset only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits

Expenditure that cannot be classified into these two categories is treated as being incurred in the research phase The Group considers that, due to the complex nature of new equipment programmes, it is not possible to distinguish reliably between research and development activities until relatively late in the programme

Expenditure capitalised is amortised over its useful economic life, up to a maximum of 15 years from the entry-into-service of the product.

Recoverable engine costs
On occasion, the Group may sell original equipment to customers at a value below its cost, on the basis that this deficit will be recovered from future aftermarket sales to the original customer Where the Group has a contractual right to supply aftermarket parts to the customer and its intellectual rights, warranty arrangements and statutory airworthiness requirements provide reasonable control over this supply, these arrangements are considered to meet the definition of an intangible asset. Such intangible assets are recognised to the extent of the deficit and amortised on a straight-line basis over the expected period of utilisation by the original customer, generally a maximum of ten years unless the specific contractual circumstances indicate a longer period

Software
The cost of acquiring software that is not specific to an item of property, plant and equipment is classified as an intangible asset and amortised over its useful economic life, up to a maximum of five years

Property, plant and equipment
Property, plant and equipment assets are stated at cost less accumulated depreciation and any provision for impairments in value

Depreciation is provided on a straight-line basis to write off the cost, less the estimated residual value, of property, plant and equipment over their estimated useful lives Estimated useful lives are as follows.

i) Land and buildings, as advised by the Group's professional advisors
  a) Freehold buildings – five to 45 years (average 23 years)
  b) Leasehold buildings – lower of advisors' estimates or period of lease
  c) No depreciation is provided on freehold land
ii) Plant and equipment – five to 25 years (average 14 years)
iii) Aircraft and engines – five to 20 years (average 18 years)
iv) No depreciation is provided on assets in the course of construction

Leases
i) As Lessee
Assets financed by leasing agreements that give rights approximating to ownership (finance leases) have been capitalised at their fair value and depreciation is 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 liability, is charged to the income statement. The annual payments under all other lease arrangements, known as operating leases are charged to the income statement on a straight-line basis
ii) As Lessor
Amounts receivable under finance leases are included within receivables and represent the total amount outstanding under the 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 investment, is included in revenue
Rentals receivable under operating leases are included in revenue on a straight-line basis.

Impairment of non-current assets
Impairment of non-current assets is considered in accordance with IAS 36 *Impairment of Assets* Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the cash-generating unit to which the asset belongs.
Goodwill and intangible assets not yet available for use are tested for impairment annually Other intangible assets and property, plant and equipment are assessed for any indications of impairment annually If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

Recoverable amount is the higher of value in use or fair value less costs to sell – if this is readily available The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset

If the recoverable amount of an asset (or cash-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense

Inventory
Inventory and work in progress are valued at the lower of cost and net realisable value on a first-in, first-out basis. Cost comprises direct materials and, where applicable, direct labour costs and those overheads, including depreciation of property, plant and equipment, that have been incurred in bringing the inventories to their present location and condition Net realisable value represents the estimated selling prices less all estimated costs of completion and costs to be incurred in marketing, selling and distribution

Cash and cash equivalents
Cash and cash equivalents include cash at bank and in hand and short-term deposits with a maturity of three months or less on inception The Group considers overdrafts (repayable on demand) to be an integral part of its cash management activities and these are included in cash and cash equivalents for the purposes of the cash flow statement

Provisions
Provisions are recognised when the Group has a present obligation as a result of a past event, and it is probable that the Group will be required to settle that obligation Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material

Post-retirement benefits
Pensions and similar benefits (principally healthcare) are accounted for under IAS 19 *Employee Benefits* For defined benefit plans, obligations are measured at discounted present value whilst plan assets are recorded at fair value The service and financing costs of such plans are recognised separately in the income statement, current service costs are spread systematically over the lives of employees and financing costs are recognised in the periods in which they arise Actuarial gains and losses are recognised immediately in the statement of recognised income and expense

Surpluses in schemes are recognised as assets only if they represent unconditional economic benefits available to the Group in the future Movements in unrecognised surpluses are included in the statement of recognised income and expense

Payments to defined contribution schemes are charged as an expense as they fall due

Share-based payments
The Group, on behalf of its parent company, provides share-based payment arrangements to certain employees. These are predominantly equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant. The fair value is expensed on a straight-line basis over the vesting period The amount recognised as an expense is adjusted to reflect the actual number of shares or options that will vest, except where additional shares vest as a result of the Total Shareholder Return performance condition in the Performance Share Plan The costs of these share-based payments

are treated as a capital contribution from the parent company Any payments made by the Group to its parent company, in respect of these arrangements, are treated as a return of this capital contribution

The fair values of the share-based payment arrangements are measured as follows

i) ShareSave plans – using the binomial pricing model
ii) Performance Share Plan – using a pricing model adjusted to reflect non-entitlement to dividends (or equivalent) and the Total Shareholder Return market-based performance condition
iii) Annual Performance Related Award plan deferred shares and free shares under the Share Incentive Plan – share price on the date of the award

See note 20 for a further description of the share-based payment plans.

Contingent liabilities

In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers These arrangements fall into two categories, credit based guarantees and asset value guarantees. In accordance with the requirements of IAS 39 *Financial Instruments Recognition and Measurement* and IFRS 4 *Insurance Contracts*, credit-based guarantees are treated as insurance contracts The Group considers asset value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts. Provision for insurance liabilities is made as described above

The Group's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio, and are reported on a discounted basis

Key sources of estimation uncertainty

In applying the above accounting policies, management has made appropriate estimates in many areas, and the actual outcome may differ from those calculated The key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are

Forecasts and discount rates

The carrying value of a number of items on the balance sheet are dependent on the estimates of future cash flows arising from the Group's operations

- The impairment tests for goodwill are dependent on forecasts of the cash flows of the cash generating units that give rise to the goodwill and the discount rate applied. No impairment resulted from the annual impairment tests in 2007 (carrying value at December 31, 2007 £801m, December 31, 2006 £735m)
- If the assessment of development, participation, certification and recoverable engine costs recognised as intangible assets indicates the possibility of impairment, a detailed impairment test is undertaken No impairment resulted from the assessment in 2007 (carrying value at December 31, 2007 £880m, December 31, 2006 £674m)
- The financial liabilities arising from financial risk and revenue sharing partnerships are valued at each reporting date using the amortised cost method (carrying value at December 31, 2007 £315m, December 31, 2006 £324m) This involves calculating the present value of the forecast cash flows of the arrangement using the internal rate of return at the inception of the arrangement as the discount rate
- The realisation of the deferred tax assets (carrying value at December 31, 2007 £81m, December 31, 2006 £141m) recognised is dependent on the generation of sufficient future taxable profits. The Group recognises deferred tax assets where it is more likely than not that the benefit will be realised

Assessment of long-term contractual arrangements

The Group has long-term contracts that fall into different accounting periods. In assessing the allocation of revenues and costs to individual accounting periods, and the consequential assets and liabilities, the Group estimates the total revenues and costs forecast to arise in respect of the contract and the stage of completion based on an appropriate measure of performance as described under revenue recognition above

Post-retirement benefits

The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19 *Employee Benefits* The accounting valuation, which was based on assumptions determined with independent actuarial advice, resulted in a net deficit of £123m before deferred taxation being recognised on the balance sheet at December 31, 2007 (December 31, 2006 £995m) The size of the net deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions Further details are included in note 17

Provisions

As described in the accounting policy above, the Group measures provisions (carrying value at December 31, 2007 £301m, December 31, 2006 £335m) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date These estimates are made, taking account of information available and different possible outcomes

Taxation

The tax payable on profits is determined based on tax laws and regulations that apply in each of the numerous jurisdictions in which the Group operates. Where the precise impact of these laws and regulations is unclear then reasonable estimates may be used to determine the tax charge included in the financial statements If the tax eventually payable or reclaimable differs from the amounts originally estimated then the difference will be charged or credited in the financial statements for the year in which it is determined

Contingent liabilities

As described in note 22 the Group has significant long-term contingent obligations The directors consider that the possibility that there will be any significant loss arising from these contingencies as remote In reaching this opinion, the directors have considered the likelihood of the contingency crystallising and have taken account of forecast aircraft values that generally provide security against the contingent liability

Revisions to IFRS not applicable in 2007

IAS 8 *Operating Segments* is applicable for 2009 This standard amends the requirements for disclosure of segmental performance and will not have any effect on the Group's overall reported results

IFRIC 12 *Service Concession Arrangements* is applicable for 2008, if endorsed for adoption in the EU If endorsed, the Group will adopt this interpretation in accounting for its interest in the Future Strategic Tanker Aircraft contract with the UK Ministry of Defence There would be no effect on the 2007 reported results

IFRIC 14 *IAS 19 – The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* is applicable for 2008 if it is endorsed for adoption in the EU If endorsed, it will provide additional guidance on the conditions under which net post-retirement benefit assets may be recognised in the balance sheet. It may also require additional liabilities to be recognised where minimum funding requirements exist. The application of this interpretation to the Group is still being assessed, but any changes to the net post-retirement position recognised would be included in the statement of recognised income and expense and would not have any effect on the income statement.

Amendment to IAS 23 *Borrowing Costs* is applicable for 2009 if it is endorsed for adoption in the EU If endorsed, the amendment generally eliminates the option to expense borrowing costs attributable to the acquisition, construction or production of qualifying asset as incurred, and instead requires the capitalisation of such borrowing costs as part of the cost of the specific asset. The Group is currently assessing the impact of the amendment on the results and net assets.

The Group does not consider that any other standards or interpretations issued by the IASB, but not yet applicable, will have a significant impact on the financial statements

Notes to the consolidated financial statements continued

2 Segmental analysis

The Group operates in four segments which reflect the internal organisation and management structure according to the nature of the products and services provided

Civil aerospace – development, manufacture, marketing and sales of commercial aero engines and aftermarket services.
Defence aerospace – development, manufacture, marketing and sales of military aero engines and aftermarket services.
Marine – development, manufacture, marketing and sales of marine propulsion systems and aftermarket services
Energy – development, manufacture, marketing and sales of power systems for the offshore oil and gas industry, electrical power generation and aftermarket services.

Details for these primary reporting segments are shown below

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Central items £m	Eliminations £m	Group £m
Analysis by business segments for the year ended December 31, 2007							
Revenue from sale of original equipment	1,417	782	996	251	—	—	3,446
Revenue from aftermarket services	2,301	854	546	288	—	—	3,989
Total revenue	3,718	1,636	1,542	539	—	—	7,435
Operating profit excluding share of profit of joint ventures	263	159	90	(15)	(49)	—	448
Share of profit of joint ventures	45	11	1	9	—	—	66
Loss on sale or termination of businesses	—	—	—	(2)	—	—	(2)
Profit/(loss) before financing and taxation	308	170	91	(8)	(49)	—	512
Financing income					762		762
Financing costs					(496)		(496)
Taxation					(133)		(133)
Profit for the year							645
Other information							
Segment assets	6,051	998	1,698	644	—	(461)	8,930
Investments in joint ventures	214	34	5	31	—	—	284
Cash and short-term investments					1,936		1,936
Fair value of swaps hedging fixed rate borrowings					42		42
Income tax assets					88		88
Post-retirement scheme surpluses					210		210
Total assets							11,490
Segment liabilities	(4,005)	(1,279)	(1,195)	(329)	—	461	(6,347)
Borrowings					(1,064)		(1,064)
Fair value of swaps hedging fixed rate borrowings					(27)		(27)
Income tax liabilities					(533)		(533)
Post-retirement scheme deficits					(333)		(333)
Total liabilities							(8,304)
Expenditure on intangible assets and property, plant and equipment	479	73	33	15			600
Depreciation and amortisation	164	28	21	20			233

2 Segmental analysis continued

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Central items £m	Eliminations £m	Group £m
Analysis by business segments for the year ended December 31, 2006[1]							
Revenue from sale of original equipment	1,543	733	812	267	—	—	3,355
Revenue from aftermarket services	2,232	836	488	245	—	—	3,801
Total revenue	3,775	1,569	1,300	512	—	—	7,156
Operating profit excluding share of profit of joint ventures	446	183	103	(33)	(47)	—	652
Share of profit of joint ventures	36	5	1	5	—	—	47
Profit on sale or termination of businesses	1	—	—	—	—	—	1
Profit/(loss) before financing and taxation	483	188	104	(28)	(47)	—	700
Financing income					1,335		1,335
Financing costs					(498)		(498)
Taxation					(397)		(397)
Profit for the year							1,140
Other information							
Segment assets	5,473	960	1,406	646	—	(264)	8,221
Investments in joint ventures	184	24	4	28	—	—	240
Cash and short-term investments					2,218		2,218
Fair value of swaps hedging fixed rate borrowings					27		27
Income tax assets					146		146
Post-retirement scheme surpluses					22		22
Total assets							10,874
Segment liabilities	(3,768)	(1,067)	(867)	(319)	—	264	(5,757)
Borrowings					(1,390)		(1,390)
Fair value of swaps hedging fixed rate borrowings					(30)		(30)
Income tax liabilities					(443)		(443)
Post-retirement scheme deficits					(1,017)		(1,017)
Total liabilities							(8,637)
Expenditure on intangible assets and property, plant and equipment	437	52	24	15			528
Depreciation and amortisation	162	30	20	19			231
Impairments	(10)	—	—	—			(10)

[1] Comparative information has been restated in line with the reclassifications made in the year (see notes 10 11 14 and 17)

Notes to the consolidated financial statements continued

2 Segmental analysis continued

Geographical segments
The Group's revenue by destination is shown below

	2007 £m	2006 £m
United Kingdom	**1,185**	944
Rest of Europe	**1,478**	1,159
USA	**2,232**	2,458
Canada	**274**	207
Asia	**1,785**	1,902
Africa	**108**	78
Australasia	**137**	146
Other	**236**	262
	7,435	7,156

The following analysis shows the carrying amounts of the Group's assets, and additions to intangible assets and property, plant and equipment, by the geographical area in which the assets are located

	Segment assets		Additions to intangible assets and property, plant and equipment	
	2007 £m	Restated* 2006 £m	2007 £m	2006 £m
United Kingdom	**7,768**	7,852	**517**	467
North America	**1,465**	1,284	**39**	22
Nordic countries	**1,280**	1,083	**18**	15
Germany	**645**	604	**20**	19
Other	**394**	331	**6**	5
Eliminations	**(62)**	(280)	**—**	—
	11,490	10,874	**600**	528

* Comparative information has been restated in line with the reclassifications made in the year (see notes 10, 11, 14 and 17)

2 Segmental analysis continued

Underlying performance

As discussed in the Finance Director's review on page 23, the Group seeks to present a measure of underlying performance that excludes items considered to be non-underlying in nature

Underlying sales exclude the release of the foreign exchange transition hedging reserve and reflect the achieved US dollar exchange rate arising on settled derivative contracts.

Underlying profit before financing includes amounts realised from settled derivative contracts (primarily relating to civil aerospace) and for 2007, excludes the £130m of past service post-retirement costs.

In addition, underlying profit before taxation excludes the unrealised amounts arising from revaluations required by IAS 32 *Financial Instruments Presentation* and IAS 39 *Financial Instruments Recognition and Measurement* and the net impact of financing costs related to post-retirement scheme benefits.

Underlying profit adjustments

	2007		2006	
	Profit before financing £m	**Profit before tax £m**	Profit before financing £m	Profit before tax £m
Profit per consolidated income statement	**512**	**778**	700	1,537
Release of transition hedging reserve	**(149)**	**(149)**	(289)	(289)
Realised gains on settled derivative contracts	**415**	**420**	343	370
Net unrealised fair value changes to derivative contracts	**—**	**(251)**	—	(730)
Effect of currency on contract accounting	**(76)**	**(76)**	1	1
Revaluation of trading assets and liabilities	**—**	**10**	—	4
Financial RRSPs – foreign exchange differences and changes in forecast payments	**—**	**13**	—	(39)
Net post-retirement scheme financing	**—**	**(30)**	—	(3)
Post-retirement schemes – past service costs[1]	**130**	**130**	—	—
Total underlying adjustments	**320**	**67**	55	(686)
Underlying profit	**832**	**845**	755	851

[1] As part of its ongoing discussions with the Trustees of its UK pension schemes, the Group agreed to reflect changes in HM Revenue & Customs practice and increase the size of the lump sum payment retirees are able to receive by commuting part of the pension Like many other employers, the Group has also increased the amount of the lump sum payment for the pension commuted Updating the commutation arrangements to reflect these factors increases the post-retirement liability by £100m.

The Group has also agreed a 2 per cent discretionary increase applicable to pensions that do not benefit from any guaranteed increase which increases the liability by £30m

Underlying profit reconciliation

	2007			2006		
	£m	**Underlying adjustments £m**	**Underlying results £m**	£m	Underlying adjustments £m	Underlying results £m
Profit before financing						
Civil aerospace	**308**	**256**	**564**	483	40	523
Defence aerospace	**170**	**29**	**199**	188	7	195
Marine	**91**	**22**	**113**	104	(2)	102
Energy	**(8)**	**13**	**5**	(28)	10	(18)
Central items	**(49)**	**—**	**(49)**	(47)	—	(47)
	512	**320**	**832**	700	55	755
Net financing	**266**	**(253)**	**13**	837	(741)	96
Profit before taxation	**778**	**67**	**845**	1,537	(686)	851
Taxation	**(133)**	**(60)**	**(193)**	(397)	207	(190)
Profit after taxation	**645**	**7**	**652**	1,140	(479)	661

Notes to the consolidated financial statements continued

3 Operating profit and profit before taxation

	2007 £m	2006 £m
After crediting		
RRSP receipts – credited to other operating income	**50**	57
Operating lease rentals receivable – credited within revenue from aftermarket services	**27**	30
After charging		
Amortisation of certification costs	**7**	5
Amortisation of development costs	**18**	16
Amortisation of recoverable engine costs	**28**	30
Amortisation of software and other intangible assets	**10**	9
Depreciation and impairment of owned property, plant and equipment [1]	**163**	153
Depreciation of property, plant and equipment held under finance leases [1]	**7**	8
Operating lease rentals payable – hire of plant and equipment	**58**	62
– hire of other assets	**18**	23
Research and development expenditure	**381**	370
RRSP payments – included in cost of sales	**199**	162

[1] Including appropriate amounts charged to inventories

Fees payable to the Company's auditors and its associates were as follows

	2007 £m	2006 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements	**1.7**	1.6
Fees payable to the Company's auditors and its associates for other services		
The audit of the Company's subsidiaries pursuant to legislation	**2.0**	1.8
Other services pursuant to legislation	**0.1**	0.2
Other services relating to taxation	**0.3**	0.4
All other services	**—**	0.3
	4.1	4.3
Fees payable in respect of the Group's pension schemes		
Audit	**0.2**	0.1
Other services relating to taxation	**0.1**	0.1

4 Net financing

	2007 £m	2007 *Underlying financing* £m	2006 £m	2006 *Underlying financing* £m
Financing income				
Interest receivable	**83**	***83***	82	*82*
Fair value gains on foreign currency contracts (note 15)[1]	**215**	—	696	—
Financial RRSPs – foreign exchange differences and changes in forecast payments	—	—	39	—
Fair value gains on commodity derivatives (note 15)[1]	**36**	—	34	—
Expected return on post-retirement scheme assets (note 17)	**384**	—	343	—
Fair value adjustments relating to parent company shares held under trust	**43**	***43***	139	*139*
Other financing income	**1**	***1***	2	*2*
	762	***127***	1,335	*223*
Financing costs				
Interest payable	**(88)**	***(88)***	(100)	*(100)*
Financial RRSPs – foreign exchange differences and changes in forecast payments	**(13)**	—	—	—
Financial charge relating to financial RRSPs	**(26)**	***(26)***	(27)	*(27)*
Interest on post-retirement scheme liabilities (note 17)	**(354)**	—	(340)	—
Net foreign exchange losses	**(15)**	—	(31)	—
	(496)	***(114)***	(498)	*(127)*
Net financing	**266**	***13***	837	*96*
Analysed as				
Net interest payable	**(5)**	***(5)***	(18)	*(18)*
Net post-retirement scheme financing	**30**	—	3	—
Net other financing	**241**	***18***	852	*114*
Net financing	**266**	***13***	837	*96*
[1] Net gain on items held for trading	**251**	—	730	—

Notes to the consolidated financial statements continued

5 Taxation

	UK		Overseas		Total	
	2007 £m	2006 £m	**2007 £m**	2006 £m	**2007 £m**	2006 £m
Current tax						
Current tax charge for the year	**47**	51	**72**	66	**119**	117
Less double tax relief	**(7)**	(47)	**—**	—	**(7)**	(47)
	40	4	**72**	66	**112**	70
Adjustments in respect of prior years	**(27)**	(2)	**21**	(6)	**(6)**	(8)
	13	2	**93**	60	**106**	62
Deferred tax						
Deferred tax charge for the year	**65**	296	**13**	33	**78**	329
Adjustments in respect of prior years	**(8)**	1	**(8)**	5	**(16)**	6
Deferred tax credit resulting from reduction in tax rates[1]	**(23)**	—	**(12)**	—	**(35)**	—
	34	297	**(7)**	38	**27**	335
Recognised in the income statement	**47**	299	**86**	98	**133**	397

Other tax charges/(credits)

	2007 £m	2006 £m
Recognised in the statement of recognised income and expense – deferred tax[1]	**95**	43
Recognised directly in equity – current tax	**(43)**	(18)
– deferred tax[1]	**23**	(58)
	75	(33)

[1] Deferred tax assets and liabilities have been restated to reflect the reductions in corporate tax rates in the UK and Germany which take effect in 2008. The resulting charges or credits have been recognised in the income statement except to the extent that they relate to items previously charged or credited to the statement of recognised income and expense or equity Accordingly in 2007 £35m has been credited to the income statement, £9m has been charged to the statement of recognised income and expense, and £5m has been charged directly to equity

Tax reconciliation

	2007 £m	2006 £m
Profit before taxation	**778**	1,537
Less share of profits of joint ventures (note 9)	**(66)**	(47)
Profit before taxation excluding joint ventures	**712**	1,490
Nominal tax charge at UK corporation tax rate **30%** (2006 30%)	**214**	447
UK R&D credit	**(22)**	(19)
Other items	**(2)**	(29)
Adjustments in respect of prior years	**(22)**	(2)
Reduction in opening deferred taxes resulting from reduction in tax rate	**(35)**	—
	133	397
Analysis of taxation charge		
Underlying items (note 2)	**193**	190
Non-underlying items	**(60)**	207
	133	397

5 Taxation continued

Deferred taxation assets and liabilities

	2007 £m	2006 £m
At January 1	**(111)**	213
Amount charged to income statement	**(27)**	(335)
Amount charged to statement of recognised income and expense (SORIE)	**(95)**	(43)
Amount (charged)/credited to equity	**(23)**	58
On acquisition of business	**—**	1
Exchange movements	**(8)**	(5)
At December 31	**(264)**	(111)
Analysed as		
Deferred tax assets	**81**	141
Deferred tax liabilities	**(345)**	(252)
	(264)	(111)
Deferred tax not recognised on unused tax losses and other items[1]	**160**	154

[1] Deferred tax not recognised on the basis that the future economic benefit is uncertain

The analysis of the deferred tax position is as follows

	At January 1, 2007 £m	Recognised in income statement £m	Recognised in SORIE £m	Recognised in equity £m	Exchange movements £m	At December 31, 2007 £m
Property, plant and equipment	**(145)**	**2**	—	—	—	**(143)**
Other temporary differences	**(278)**	**84**	—	**(23)**	**(6)**	**(223)**
Pensions and other post-retirement scheme benefits	**314**	**(133)**	**(144)**	—	**(2)**	**35**
Foreign exchange and commodity financial assets and liabilities	**(183)**	**13**	**49**	—	—	**(121)**
Losses	**117**	**7**	—	—	—	**124**
Advance corporation tax	**64**	—	—	—	—	**64**
	(111)	**(27)**	**(95)**	**(23)**	**(8)**	**(264)**

In addition, there are temporary differences of **£943m** (2006 £593m) relating to investments in subsidiaries and joint ventures. No deferred tax has been provided in respect of these differences, since the timing of the reversals can be controlled and it is probable that the temporary differences will not reverse in the future

6 Employee information

	2007 Number	2006 Number
Average weekly number of Group employees during the year		
United Kingdom	**22,900**	22,500
Overseas	**15,700**	14,800
	38,600	37,300
Civil aerospace	**22,800**	21,800
Defence aerospace	**5,600**	5,400
Marine	**7,700**	7,400
Energy	**2,500**	2,700
	38,600	37,300

	£m	£m
Group employment costs [1]		
Wages and salaries	**1,534**	1,456
Social security costs	**172**	158
Share-based payments (note 20)	**36**	36
Pensions and other post-retirement scheme benefits (note 17)	**248**	145
	1,990	1,795

[1] Remuneration of key management personnel is shown in note 23

Notes to the consolidated financial statements continued

7 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
Cost:						
At January 1, 2006	751	284	381	265	44	1,725
Exchange adjustments	(23)	—	—	—	—	(23)
Additions	—	91	41	64	29	225
On acquisitions of businesses	7	—	—	—	3	10
Disposals	—	(1)	—	—	(6)	(7)
At January 1, 2007	**735**	**374**	**422**	**329**	**70**	**1,930**
Exchange adjustments	**59**	**1**	**—**	**—**	**—**	**60**
Additions	**—**	**129**	**91**	**37**	**39**	**296**
On acquisitions of businesses	**7**	**—**	**1**	**—**	**1**	**9**
Disposals	**—**	**—**	**—**	**—**	**(1)**	**(1)**
At December 31, 2007	**801**	**504**	**514**	**366**	**109**	**2,294**
Accumulated amortisation and impairment:						
At January 1, 2006	—	138	116	146	10	410
Provided during the year (charged to cost of sales)	—	5	16	30	9	60
At January 1, 2007	**—**	**143**	**132**	**176**	**19**	**470**
Provided during the year (charged to cost of sales)	**—**	**7**	**18**	**28**	**10**	**63**
At December 31, 2007	**—**	**150**	**150**	**204**	**29**	**533**
Net book value at December 31, 2007	**801**	**354**	**364**	**162**	**80**	**1,761**
Net book value at December 31, 2006	735	231	290	153	51	1,460
Net book value at January 1, 2006	751	146	265	119	34	1,315

Goodwill

In accordance with the requirements of IAS 36 *Impairment of Assets*, goodwill is allocated to the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the business combination that gave rise to the goodwill as follows

Cash-generating unit (CGU) or group of CGUs.

	Primary reporting segment	2007 £m	2006 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**203**	186
Commercial marine – arising from the acquisition of Vinters plc	Marine	**514**	470
Energy – arising from the acquisition of Rolls-Royce Energy Systems Inc.	Energy	**54**	55
Other	Various	**30**	24
		801	735

Goodwill has been tested for impairment during 2007 on the following basis.

- The carrying value of goodwill has been assessed by reference to value in use Values in use have been estimated using cash flows from the most recent forecasts prepared by management. Given the long-term nature of the business in which the Group operates, these typically forecast the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate
- The key assumptions on which the cash flow projections for the most recent forecast are based are discount rates, growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs
- The pre-tax cash flow projections have been discounted at 12.75 per cent, based on the Group's weighted average cost of capital

8 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At January 1, 2006	587	1,953	212	210	2,962
Exchange adjustments	(16)	(51)	(17)	(4)	(88)
Additions	4	78	44	177	303
On acquisitions of businesses	—	2	—	—	2
Reclassifications	28	97	—	(125)	—
Disposals/write-offs	(16)	(83)	(84)	(1)	(184)
At January 1, 2007	**587**	**1,996**	**155**	**257**	**2,995**
Exchange adjustments	**19**	**39**	**—**	**2**	**60**
Additions	**22**	**88**	**92**	**102**	**304**
On acquisitions of businesses	**1**	**—**	**—**	**—**	**1**
On disposal of businesses	**—**	**(4)**	**—**	**—**	**(4)**
Reclassifications	**70**	**111**	**4**	**(185)**	**—**
Transferred to assets held for sale	**—**	**—**	**(12)**	**—**	**(12)**
Disposals/write-offs	**—**	**(120)**	**(65)**	**—**	**(185)**
At December 31, 2007	**699**	**2,110**	**174**	**176**	**3,159**
Accumulated depreciation and impairment:					
At January 1, 2006	141	1,066	106	—	1,313
Exchange adjustments	(5)	(33)	(9)	—	(47)
Impairment adjustment [1]	—	—	(10)	—	(10)
Provided during the year	22	139	10	—	171
Disposals/write-offs	(8)	(76)	(54)	—	(138)
At January 1, 2007	**150**	**1,096**	**43**	**—**	**1,289**
Exchange adjustments	**7**	**24**	**—**	**—**	**31**
Provided during the year	**23**	**139**	**8**	**—**	**170**
On disposal of businesses	**—**	**(2)**	**—**	**—**	**(2)**
Transferred to assets held for sale	**—**	**—**	**(5)**	**—**	**(5)**
Disposals/write-offs	**—**	**(111)**	**(26)**	**—**	**(137)**
At December 31, 2007	**180**	**1,146**	**20**	**—**	**1,346**
Net book value at December 31, 2007	**519**	**964**	**154**	**176**	**1,813**
Net book value at December 31, 2006	437	900	112	257	1,706
Net book value at January 1, 2006	446	887	106	210	1,649

[1] Impairment charge reversal of £nil (2006 £10m) relating to aircraft, as a result of improved lease terms and values provided by independent aircraft appraisers.

Property, plant and equipment includes

	2007 £m	2006 £m
Net book value of finance leased assets		
Land and buildings	**9**	9
Plant and equipment	**14**	21
Assets held for use in operating leases		
Cost	**141**	148
Depreciation	**(18)**	(42)
Net book value	**123**	106
Non-depreciable land	**94**	92
Land and buildings at net book value comprise		
Freehold	**489**	406
Long leasehold	**13**	15
Short leasehold	**17**	16
	519	437
Capital expenditure commitments – contracted but not provided for	**82**	91
Net book value of assets held as security for liabilities	**—**	48
Cost of fully depreciated assets	**382**	420

Notes to the consolidated financial statements continued

9 Investments

	Joint ventures					Other[1]	
	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m	Unlisted investments at cost[1] £m	Parent company shares held under trust £m	Total £m
At January 1, 2006	131	98	18	247	52	293	345
Exchange adjustments	(4)	(13)	—	(17)	—	—	—
Additions	8	—	3	11	1	47	48
Taxation paid by the Group	—	2	—	2	—	—	—
Fair value adjustments	—	—	—	—	—	2	2
Impairment	(21)	17	(6)	(10)[2]	—	—	—
Share of retained profit	—	13	—	13	—	—	—
Amortisation/disposals	(4)	(1)	(1)	(6)[3]	(2)	(268)	(270)
At January 1, 2007	**110**	**116**	**14**	**240**	**51**	**74**	**125**
Exchange adjustments	**1**	**5**	—	**6**	—	—	—
Additions	**13**	—	—	**13**	**6**	**78**	**84**
Taxation paid by the Group	—	**2**	—	**2**	—	—	—
Fair value adjustments	—	—	—	—	—	**15**	**15**
Share of retained profit	—	**24**	—	**24**	—	—	—
Amortisation/disposals	—	**(1)**	—	**(1)**	—	**(135)**	**(135)**
At December 31, 2007	**124**	**146**	**14**	**284**	**57**	**32**	**89**

[1] These primarily comprise floating rate convertible loan stock.
[2] Impairment charge of £10m recognised in 2006 to reflect the write down of the Group's investment in Pembroke Group to its recoverable amount of £1m. In addition previous impairment charges in respect of Pembroke Group which were all charged against share of post acquisition reserves, were reallocated in 2006.
[3] Includes £5m for Data Systems & Solutions. The remaining 50 per cent of this joint venture was acquired during 2006 and as such it has been included in the consolidated results of the Group from the date of the transaction.

Investments in joint ventures are represented by

	2007 £m	2006 £m
Share of aggregate assets		
Non-current assets[4]	**658**	585
Current assets	**635**	645
Share of aggregate liabilities[5]		
Current liabilities	**(523)**	(551)
Non-current liabilities	**(486)**	(439)
	284	240
[4] Non-current assets include goodwill of	**7**	7
[5] Liabilities include borrowings of	**(372)**	(358)

	2007 £m	2006 £m
Share of income	**94**	82
Share of interest	**(21)**	(23)
Share of taxation	**(7)**	(12)
Share of profit of joint ventures recognised in the income statement	**66**	47
Dividend received	**(42)**	(44)
Share of retained profit	**24**	3

The tax charge on joint venture profits represents an effective tax rate of **10 per cent** (2006 20 per cent), a decrease of 10 per cent This results from a change in profit mix between joint ventures taxed at different effective rates.

The principal joint ventures are listed on pages 91 and 92

10 Inventory

	2007 £m	Restated* 2006 £m
Raw materials	**223**	156
Work in progress	**732**	766
Long-term contracts work in progress	**93**	121
Finished goods	**1,123**	771
Payments on account	**32**	31
Inventory per balance sheet	**2,203**	1,845
Progress payments received against other inventory	**(426)**	(398)
Net inventory after progress payments	**1,777**	1,447
Inventories stated at net realisable value	**154**	116
Amount of inventory write-down	**79**	46
Reversal of inventory write-down	**6**	7

* Progress payments included in the prior year have been reclassified as follows: received against long term contracts (£18m) offset against 'Long-term contracts work in progress' above received against other inventory (£398m) included within 'Trade and other payables' – see note 14

11 Trade and other receivables

	2007 £m	Restated* 2006 £m
Trade receivables	**889**	864
Amounts recoverable on contracts	**904**	820
Amounts owed by joint ventures	**300**	241
Other receivables	**315**	308
Prepayments and accrued income	**177**	235
	2,585 [1]	2,468 [1]
Analysed as		
Financial instruments		
Trade receivables and similar items (note 15)	**1,211**	1,210
Other non-derivative financial assets (note 15)	**321**	300
Non-financial instruments (note 15)	**1,053**	958
	2,585	2 468
[1] Trade and other receivables expected to be recovered in more than one year		
Trade receivables	**26**	12
Amounts recoverable on contracts	**704**	624
Amounts owed by joint ventures	**29**	26
Other receivables	**40**	65
Prepayments and accrued income	**28**	99
	827	826

* Prepayments and accrued income in the prior year have been restated from £232m to £235m on the adoption of IFRIC 11 *Group and Treasury Share Transactions*

12 Cash and cash equivalents

	2007 £m	2006 £m
Cash at bank and in hand	**1,264**	756
Short-term deposits	**632**	1,428
	1,896	2,184
Overdrafts (note 13)	**(25)**	(14)
Cash and cash equivalents per cash flow statement (page 30)	**1,871**	2 170
Cash held as collateral against third party obligations	**60**	58

Notes to the consolidated financial statements continued

13 Borrowings

	Current		Non-current	
	2007 £m	2006 £m	2007 £m	2006 £m
Unsecured				
Overdrafts	25	14	—	—
Bank loans	3	4	2	3
6 ⅞% Notes 2007 €500m[1]	—	337	—	—
7 ⅜% Notes 2016 £200m	—	—	200	200
5 84% Notes 2010 US$187m[2]	—	—	97	96
6 38% Notes 2013 US$230m[2]	—	—	123	121
6 55% Notes 2015 US$83m[2]	—	—	46	44
4 ½% Notes 2011 €750m[1]	—	—	534	494
Other loan 2008 (interest rate nil)	1	—	—	1
Secured				
Bank loans[3]	—	38	24	24
Obligations under finance leases payable[4] (note 21)				
Less than one year	5	7	—	—
Between one and two years	—	—	3	4
Between two and five years	—	—	—	2
After five years	—	—	1	1
	34	400	1,030	990
Repayable				
Between one and two years – by instalments			4	6
Between two and five years – by instalments			1	4
– otherwise			655	614
After five years – by instalments			1	1
– otherwise			369	365
			1,030	990

[1] These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable at variable rates of interest and at fixed exchange rates.
[2] These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge
[3] Secured on aircraft.
[4] Obligations under finance leases are secured by related leased assets.

14 Trade and other payables

	Current		Non-current	
	2007 £m	Restated* 2006 £m	2007 £m	2006 £m
Payments received on account[1]	1,226	1,055	332	171
Trade payables	778	654	—	—
Amounts owed to joint ventures	272	167	32	31
Amounts owed to parent undertaking	413	577	—	—
Other taxation and social security	64	50	—	—
Other payables	766	731	103	200
Accruals and deferred income	1,217	1,031	498	425
	4,736	4,265	965	827
[1] Includes payments received from joint ventures	195	139	25	62

Total trade and other payables are analysed as

	2007 £m	2006 £m
Financial instruments		
Trade payables and similar items (note 15)	1,872	1,735
Other non-derivative financial liabilities (note 15)	315	282
Non-financial instruments (note 15)	3,514	3,075
	5,701	5,092

* 'Payments received on account' in 2006 have been restated from £657m due to the reclassification from 'Inventory' of £398m of progress payments received against other inventory. 'Amounts owed to parent undertaking' have been restated from £554m to £577m on the adoption of IFRIC 11 *Group and Treasury Share Transactions*

15 Financial instruments

This note should be read in conjunction with the Finance Director's review on pages 23 to 27

Carrying values and fair values of financial instruments

The carrying values of the Group's financial instruments (together with non-financial instruments for reconciling purposes) are analysed as follows

		2007				2006			
		Financial instruments				Financial instruments			
	Notes	**Derivative £m**	**Non-derivative £m**	**Non-financial instruments £m**	**Total £m**	Derivative £m	Non-derivative £m	Non-financial instruments £m	Total £m
Assets									
Unlisted non-current asset investments [1,2]	9	—	**57**	—	**57**	—	51	—	51
Parent company shares held under trust [3]	9	—	**32**	—	**32**	—	74	—	74
Other non-current assets		—	—	**4,149**	**4,149**	—	—	3,569	3,569
Trade and other receivables [4]									
Trade receivables and similar items [1]	11	—	**1,211**	—	**1,211**	—	1,210	—	1,210
Other non-derivative financial assets [1]	11	—	**321**	—	**321**	—	300	—	300
Non-financial instruments	11	—	—	**1,053**	**1,053**	—	—	958	958
Other financial assets [5]		**514**	—	—	**514**	644	—	—	644
Short-term investments [1,4]		—	**40**	—	**40**	—	34	—	34
Cash and cash equivalents [4]									
Cash at bank and in hand	12	—	**1,264**	—	**1,264**	—	756	—	756
Short-term deposits	12	—	**632**	—	**632**	—	1,428	—	1,428
Other current assets		—	—	**2,217**	**2,217**	—	—	1,850	1,850
		514	**3,557**	**7,419**	**11,490**	644	3,853	6,377	10,874
Liabilities									
Borrowings – current [5]	13	—	**(34)**	—	**(34)**	—	(400)	—	(400)
– non-current [5]	13	—	**(1,030)**	—	**(1,030)**	—	(990)	—	(990)
Other financial liabilities [5]									
Financial RRSPs		—	**(315)**	—	**(315)**	—	(324)	—	(324)
Other		**(57)**	—	—	**(57)**	(36)	—	—	(36)
Trade and other payables [4]									
Trade payables and similar items	14	—	**(1,872)**	—	**(1,872)**	—	(1,735)	—	(1,735)
Other non-derivative financial liabilities	14	—	**(315)**	—	**(315)**	—	(282)	—	(282)
Non-financial instruments	14	—	—	**(3,514)**	**(3,514)**	—	—	(3,075)	(3,075)
Other liabilities		—	—	**(1,167)**	**(1,167)**	—	—	(1,795)	(1,795)
		(57)	**(3,566)**	**(4,681)**	**(8,304)**	(36)	(3,731)	(4,870)	(8,637)
Net assets/(liabilities)		**457**	**(9)**	**2,738**	**3,186**	608	122	1,507	2,237

The fair value of a financial instrument is the price at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction Fair values have been determined with reference to available market information at the balance sheet date, using the methodologies discussed below

[1] Loans and receivables.

[2] These primarily comprise floating rate convertible loan stock. The conversion conditions are such that fair value approximates to the book value

[3] Fair value is determined using the market value bid price

[4] Fair values are assumed to approximate to cost either due to the short term maturity of the instruments or because the interest rate of the investments is reset after periods not exceeding six months.

[5] Where available market values have been used to determine fair values Where market values are not readily available (principally in respect of derivatives, borrowings and financial RRSPs) fair values have been estimated by discounting expected future cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date

Notes to the consolidated financial statements continued

15 Financial instruments continued

Fair values equate to book values for both 2007 and 2006, with the following exceptions

	2007 Book value £m	2007 Fair value £m	2006 Book value £m	2006 Fair value £m
Borrowings – current	**(34)**	**(34)**	(400)	(402)
– non-current	**(1,030)**	**(1,058)**	(990)	(1,030)
Financial RRSPs	**(315)**	**(340)**	(324)	(347)

The carrying values of financial assets and liabilities by category, as defined by IAS 39 *Financial Instruments. Recognition and Measurement*, are as follows

	2007 £m	2006 £m
Assets		
Held for trading	**514**	644
Loans and receivables	**1,629**	1,595
Available for sale	**664**	1,502
Cash	**1,264**	756
Liabilities		
Held for trading	**(57)**	(36)
Financial liabilities at amortised cost	**(3,566)**	(3,731)
	448	730

Carrying values of other financial assets and liabilities

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
At December 31, 2007					
Assets	**433**	**39**	**42**	**—**	**514**
Liabilities	**(54)**	**—**	**(3)**	**(315)**	**(372)**
	379	**39**	**39**	**(315)**	**142**
At December 31, 2006					
Assets	578	39	27	—	644
Liabilities	(24)	—	(12)	(324)	(360)
	554	39	15	(324)	284

Other financial liabilities are analysed as follows

	2007 £m	2006 £m
Current liabilities	**(69)**	(24)
Non-current liabilities	**(303)**	(336)
	(372)	(360)

15 Financial instruments continued

Foreign exchange and commodity financial instruments

The Group uses various financial instruments to manage its exposure to movements in foreign exchange rates The Group uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals) From January 1, 2005, the Group has not included foreign exchange or commodity financial instruments in any cash flow hedging relationships for accounting purposes To hedge the currency risk associated with a borrowing denominated in US dollars, the Group has currency derivatives designated as part of fair value hedges.

Movements in the fair values of foreign exchange and commodity instruments were as follows

	Foreign exchange instruments			Commodity instruments		
	Total £m	Included in transition hedging reserve £m	Included in income statement £m	Total £m	Included in transition hedging reserve £m	Included in income statement £m
At January 1, 2006	228	538		31	5	
Fair value changes to derivative contracts not in accounting hedging relationships[1]	696	—	696	34	—	34
Fair value changes to fair value hedges[1,2]	(26)	—	(26)	—	—	—
Fair value of contracts settled	(344)	—	—	(26)	—	—
Transferred to revenue	—	(284)	284	—	(5)	5
At January 1, 2007	**554**	**254**		**39**	—	
Fair value changes to derivative contracts not in accounting hedging relationships[1]	**215**	—	**215**	**36**	—	**36**
Fair value changes to fair value hedges[1,2]	**(6)**	—	**(6)**	—	—	—
Fair value of contracts settled	**(384)**	—	—	**(36)**	—	—
Transferred to revenue	—	**(149)**	**149**	—	—	—
At December 31, 2007	**379**	**105**		**39**	—	

[1] Included in financing
[2] Gain on related hedged items **£6m** (2006 £26m)

Interest rate financial instruments

The Group uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates. Where the effectiveness of the hedge relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the hedging reserve and released to match actual payments on the hedged item

Movements in the fair values of interest rate financial instruments were as follows

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in income statement £m
At January 1, 2006	62	69	(7)	
Changes deemed ineffective for cash flow hedge accounting purposes[1]	4	—	4	4
Other changes[1,2]	(51)	(51)	—	(51)
At January 1, 2007	**15**	**18**	**(3)**	
Other changes[1,2]	**24**	**24**	—	**24**
At December 31, 2007	**39**	**42**	**(3)**	

[1] Included in financing.
[2] Movement on related hedged items **£24m loss** (2006 £51m gain)

Notes to the consolidated financial statements continued

15 Financial instruments continued

Financial risk and revenue sharing partnerships (RRSPs)
The Group has financial liabilities arising from financial RRSPs These financial liabilities are valued at each reporting date using the amortised cost method This involves calculating the present value of the forecast cash flows of the arrangements using the internal rate of return at the inception of the arrangements as the discount rate

Movements in the amortised cost values of financial RRSPs were as follows.

	2007 £m	2006 £m
At January 1	**324**	423
Cash paid to partners	**(55)**	(87)
Exchange adjustments direct to reserves	**7**	—
Financing charge[1]	**26**	27
Excluded from underlying profit:		
Exchange adjustments[1]	**(7)**	(42)
Restructuring of financial RRSP agreements and changes in forecast payments[1]	**20**	3
At December 31	**315**	324

[1] Included in financing.

Risk management policies and hedging activities

The principal financial risks to which the Group is exposed are foreign currency exchange rate risk, interest rate risk, and commodity price risk. The Board has approved policies for the management of these risks

Foreign currency exchange rate risk – The Group has significant cash flows (most significantly US dollars, followed by the Euro) denominated in currencies other than the functional currency of the relevant trading entity To manage its exposures to changes in values of future foreign currency cash flows, so as to maintain relatively stable long-term foreign exchange rates on settled transactions, the Group enters into derivative forward foreign currency transactions For accounting purposes, these derivative contracts are not designated as hedging instruments.

The Group also has exposures to the fair values of non-derivative financial instruments denominated in foreign currencies. To manage the risk of changes in these fair values, the Group enters into derivative forward foreign exchange contracts, which are designated as fair value hedges for accounting purposes.

The Group regards its interests in overseas subsidiary companies as long-term investments The Group aims to match its translational exposures by matching the currencies of assets and liabilities Where appropriate, foreign currency financial liabilities may be designated as hedges of the net investment.

Interest rate risk – The Group's interest rate risk is primarily in relation to its fixed rate borrowings (fair value risk) and floating rate borrowings (cash flow risk) Interest rate derivatives are used to manage the overall interest rate profile within the Group policy, which is to maintain a higher proportion of net debt at fixed rates of interest having regard to the prevailing interest rate outlook. These are designated as either fair value or cash flow hedges as appropriate

Commodity risk – The Group has exposures to the price of jet fuel and base metals arising from business operations. To minimise its cash flow exposures to changes in commodity prices, the Group enters into derivative commodity transactions For accounting purposes, these derivative contracts are not designated as hedging instruments.

Other price risk – The Group's cash equivalent balances represent investments in money market instruments, with a term of up to one month The Group does not consider that these are subject to significant price risk.

Liquidity risk – The Group's policy is to hold financial investments and maintain undrawn committed facilities at a level sufficient to ensure that the Group has available funds to meet its medium-term capital and funding obligations and to meet any unforeseen obligations and opportunities The Group holds cash and short-term investments, which together with the undrawn committed facilities, enable the Group to manage its liquidity risk.

Credit risk – The Group is exposed to credit risk to the extent of non-payment by either its customers or the counterparties of its financial instruments The Group has credit policies covering both trading and financial exposures. At the balance sheet date, there were no significant concentrations of credit risk. The maximum exposure to credit risk at the balance sheet date is represented by the carrying value of each financial asset, including derivative financial instruments

15 Financial instruments continued

Derivative financial instruments

The nominal amounts and fair values of derivative financial instruments are as follows, analysed by year of expected maturity

							2007
		Expected maturity				Fair value	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
Foreign exchange contracts							
Fair value hedges	(280)	—	—	(105)	(175)	—	(27)
Non-hedge accounted	5,168	2,135	1,816	1,217	—	433	(27)
Interest rate contracts							
Fair value hedges	751	—	—	594	157	42	—
Non-hedge accounted	74	20	18	16	20	—	(3)
Commodity contracts.							
Non-hedge accounted	166	91	55	20	—	39	—
	5,879	2,246	1,889	1,742	2	514	(57)

							2006
		Expected maturity				Fair value	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
Foreign exchange contracts							
Fair value hedges	(280)	—	—	(105)	(175)	—	(21)
Non-hedge accounted	5,473	1,861	1,964	1,648	—	578	(3)
Interest rate contracts.							
Fair value hedges	1,069	313	—	596	160	27	(9)
Non-hedge accounted	98	21	21	34	22	—	(3)
Commodity contracts							
Non-hedge accounted	152	68	49	35	—	39	—
	6,512	2,263	2,034	2,208	7	644	(36)

As described above, all derivative financial instruments are entered into for risk management purposes, although these may not be designated into hedging relationships for accounting purposes

Notes to the consolidated financial statements continued

15 Financial instruments continued

Derivative financial instruments related to foreign exchange risks are denominated in the following currencies

	2007 Currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Currencies sold forward					
Sterling	—	280	—	30	310
US dollar	5,136	—	922	431	6,489
Euro	—	—	—	497	497
Other	3	12	151	98	264

	2006 Currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Currencies sold forward					
Sterling	—	280	—	16	296
US dollar	5,543	—	466	351	6,360
Euro	—	—	—	241	241
Other	3	22	77	29	131

Other derivative financial instruments are denominated in the following currencies

	2007 £m	2006 £m
Sterling	20	22
US dollar	470	484
Euro	500	813
Other	—	—

15 Financial instruments continued

Non-derivative financial instruments

Non-derivative financial instruments are denominated in the following currencies

2007	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Assets					
Unlisted non-current investments	46	6	2	3	57
Parent company shares held under trust	32	—	—	—	32
Trade receivables and similar items	233	720	133	125	1,211
Other non-derivative financial assets	150	68	40	63	321
Short-term investments	40	—	—	—	40
Cash at bank and in hand	160	376	608	120	1,264
Short-term deposits	319	293	3	17	632
	980	1,463	786	328	3,557
Liabilities					
Borrowings – current	(5)	(3)	(1)	(25)	(34)
– non-current	(203)	(290)	(537)	—	(1,030)
Financial RRSPs	—	(315)	—	—	(315)
Trade payables and similar items	(959)	(495)	(248)	(170)	(1,872)
Other non-derivative financial liabilities	(148)	(85)	(35)	(47)	(315)
	(1,315)	(1,188)	(821)	(242)	(3,566)
	(335)	275	(35)	86	(9)

2006	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Assets					
Unlisted non-current investments	46	1	2	2	51
Parent company shares held under trust	74	—	—	—	74
Trade receivables and similar items	270	728	114	98	1,210
Other non-derivative financial assets	113	90	44	53	300
Short-term investments	34	—	—	—	34
Cash at bank and in hand	104	255	335	62	756
Short-term deposits	1,250	157	8	13	1,428
	1,891	1,231	503	228	3,853
Liabilities					
Borrowings – current	(7)	(41)	(341)	(11)	(400)
– non-current	(206)	(285)	(498)	(1)	(990)
Financial RRSPs	—	(324)	—	—	(324)
Trade payables and similar items	(890)	(512)	(236)	(97)	(1,735)
Other non-derivative financial liabilities	(158)	(63)	(5)	(56)	(282)
	(1,261)	(1,225)	(1,080)	(165)	(3,731)
	630	6	(577)	63	122

Notes to the consolidated financial statements continued

15 Financial instruments continued

Currency exposures

The Group's actual currency exposures after taking account of derivative foreign currency contracts, which are not designated as hedging instruments for accounting purposes are as follows

Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
					2007
Sterling	—	3	—	2	5
US dollar	6	—	—	6	12
Euro	—	5	—	—	5
Other	—	4	9	12	25

Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
					2006
Sterling	—	3	1	(1)	3
US dollar	4	—	—	2	6
Euro	(1)	—	—	—	(1)
Other	1	7	7	7	22

Ageing beyond contractual due date

The ageing beyond contractual due date of the Group's financial assets is

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
					2007
Assets					
Unlisted non-current asset investments	57	—	—	—	57
Parent company shares held under trust	32	—	—	—	32
Trade receivables and similar items	973	186	52	—	1,211
Other non-derivative financial assets	296	8	17	—	321
Other financial assets	514	—	—	—	514
Short-term investments	40	—	—	—	40
Cash at bank and in hand	1,264	—	—	—	1,264
Short-term deposits	632	—	—	—	632
	3,808	194	69	—	4,071

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
					2006
Assets					
Unlisted non-current asset investments	51	—	—	—	51
Parent company shares held under trust	74	—	—	—	74
Trade receivables and similar items	976	208	26	—	1,210
Other non-derivative financial assets	263	20	17	—	300
Other financial assets	644	—	—	—	644
Short-term investments	34	—	—	—	34
Cash at bank and in hand	756	—	—	—	756
Short-term deposits	1,428	—	—	—	1,428
	4,226	228	43	—	4,497

15 Financial instruments continued

Contractual maturity analysis

	Gross cash flows					2007
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
Borrowings:						
Unsecured bank loans	(26)	(1)	(1)	—	—	(28)
Other unsecured	(3)	—	—	—	—	(3)
Unsecured bond issues	(56)	(56)	(773)	(432)	317	(1,000)
Secured bank loans	(1)	(1)	(26)	—	4	(24)
Other secured	(6)	(3)	—	(1)	1	(9)
	(92)	(61)	(800)	(433)	322	(1,064)
Other						
Trade payables and similar items	(1,862)	(2)	(7)	(1)	—	(1,872)
Derivative financial liabilities [1]	(13)	(2)	(4)	20	(58)	(57)
Financial RRSPs	(38)	(34)	(201)	(141)	99	(315)
Other non-derivative financial liabilities	(271)	(1)	(29)	(14)	—	(315)
	(2,184)	(39)	(241)	(136)	41	(2,559)
	(2,276)	(100)	(1,041)	(569)	363	(3,623)

	Gross cash flows					2006
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
Borrowings						
Unsecured bank loans	(18)	(1)	(2)	—	—	(21)
Other unsecured	—	(1)	—	—	—	(1)
Unsecured bond issues	(412)	(54)	(755)	(460)	389	(1,292)
Secured bank loans	(40)	(1)	(28)	—	7	(62)
Other secured	(9)	(5)	(3)	(1)	4	(14)
	(479)	(62)	(788)	(461)	400	(1,390)
Other						
Trade payables and similar items	(1,735)	—	—	—	—	(1,735)
Derivative financial liabilities [1]	(17)	(12)	(10)	(21)	24	(36)
Financial RRSPs	(41)	(36)	(196)	(170)	119	(324)
Other non-derivative financial liabilities	(247)	—	—	(35)	—	(282)
	(2,040)	(48)	(206)	(226)	143	(2,377)
	(2,519)	(110)	(994)	(687)	543	(3,767)

[1] Foreign exchange contract and interest rate contract liabilities.

Notes to the consolidated financial statements continued

15 Financial instruments continued

Interest rate risk

In respect of income earning financial assets and interest bearing financial liabilities, the following table indicates their effective interest rates and the periods in which they reprice The value shown is the carrying amount

							2007
			Period in which interest rate reprices				
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments[1]	5.5913%	40	14	6	—	12	8
Cash at bank and in hand[2]		1,264	1,264	—	—	—	—
Short-term deposits[3]		632	632	—	—	—	—
Unsecured bank loans							
€4m floating rate loan	EURIBOR +1.2	(3)	(3)	—	—	—	—
Overdrafts[4]		(25)	(25)	—	—	—	—
Effect of other interest rate swaps	1.2277%	—	54	—	(18)	(16)	(20)
Other unsecured							
South Korean Won floating rate loan	KRW LIBOR +0 9	(2)	(2)	—	—	—	—
Other loan 2008 (interest rate nil)	0 0000%	(1)	(1)	—	—	—	—
Unsecured bond issues							
7 ⅜% Notes 2016 £200m	7.3750%	(200)	—	—	—	—	(200)
5.84% Notes 2010 US$187m	5.8400%	(97)	—	—	—	(97)	—
Effect of interest rate swaps	USD LIBOR +1 159	—	(97)	—	—	97	—
6.38% Notes 2013 US$230m	6.3800%	(123)	—	—	—	—	(123)
Effect of interest rate swaps	USD LIBOR +1.26	—	(123)	—	—	—	123
6 55% Notes 2015 US$83m	6.5500%	(46)	—	—	—	—	(46)
Effect of interest rate swaps	USD LIBOR +1.24	—	(46)	—	—	—	46
4 ½% Notes 2011 €750m	4.5000%	(534)	—	—	—	(534)	—
Effect of interest rate swaps	GBP LIBOR +0 911	—	(534)	—	—	534	—
Secured bank loans							
US$ floating rate loan	USD LIBOR +0 53	(24)	(24)	—	—	—	—
Other secured							
Obligations under finance leases payable	6 0183%	(9)	(2)	(3)	(3)	—	(1)
		872	1,107	3	(21)	(4)	(213)

15 Financial instruments continued

Interest rate risk continued

							2006
			Period in which interest rate reprices				
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments[1]	4.8374%	34	15	5	—	8	6
Cash at bank and in hand[2]		756	756	—	—	—	—
Short-term deposits[3]		1,428	1,428	—	—	—	—
Unsecured bank loans							
€6m floating rate loan	EURIBOR + 1.2	(4)	(4)	—	—	—	—
€5m fixed rate loan	4.1200%	(3)	—	(3)	—	—	—
Overdrafts[4]		(14)	(14)	—	—	—	—
Effect of other interest rate swaps	1.1392%	—	78	—	(21)	(35)	(22)
Other unsecured							
Other loan 2008 (interest rate nil)	0.0000%	(1)	—	—	(1)	—	—
Unsecured bond issues							
6⅜% Notes 2007 €500m	6.3750%	(337)	(337)	—	—	—	—
Effect of interest rate swaps	GBP LIBOR + 0.866	—	—	—	—	—	—
7⅜% Notes 2016 £200m	7.3750%	(200)	—	—	—	—	(200)
5.84% Notes 2010 US$187m	5.8400%	(96)	—	—	—	(96)	—
Effect of interest rate swaps	USD LIBOR + 1.159	—	(96)	—	—	96	—
6.38% Notes 2013 US$230m	6.3800%	(121)	—	—	—	—	(121)
Effect of interest rate swaps	USD LIBOR + 1.26	—	(121)	—	—	—	121
6.55% Notes 2015 US$83m	6.5500%	(44)	—	—	—	—	(44)
Effect of interest rate swaps	USD LIBOR + 1.24	—	(44)	—	—	—	44
4½% Notes 2011 €750m	4.5000%	(494)	—	—	—	(494)	—
Effect of interest rate swaps	GBP LIBOR + 0.911	—	(494)	—	—	494	—
Secured bank loans							
US$ floating rate loan	USD LIBOR + 0.97	(62)	(62)	—	—	—	—
Other secured							
Obligations under finance leases payable	9.9153%	(14)	(4)	(3)	(4)	(2)	(1)
		828	1,101	(1)	(26)	(29)	(217)

[1] Interest on the short-term investments are at fixed rates.
[2] Cash at bank and in hand comprises bank balances and demand deposits and earns interest at rates based on daily bank deposit rates.
[3] Short-term deposits are deposits placed on money markets for periods up to three months and earn interest at the respective short term deposit rates.
[4] Overdrafts bear interest at rates linked to applicable LIBOR rates that fluctuate in accordance with local practice.

Some of the Group's borrowings are subject to the Group meeting certain obligations, including customary financial covenants. If the Group fails to meet its obligations these arrangements give rights to the lenders, upon agreement, to accelerate repayment of the facilities. There are no rating triggers contained in any of the Group's facilities that could require the Group to accelerate or repay any facility for a given movement in the Group's credit rating.

In addition, the Group has undrawn committed borrowing facilities available as follows.

	2007 £m	2006 £m
Expiring within one year	—	—
Expiring in one to two years	—	—
Expiring thereafter	**450**	450
	450	450

Notes to the consolidated financial statements continued

15 Financial instruments continued

Sensitivity analysis

The Group is exposed to a number of foreign currencies The most significant transactional currency exposures are US dollar with sterling and US dollar with euro

At December 31, 2007 if sterling had weakened five per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been **£157m** lower (2006 £166m) If sterling had strengthened five per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been **£142m** higher (2006 £150m) There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2007 if the euro had weakened five per cent against the US dollar with all other variables held constant, profit after tax and equity for the year would have been **£35m** lower (2006 £18m) If the euro had strengthened five per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been **£32m** higher (2006 £16m) There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2007 if interest rates at that date had been 25 basis points lower, with all other variables remaining constant, profit after tax for the year and equity would have been unchanged (2006 unchanged) If interest rates had been 25 basis points higher, with all other variables remaining constant profit after tax for the year and equity would have been unchanged (2006 unchanged)

At December 31, 2007 if the price of commodities had been five per cent lower, with all other variables remaining constant, profit after tax for the year and equity would have been **£8m** lower (2006 £6m), arising mainly as the result of lower fair value gains on derivative contracts If the price of commodities had been five per cent higher, with all other variables remaining constant, profit after tax and equity would have been **£8m** higher (2006 £6m), arising mainly as the result of higher fair value gains on derivatives. There would have been no change to the underlying results that exclude unrealised gains and losses on commodity derivatives.

16 Provisions

	At December 31, 2006 £m	Exchange adjustments £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2007 £m
Warranties and guarantees	139	4	(4)	52	(26)	165
Contract loss	44	1	(4)	12	(25)	28
Customer financing	98	2	(20)	5	(41)	44
Insurance	37	—	(3)	11	(5)	40
Restructuring	3	—	—	9	(1)	11
Other	14	1	(1)	2	(3)	13
	335	8	(32)	91	(101)	301

Analysed as

	2007 £m	2006 £m
Current liabilities	121	146
Non-current liabilities	180	189
	301	335

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.
Provisions for contract loss and restructuring are generally expected to be utilised within two years.
The Group's captive insurance company retains a portion of the exposures it insures on behalf of the remainder of the Group Significant delays occur in the notification and settlement of claims and judgement is involved in assessing outstanding liabilities, the ultimate cost and timing of which cannot be known with certainty at the balance sheet date The insurance provisions are based on information currently available, however it is inherent in the nature of the business that ultimate liabilities may vary Provisions for outstanding claims are established to cover the outstanding expected liability as well as claims incurred but not yet reported
Other provisions comprise a number of liabilities with varying expected utilisation rates

Customer financing provisions cover guarantees provided for asset value and/or financing. These guarantees are considered to be insurance contracts in nature and provision is made in accordance with IFRS 4 *Insurance Contracts* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* These guarantees, the risks arising and the process used to assess the extent of the risk are described under the heading Sales financing' in the Finance Director's review on page 27 The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 22 Based on the assumptions used to estimate the customer finance provision, it is estimated that the provision will be utilised as follows

	2007 £m	2006 £m
Potential claims with specific claim dates		
In one year or less	1	—
In more than one year but less than five years	3	19
In more than five years	14	14
Potential claims that may arise at any time by date of expiry of the guarantee		
Up to one year	16	35
Up to five years	4	11
Thereafter	6	19
	44	98

Notes to the consolidated financial statements continued

17 Post-retirement benefits

The Group operates a number of defined benefit and defined contribution schemes.

For the UK defined benefit schemes, the assets are held in separate trustee administered funds and employees are entitled to retirement benefits based on their final salaries and length of service

Overseas defined benefit schemes are a mixture of funded and unfunded plans Additionally in the US, 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. These schemes are unfunded

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2007 The most recent funding valuations of the main UK schemes were

Scheme	Valuation date
Rolls-Royce Pension Fund	March 31, 2006
Rolls-Royce Group Pension Scheme	April 5, 2007 [1]
Vickers Group Pension Scheme	March 31, 2007 [1]

[1] Preliminary

As described in the Finance Director's review on page 24, during 2007, the trustees of the UK defined benefit schemes, in consultation with the Group, have undertaken a review of their investment strategies. As a result, revised investment strategies have been adopted that aim to hedge, on an economic basis, the majority of the interest rate and inflation risks associated with pension liabilities by investing a significant proportion of each schemes' assets in swap contracts, backed by short-term money market deposits (the liability-driven investment or LDI portfolio) Following the agreement of this revised strategy, new entrants are no longer able to join the schemes and the Group has paid additional contributions of £500m to the main UK pensions schemes.

As described in note 1, for accounting purposes, the defined benefit schemes are valued in accordance with IAS 19 *Employee Benefits* In particular, IAS 19 requires the discount rate used for the valuation of forecast liabilities to be determined by reference to the market yield on high quality corporate bonds. In contrast, for funding purposes, the discount rate is determined by reference to the expected rate of return on the scheme's assets, taking account of the specific investment strategy in place As a result of this difference in valuation methodologies, the amounts recognised in the balance sheet will differ from those that would have been recognised if the valuation had been undertaken using the assumptions used for funding purposes

Accordingly, although the investment strategy aims to hedge interest rate and inflation risk on an economic basis, the net position recognised in the balance sheet for UK defined benefit schemes may vary over time as a result of actuarial gains and losses that arise due to this difference in valuation methodologies

Amounts recognised in the income statement

	2007			2006		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes						
Current service cost	**100**	**25**	**125**	102	28	130
Past service cost	**131**	**2**	**133**	—	2	2
	231	**27**	**258**	102	30	132
Defined contribution schemes	**3**	**17**	**20**	2	14	16
Operating cost	**234**	**44**	**278**	104	44	148
Financing (income)/costs in respect of defined benefit schemes						
Expected return on assets	**(367)**	**(17)**	**(384)**	(328)	(15)	(343)
Interest on liabilities	**323**	**31**	**354**	310	30	340
	(44)	**14**	**(30)**	(18)	15	(3)
Total income statement charge	**190**	**58**	**248**	86	59	145

The operating cost is charged as follows

	Defined benefit		Defined contribution		Total	
	2007 £m	2006 £m	**2007 £m**	2006 £m	**2007 £m**	2006 £m
Cost of sales	**223**	93	**15**	11	**238**	104
Commercial and administrative costs	**26**	30	**4**	4	**30**	34
Research and development	**9**	9	**1**	1	**10**	10
	258	132	**20**	16	**278**	148

Amounts recognised in the statement of recognised income and expense

	2007 £m	2006 £m
Actuarial gain on scheme assets	**161**	132
Experience gains on scheme liabilities	**350**	470
Movement in unrecognised surplus	**(112)**	—
	399	602

17 Post-retirement benefits continued

In December 2007, PaySave was introduced in the UK. This is a salary sacrifice scheme under which employees elect to stop making employee contributions and the Group makes additional contributions in return for a reduction in gross contractual pay As a result, there has been a decrease in wages and salaries and a corresponding increase in pensions costs of £3m in the year

Defined benefit schemes

Assumptions

The principal actuarial assumptions used at the balance sheet date were as follows

	2007		2006	
	UK schemes %	**Overseas schemes %**	UK schemes %	Overseas schemes %
Rate of increase in salaries	**5 0**	**3.8**	44	36
Rate of increase of pensions in payment	**3 5**[1]	**0 4**	29	03
Discount rate	**5.8**	**6 0**	51	56
Expected rate of return on scheme assets	**5.4**	**7.5**	66	70
Inflation assumption	**3.5**	**2.5**	29	24

[1] Benefits accruing after April 5, 2005 are assumed to increase in payment at a rate of 2 4 per cent.

The discount rates are determined by reference to the market yields on AA rated corporate bonds. For the main UK schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve For less significant UK schemes and overseas schemes, the rate is determined as the market yield at the average duration of the forecast benefit payments. The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities

The overall expected rate of return is calculated by weighting the individual returns expected from each asset class (see below) in accordance with the actual asset balance in the schemes' investment portfolios.

The mortality assumptions adopted for the UK pension schemes are derived from the PA92 actuarial tables, with medium cohort, published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant scheme's actual experience The resulting range of life expectancies in the principal UK schemes are as follows

Life expectancy from age 65	
Current pensioner	17.5 years to 22.2 years
Future pensioner	19.5 years to 23 9 years

Other demographic assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and other relevant data The assumptions are reviewed and updated as necessary as part of the periodic actuarial valuation of the schemes.

Assumptions in respect of overseas schemes are also set in accordance with advice from local actuaries.

The future costs of healthcare benefits are based on an assumed healthcare costs trend rate of nine per cent grading down to five per cent over seven years

Amounts recognised in the balance sheet

	2007			2006		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	**(6,335)**	**(293)**	**(6,628)**	(6,338)	(271)	(6,609)
Fair value of scheme assets	**6,626**	**277**	**6,903**	5,673	233	5,906
	291	**(16)**	**275**	(665)	(38)	(703)
Present value of unfunded obligations	**—**	**(284)**	**(284)**	—	(290)	(290)
Unrecognised surplus[2]	**(110)**	**(4)**	**(114)**	—	(2)	(2)
Net asset/(liability) recognised in the balance sheet	**181**	**(304)**	**(123)**	(665)	(330)	(995)
Analysed as [3]						
Post-retirement scheme surpluses	**210**	**—**	**210**	22	—	22
Post-retirement scheme deficits	**(29)**	**(304)**	**(333)**	(687)	(330)	(1,017)
	181	**(304)**	**(123)**	(665)	(330)	(995)

[2] Where a surplus has arisen on a scheme in accordance with IAS 19 the surplus is recognised as an asset only if it represents an unconditional economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet. Surpluses have arisen on the UK schemes in 2007 largely as a result of differences between the actuarial and IAS 19 valuation assumptions.

[3] Comparatives have been restated to show the split between post-retirement scheme surpluses and deficits.

Notes to the consolidated financial statements continued

17 Post-retirement benefits continued

Changes in present value of defined benefit obligations

	2007			2006		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At January 1	(6,338)	(561)	(6,899)	(6,661)	(559)	(7,220)
Exchange adjustments	—	(15)	(15)	—	65	65
Current service cost	(100)	(25)	(125)	(102)	(28)	(130)
Past service cost	(131)	(2)	(133)	—	(2)	(2)
Finance cost	(323)	(31)	(354)	(310)	(30)	(340)
Contributions by employees	(38)	(2)	(40)	(39)	(2)	(41)
Net benefits paid out	286	18	304	279	18	297
Actuarial gains/(losses)	309	41	350	495	(25)	470
Settlements/curtailment	—	—	—	—	2	2
At December 31	(6,335)	(577)	(6,912)	(6,338)	(561)	(6,899)
Funded schemes	(6,335)	(293)	(6,628)	(6,338)	(271)	(6,609)
Unfunded schemes	—	(284)	(284)	—	(290)	(290)

Changes in fair value of scheme assets

	2007			2006		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At January 1	5,673	233	5,906	5,343	220	5,563
Exchange adjustments	—	9	9	—	(27)	(27)
Expected return on assets	367	17	384	328	15	343
Contributions by employer	677	30	707	122	31	153
Contributions by employees	38	2	40	39	2	41
Benefits paid out	(286)	(18)	(304)	(279)	(18)	(297)
Actuarial gains	157	4	161	120	12	132
Settlements/curtailment	—	—	—	—	(2)	(2)
At December 31	6,626	277	6,903	5,673	233	5,906
Actual return on scheme assets			545			475

The fair value of the scheme assets in the principal schemes and the expected rates of return at December 31, were as follows.

	2007		2006	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
UK schemes				
LDI portfolio	4 7	4,595	—	—
Equities	7.8	1,651	7 5	3,876
Sovereign debt	4 6	48	4 5	629
Corporate bonds	5 1	88	4 9	1,164
Other	4 9	244	5 0	4
	5 4	6,626	6 6	5,673
Overseas schemes				
Equities	9 0	165	8.3	146
Corporate bonds	4.8	86	4 9	71
Other	6 4	26	5 1	16
	7.5	277	7 0	233

The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group

The expected rate of return for LDI portfolios is determined by the implicit yield on the portfolio at the balance sheet date

The expected rates of return on other individual categories of scheme assets are determined by reference to gilt yields. In the UK, equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3 25 per cent and 0 8 per cent per annum respectively

The expected rates of return above are the weighted average of the rates for each scheme

17 Post-retirement benefits continued

Future contributions
The Group expects to contribute approximately £271m to its defined benefit schemes in 2008

Sensitivities
As described above, the revised investment strategies are designed to hedge the risks from interest rates and inflation The principle remaining risks relate to the assumptions for mortality and increases in salaries If the age ratings in respect of the principal UK defined benefit schemes were increased by one year, the scheme liabilities would increase by £164m If the rate of increase in salaries were 0 5 per cent higher, scheme liabilities would increase by £112m

The defined benefit obligation relating to post-retirement medical benefits would increase by £33m if the healthcare trend rate increases by one per cent, and reduce by £27m if it decreases by one per cent. The pension expense relating to post-retirement medical benefits, comprising service cost and interest cost, would increase by £4m if the healthcare trend increases by one per cent, and reduce by £3m if it decreases by one per cent

History of defined benefit schemes
The history of the schemes for the current and prior years is as follows

	2007 £m	2006 £m	2005 £m	2004 £m
Balance sheet				
Present value of defined benefit obligations	**(6,912)**	(6,899)	(7,220)	(6,107)
Fair value of scheme assets	**6,903**	5,906	5,563	4,698
Unrecognised surplus	**(114)**	(2)	(2)	—
Deficit	**(123)**	(995)	(1,659)	(1,409)
Experience gains/losses				
Actuarial gains on scheme assets	**161**	132	588	126
Experience gains/(losses) on scheme liabilities	**350**	470	(868)	(133)
Movement in unrecognised surplus	**(112)**	—	(2)	—
Total amount recognised in the statement of recognised income and expense	**399**	602	(282)	(7)
Cumulative since January 1, 2004	**712**	313	(289)	(7)

In accordance with the transitional provision amendments to IAS 19 *Employee Benefits* in December 2004, the disclosures above are determined prospectively from 2004

18 Share capital

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At January 1, 2006 and December 31, 2007	**2,000**	**400**
Issued and fully paid		
At January 1, 2006 and December 31, 2007	**1,631**	**326**

On June 23, 2003 Rolls-Royce plc had 1,630,996,508 shares in issue with an aggregate nominal value of £326m On this date, under a scheme of arrangement between Rolls-Royce plc and its shareholders under Section 425 of the Companies Act 1985, and as sanctioned by the High Court, all the issued shares in the Company were cancelled and the same number of new shares were issued to Rolls-Royce Group plc the new holding company of the Rolls-Royce Group in consideration for the allotment to shareholders of one ordinary share in Rolls-Royce Group plc for each ordinary share in Rolls-Royce plc held on the record date (June 20, 2003)

As a result of the scheme of arrangement, holders of options over ordinary shares in Rolls-Royce plc under the ShareSave schemes and the executive option schemes were permitted to exchange their options for options over an equivalent number of ordinary shares in Rolls-Royce Group plc.

Notes to the consolidated financial statements continued

19 Movements in capital and reserves

	Share capital £m	Share premium £m	Transition hedging reserve [1] £m	Translation reserve £m	Retained earnings [2] £m	Total £m	Minority interests £m	Total equity £m
	Attributable to equity holders of the parent							
At January 1, 2006	326	631	379	17	(432)	921	6	927
Total recognised income and expense for the year	—	—	(202)	(75)	1,490	1,213	(4)	1,209
Share-based payments adjustment	—	—	—	—	20	20	—	20
Transactions with minority interests	—	—	—	—	—	—	5	5
Related tax movements – current tax	—	—	—	—	18	18	—	18
– deferred tax	—	—	—	—	58	58	—	58
At January 1, 2007	**326**	**631**	**177**	**(58)**	**1,154**	**2,230**	**7**	**2,237**
Total recognised income and expense for the year	—	—	**(100)**	**117**	**878**	**895**	**(6)**	**889**
Share-based payments adjustment	—	—	—	—	**29**	**29**	—	**29**
Transactions with minority interests	—	—	—	—	—	—	**11**	**11**
Related tax movements – current tax	—	—	—	—	**43**	**43**	—	**43**
– deferred tax	—	—	—	—	**(18)**	**(18)**	—	**(18)**
Change in rate of UK corporation tax – deferred tax	—	—	—	—	**(5)**	**(5)**	—	**(5)**
At December 31, 2007	**326**	**631**	**77**	**59**	**2,081**	**3,174**	**12**	**3,186**

[1] See accounting policies note 1 – hedge accounting
[2] Prior year share-based payments adjustment restated from £40m to £20m on the adoption of IFRIC 11 *Group and Treasury Share Transactions*

20 Share-based payments

Share-based payment plans in operation during the year
The Group had the following share-based payment plans in operation during the year

Performance Share Plan (PSP)
This plan involves the award of shares to participants subject to performance conditions Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market based performance condition (Total Shareholder Return – TSR)

ShareSave share option plan
Based on a three or five year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into Vesting of the options is not subject to the achievement of a performance target In the UK, the plan is HM Revenue & Customs approved Overseas, employees in 32 countries participate in ShareSave plans through arrangements broadly comparable to the UK plan A small proportion of the ShareSave options are settled in cash

Executive Share Option Plan (ESOP)
This plan involves the grant of market value share options to participants. The options are subject to a non-market based performance condition (growth in EPS) The options have a maximum contractual life of ten years. Following the introduction of the PSP, it is not intended to grant any further executive share options.

Annual Performance Related Award (APRA) plan deferred shares
Deferred shares are awarded as part of the APRA plan One third of the value of any annual bonus is delivered in the form of a deferred share award The release of deferred share awards is not dependent on the achievement of any further performance conditions other than that participants remain an employee of the Group for two years from the date of the award in order to retain the full number of shares. During the two year deferral period, participants are entitled to receive dividends on the deferred shares

Share Incentive Plan (SIP)
There is a 'Free Share' element of the UK Share Incentive Plan Eligible employees may receive shares with a value of up to one and a half weeks' salary as part of any bonus paid There are no conditions attached to the shares.

In accordance with the transitional provisions of IFRS 2 *Share-based Payment*, the Group has recognised an expense in respect of all grants under these plans made after November 7, 2002 and unvested at January 1, 2005

The Group recognised a total expense of **£36m** (2006 £36m)

20 Share-based payments continued

The movements in awards under the Group's various share plans are shown in the tables below

PSP	Number of shares awarded 2007 Millions	2006 Millions
Outstanding at January 1	**15 7**	11 5
Awarded during the year	**4.6**	4 8
Forfeited during the year	**(0.8)**	(0 6)
Additional entitlements arising from TSR performance	**1.3**	—
Vested during the year	**(6.8)**	—
Outstanding at December 31	**14 0**	15 7

ShareSave	2007 Number of share options Millions	2007 Weighted average exercise price Pence	2006 Number of share options Millions	2006 Weighted average exercise price Pence
Outstanding at January 1	**54 7**	**160p**	64 7	157p
Granted during the year	**13 0**	**416p**	—	—
Forfeited during the year	**(0.8)**	**207p**	(1.2)	168p
Exercised during the year	**(23 6)**	**116p**	(8 8)	140p
Outstanding at December 31	**43.3**	**260p**	54 7	160p
Exercisable at December 31	—	—	0 7	141p

ESOP	2007 Number of share options Millions	2007 Weighted average exercise price Pence	2006 Number of share options Millions	2006 Weighted average exercise price Pence
Outstanding at January 1	**19 0**	**188p**	76.8	148p
Forfeited during the year	—	—	(1 1)	216p
Exercised during the year	**(16 7)**	**189p**	(56 7)	134p
Outstanding at December 31	**2.3**	**175p**	19 0	188p
Exercisable at December 31	**2.3**	**175p**	5 8	124p

Deferred shares under APRA	Number of shares awarded 2007 Millions	2006 Millions
Outstanding at January 1	**4 9**	8.2
Awarded during the year	**1 9**	2 0
Forfeited during the year	**(0 1)**	(0 1)
Additional shares accrued from conversion of B Shares	**0.2**	0.2
Vested during the year	**(3.5)**	(5 4)
Outstanding at December 31	**3.4**	4 9

Free Shares under SIP	Number of shares awarded 2007 Millions	2006 Millions
Awarded during the year	**0 7**	0 7

Options were exercised on a regular basis during the year The average share price during the year was **510p** (2006 439p)

Fair values

The weighted average fair values per share for PSP awards, ShareSave grants, APRA deferred share awards, and SIP Free Share awards included in the expense for the year were as follows

	2007 Pence	2006 Pence	2005 Pence	2004 Pence	2003 Pence
PSP awards	**557p**	494p	282p	249p	—
ShareSave – 3 year grants	**230p**	—	131p	—	61p
ShareSave – 5 year grants	**264p**	—	154p	—	71p
ESOP	—	—	—	—	22 7p
APRA deferred share awards	**502p**	448p	260p	220p	—
SIP Free Share awards	**499p**	462p	257p	231p	—

Notes to the consolidated financial statements continued

20 Share-based payments continued

Details of the assumptions used in the calculation of these fair values are set out below Expected volatility was based on the historical volatility of the Rolls-Royce Group plc's share price over the seven years prior to the grant or award date Expected dividends were based on payments to shareholders over the five years prior to the grant or award date

PSP awards
The fair value of shares awarded under the PSP are calculated using the market value of shares at the time of the award adjusted to take into account non-entitlement to dividends (or equivalent) during the vesting period and the TSR performance condition The PSP fair values were calculated using the following assumptions

	2007	2006	2005	2004
Weighted average share price	**501p**	444p	262p	233p
Expected dividends	**8.30p**	7 92p	7.81p	7 61p
Volatility	**29%**	32%	34%	35%
Correlation	**26%**	19%	19%	22%
Expected life	**3 years**	3 years	3 years	3 years
Risk free interest rate	**5.2%**	4 3%	4 9%	5 2%

The PSP has a TSR market-based performance condition, such that the Rolls-Royce Group plc's TSR over the performance period will be compared with the TSR of the companies constituting the FTSE 100 index on the date of grant If the Rolls-Royce Group plc's TSR exceeds the median TSR of the FTSE 100, the number of shares that vest will be increased by 25 per cent. The fair value of an award of shares under the PSP has been adjusted to take into account this market-based performance condition using a pricing model based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting This adjustment increases the fair value relative to the share price at the date of grant.

ShareSave awards
The fair value of options granted under the ShareSave plan are calculated using a binomial pricing model with the following assumptions

	2007	2005	2003
Weighted average share price	**553p**	351p	173p
Exercise price	**416p**	298p	142p
Volatility	**37%**	40%	43%
Expected dividends	**8.80p**	7.86p	7 61p
Expected life[1] – 3 year ShareSave	**3 3-3.8 years**	3 3-3 8 years	3 2-3 7 years
– 5 year ShareSave	**5.3-5.8 years**	5 3-5.8 years	5 2-5 7 years
Close periods			
From January 1	**6 weeks**	6 weeks	6 weeks
From July 1	**1 month**	1 month	1 month
Risk free interest rate	**5 0%**	4 4%	4 6%

[1] The binomial pricing model assumes that participants will exercise their options at the beginning of the six month window if the share price is greater than the exercise price Otherwise it assumes that options are held until the expiration of their contractual term. This results in an expected life that falls somewhere between the start and end of the exercise window

Deferred shares under APRA and Free Shares under SIP
The fair value of shares awarded under these plans is calculated as the share price on the date of the award

ESOP
These fair values were calculated using the following assumptions.

	2003
Weighted average share price	79p
Weighted average exercise price	78p
Volatility	43%
Expected dividends	7 61p
Expected life	4 5 years
Close periods.	
From January 1	6 weeks
From July 1	1 month
Risk free interest rate	4 1%

21 Operating and finance leases

Operating leases
Leases as lessee – non-cancellable operating lease rentals are payable as follows

	2007 £m	2006 £m
Within one year	**77**	78
Between one and five years	**179**	213
After five years	**99**	106
	355	397

Leases as lessor – non-cancellable operating lease rentals are receivable as follows

	2007 £m	2006 £m
Within one year	**5**	8
Between one and five years	**13**	13
After five years	**3**	4
	21	25

The Group acts as lessee and lessor for both land and buildings and gas turbine engines, and acts as lessee for some plant and machinery
- Sublease payments of **£15m** (2006 £23m) and sublease receipts of **£8m** (2006 £11m) were recognised in the income statement in the year
- Purchase options exist on aero engines with the period to the purchase option date varying between two to six years.
- Escalation clauses exist on some leases and are linked to LIBOR
- The total future minimum sublease payments expected to be made is **£13m** (2006 £23m) and sublease receipts expected to be received is **£3m** (2006 £5m)

Finance leases
Finance lease liabilities are payable as follows

	2007			2006		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Within one year	**6**	**1**	**5**	9	2	7
Between one and five years	**3**	**—**	**3**	8	2	6
After five years	**1**	**—**	**1**	1	—	1
	10	**1**	**9**	18	4	14

There were no contingent rents recognised as an expense in the year (2006 £nil) and no future minimum sublease receipts are expected under non-cancellable subleases (2006 £nil)

22 Contingent liabilities

In connection with the sale of its products the Group will, on some occasions, provide financing support for its customers. The Group's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio

Contingent liabilities are disclosed on a discounted basis As the directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a present value However, the amounts are discounted at the Group's borrowing rate to reflect better the time span over which these exposures could arise The contingent liabilities are denominated in US dollars. As the Group does not adopt cash flow hedge accounting for forecast foreign exchange transactions, this amount is reported, together with the sterling equivalent at the reporting date spot rate

The discounted value of the total gross contingent liabilities relating to delivered aircraft and other arrangements where financing is in place, less insurance arrangements and relevant provisions, at December 31, 2007 amounted to **$1,227m, £616m** (2006 $1,109m, £566m) Taking into account the net realisable value of the relevant security including unrestricted cash collateral of **$120m, £60m** (2006 $114m, £58m), the discounted value of the net contingent liabilities amounted to **$279m, £140m** (2006 $243m, £124m) Sensitivity calculations are complex, but for example, if the value of the relevant security was reduced by 20 per cent, a net contingent liability with a discounted value of approximately **$434m, £218m** (2006 $361m, £184m) 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 relevant financing will only be put in place at the appropriate time

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

Notes to the consolidated financial statements continued

23 Related party transactions

	2007 £m	2006 £m
Sales of goods and services to joint ventures	**1,289**	1,252
Purchases of goods and services from joint ventures	**(1,100)**	(830)
Operating lease payments to joint ventures	**(41)**	(43)
Dividends received from joint ventures	**42**	44
RRSP receipts from joint ventures	**29**	7
Interest received from joint ventures	**2**	3
Other income received from joint ventures	**25**	12

The aggregated balances with joint ventures are shown in notes 11 and 14 Transactions with Group pension schemes are shown in note 17

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis Rolls-Royce Group plc is a non-trading holding company for Rolls-Royce plc.

Key management personnel are deemed to be the directors and the members of the Group Executive as set out in the Annual report of Rolls-Royce Group plc. Remuneration for key management personnel is shown below

	2007 £m	2006 £m
Salaries and short-term benefits	**9**	10
Post-retirement schemes	**2**	2
Share-based payments	**5**	5
	16	17

24 Acquisitions and disposals

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

	Total £m
Intangible assets	**2**
Property, plant and equipment	**1**
Trade and other receivables	**1**
Trade and other payables	**(1)**
Net assets acquired	**3**
Goodwill arising	**7**
	10
Financed by:	
Net cash outflow per cash flow statement	**6**
Dilution of minority interests due to share issue	**4**
	10

There were no significant fair value adjustments in respect of the net assets acquired

During the year the Group disposed of its interests in a number of small businesses, as summarised below

	Total £m
Property, plant and equipment	**2**
Inventory	**1**
Trade and other receivables	**2**
Trade and other payables	**(1)**
	4
Investments in joint ventures	**1**
Net assets	**5**
Loss on sale or termination of businesses	**(2)**
Net cash inflow per cash flow statement	**3**

Company financial statements
December 31, 2007

Company balance sheet
At December 31, 2007

	Notes	2007 £m	Restated* 2006 £m
Fixed assets			
Intangible assets	3	**410**	270
Tangible assets	4	**1,041**	990
Investments – subsidiary undertakings	5	**1,807**	1,713
Investments – joint ventures	5	**78**	74
Investments – other	5	**79**	120
		3,415	3,167
Current assets			
Stocks	6	**1,302**	1,114
Debtors – amounts falling due within one year	7	**1,997**	1,074
Debtors – amounts falling due after one year	7	**353**	387
Other financial assets	10	**531**	654
Post-retirement scheme surpluses	13	**149**	2
Short-term deposits		**316**	1,249
Cash at bank and in hand	8	**941**	448
		5,589	4,928
Creditors – amounts falling due within one year			
Borrowings	8	**(352)**	(671)
Other financial liabilities	10	**(172)**	(92)
Other creditors	9	**(5,061)**	(3,847)
Net current assets		**4**	318
Total assets less current liabilities		**3,419**	3,485
Creditors – amounts falling due after one year			
Borrowings	8	**(1,003)**	(961)
Other financial liabilities	10	**(301)**	(353)
Other creditors	9	**(422)**	(356)
Provisions for liabilities and charges	11	**(60)**	(150)
Post-retirement scheme deficits	13	**(21)**	(481)
		1,612	1,184
Capital and reserves			
Called-up share capital	14	**326**	326
Share premium account	15	**631**	631
Revaluation reserve	15	**71**	73
Transition hedging reserve	15	**76**	178
Other reserves	15	**167**	167
Profit and loss account	15	**341**	(191)
		1,612	1,184

* See notes 6, 7, 8, 9, 13 and 15

The financial statements on pages 72 to 89 were approved by the Board on February 6, 2008 and signed on its behalf by

Simon Robertson Chairman

Andrew Shilston Finance Director

Statement of total recognised gains and losses

For the year ended December 31, 2007

	2007 £m	2006 £m
Profit attributable to the shareholders of Rolls-Royce plc	**293**	749
Net actuarial gains	**353**	414
Movement in fair value of available for sale assets	**(28)**	(126)
Related tax movements	**(104)**	48
Total recognised gains relating to the year	**514**	1,085
Prior year adjustment *	**(12)**	
Total gains and losses recognised since last Report of the directors and financial statements	**502**	

Reconciliation of movements in shareholders' funds

For the year ended December 31, 2007

	2007 £m	Restated* 2006 £m
At January 1, 2006 as previously reported		191
Prior year adjustment *		(12)
At January 1, 2007 and January 1, 2006 (restated)	**1,184**	179
Total recognised gains for the year	**514**	1,085
Transfer from transition hedging reserve	**(149)**	(230)
Share-based payments adjustment	**16**	34
Related tax movements	**47**	116
At December 31	**1,612**	1,184

* Prior year has been restated on the adoption of UITF 41 Scope of FRS 20 and UITF 44 Group and Treasury Share Transactions. The associated adjustments to the prior year comparatives are: within debtors falling due within one year (note 7) 'Prepayments and accrued income' have increased by £1m and within other creditors falling due within one year (note 9) 'Amounts owed to parent and its subsidiaries' have increased by £21m and 'Accruals and deferred income' have decreased by £8m.

Notes to the Company financial statements

1 Significant 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

As permitted by section 230(4) of the Companies Act 1985, a separate profit and loss account for the Company has not been included in these financial statements

As permitted by FRS 1 *Cash flow statements*, no cash flow statement has been prepared, as a consolidated cash flow statement has been prepared by the ultimate parent company

During 2007, the Company has adopted the requirements of UITF 41 *Scope of FRS 20* and UITF 44 *Group and Treasury Share Transactions*

Reclassifications to comparative figures were made to borrowings and payments received on account and are set out in notes 8 and 9 respectively

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

Revenue recognition

Revenues comprise sales to external customers after discounts, and excluding value added tax

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured

Sales of services and long-term contracts are recognised when the outcome of the transaction can be reliably estimated Revenue is recognised by reference to the stage of completion based on services performed to date as a percentage of the total contractual obligation The assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on costs incurred to the extent these relate to services performed up to the reporting date, achievement of contractual milestones where appropriate, or flying hours or equivalent for long-term aftermarket arrangements

Linked sales of product and services are treated as a single long-term contract where these components have been negotiated as a single commercial package and are so closely interrelated that they do not operate independently of each other and are considered to form a single project with an overall profit margin Revenue is recognised on the same basis as for other sales of products and services as described above

Full provision is made for any estimated losses to completion of contracts having regard to the overall substance of the arrangements

Progress payments received on long-term contracts, 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

Risk and revenue sharing partnerships (RRSPs)

From time-to-time, the Company enters into arrangements with partners who, in return for a share in future programme revenues or profits, make cash payments that are not refundable (except under certain remote circumstances) Cash sums received, which reimburse the Company for past expenditure, are credited to other operating income The arrangements also require partners to undertake development work and/or supply components for use in the programme at their own expense No accounting entries are recorded where partners undertake such development work or where programme components are supplied by partners because no obligation arises unless and until programme sales are made, instead, payments to partners for their share in the programme are charged to cost of sales as programme revenues arise

The Company has arrangements with partners who do not undertake development work or supply parts Such arrangements are considered to be financial instruments as defined by FRS 25 *Financial instruments Presentation* and are accounted for using the amortised cost method

Research and development

The charge to the profit and loss account consists of research and development expenditure incurred in the year, excluding known recoverable costs on contracts, contributions to shared engineering programmes and application engineering Application engineering expenditure, incurred in the adaptation of existing technology to new products, is capitalised and amortised over the programme life, up to a maximum of 15 years, where both the technical and commercial risks are considered to be sufficiently low

Interest

Interest receivable/payable is credited/charged to the profit and loss account using the effective interest method

Taxation

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

Foreign currency translation

Transactions in overseas currencies are translated into local currency at the exchange rate ruling on the date of the transaction Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rate ruling at the year end Exchange differences arising on foreign exchange transactions and the retranslation of assets and liabilities into sterling at the rate ruling at the year end are taken into account in determining profit on ordinary activities before taxation

Financial instruments

FRS 26 *Financial instruments Recognition and measurement*, requires the classification of financial instruments into separate categories for which the accounting requirement is different Rolls-Royce has classified its financial instruments as follows

- Fixed deposits, principally comprising funds held with banks and other financial institutions, are classified as loans and receivables
- Investments (other than interests in joint ventures and fixed deposits) and short term deposits (other than fixed deposits) are normally classified as available for sale
- Borrowings, trade creditors and financial RRSPs are generally classified as other liabilities
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading

Financial instruments are recognised at the contract date and initially measured at fair value Their subsequent measurement depends on their classification

- Loans and receivables and other liabilities are generally held at amortised cost and not revalued unless they are included in a fair value hedge accounting relationship. Where such a relationship exists, the instruments are revalued in respect of the risk being hedged If instruments held at amortised cost are hedged, generally by interest rate swaps, and the hedges are effective, the carrying values are adjusted for changes in fair value, which are included in the profit and loss account.
- Available for sale assets are held at fair value Changes in fair value arising from changes in exchange rates are included in the profit and loss account. All other changes in fair value are taken to reserves On disposal of the related asset, the accumulated changes in value recorded in reserves are included in the gain or loss recorded in the profit and loss account
- Held for trading instruments are held at fair value Changes in fair value are included in the profit and loss account unless the instrument is included in a cash flow hedge If the instruments are included in a cash flow hedging relationship, which is effective, changes in value are taken to reserves When the hedged forecast transaction occurs, amounts previously recorded in reserves are recognised in the profit and loss account
- Foreign exchange gains and losses are recognised in the profit and loss account.

Financial instruments are derecognised on expiry or when all contractual rights and obligations are transferred

Hedge accounting
The Company does not apply hedge accounting in respect of forward foreign exchange contracts held to manage the cash flow exposures of forecast future transactions denominated in foreign currencies.

The Company does not apply hedge accounting in respect of commodity swaps held to manage the cash flow exposures of forecast future transactions in those commodities

The Company applies hedge accounting in respect of transactions entered into to manage the fair value and cash flow exposures of its borrowings. Forward foreign exchange contracts are held to manage the fair value exposures of borrowings denominated in foreign currencies and are designated as fair value hedges Interest rate swaps are held to manage the interest rate exposures and are designated as fair value or cash flow hedges of fixed and floating rate borrowings respectively

Changes in the fair values of derivatives designated as fair value hedges and changes in fair value of the related hedged item are recognised directly in the profit and loss account

Changes in the fair values of derivatives that are designated as cash flow hedges and are effective are recognised directly in reserves. Any ineffectiveness in the hedging relationships is included in the profit and loss account. The amounts deferred in reserves are recognised in the profit and loss account to match the recognition of the hedged item

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting At that time, for cash flow hedges, any cumulative gain or loss on the hedging instrument recognised in reserves, is retained in reserves until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in reserves is transferred to the profit and loss account.

The portion of a gain or loss on an instrument used to hedge a net investment in a foreign operation that is determined to be an effective hedge is recognised directly in reserves. The ineffective portion is recognised immediately in the profit and loss account.

Until December 31, 2004 the Company applied hedge accounting for forecast foreign exchange transactions and commodity exposures in accordance with UK Accounting Standards On January 1, 2005, the fair values of derivatives used for hedging these exposures were included in the transition hedging reserve This reserve is released to the profit and loss account based on the designation of the hedges on January 1, 2005

Certification costs and participation fees
Costs incurred in respect of meeting regulatory certification requirements for new civil aero-engine/aircraft combinations and payments made to airframe manufacturers for this, and participation fees, are carried forward in intangible assets to the extent that they can be recovered out of future sales and are charged to the profit and loss account over the programme life, up to a maximum of 15 years

Software
The cost of acquiring software that is not specific to an item of tangible fixed assets is classified as an intangible asset.

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

Depreciation is provided on a straight-line basis to write-off the cost or valuation, less the estimated residual value, over the estimated useful life Estimated useful lives are as follows

i) Land and buildings, as advised by the Group's professional valuers.
   a) Freehold buildings – five to 45 years (average 22 years)
   b) Leasehold land and buildings – lower of valuers' estimates or period of lease
   c) No depreciation is provided in respect of freehold land
ii) Plant and equipment – five to 25 years (average 15 years)
iii) Aircraft and engines – five to 20 years (average 16 years)
iv) No depreciation is provided on assets in the course of construction

Accounting for leases
i) As Lessee
   Assets financed by leasing agreements that 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 Company 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 a straight-line 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 a straight-line basis

Stock
Stock and work in progress are valued at the lower of cost and net realisable value

Provisions
Provisions are recognised when the Company has a present obligation as a result of a past event, and it is probable that the Company will be required to settle that obligation Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material

Post-retirement benefits
Pensions and similar benefits are accounted for under FRS 17 *Post-retirement benefits* For defined benefit plans, obligations are measured at discounted present value whilst plan assets are recorded at fair value The service and financing costs of such plans are recognised separately in the profit and loss account, service costs are spread systematically over the lives of employees and financing costs are recognised in the periods in which they arise Actuarial gains and losses are recognised immediately in the statement of total recognised gains and losses.

Payments to defined contribution schemes are charged as an expense as they fall due

Share-based payments
The Company, on behalf of its parent company, provides share-based payment arrangements to certain employees. These are equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of shares or options that will eventually vest The costs of these share-based payments are treated as a capital contribution from the parent company Any payments made by the Company to its parent company, in respect of these arrangements, are treated as a return of this capital contribution

The fair values of the share-based payment arrangements are measured as follows

i) ShareSave – using the binomial pricing method
ii) Performance Share Plan – using a pricing model adjusted to reflect non-entitlement to dividends (or equivalent) and the Total Shareholder Return market based condition
iii) Annual performance Related Award plan and free shares under the Share Incentive plan – share price on the date of the award

See note 17 for further description of the share-based payment plans.

Notes to the Company financial statements continued

2 Emoluments of directors

	2007 Highest paid director[1] £000	2007 Other directors £000	2006 Highest paid director[1] £000	2006 Other directors £000
Aggregate emoluments excluding deferred share plans	1,109	3,412	1,151	3,463
Aggregate amounts relating to deferred share plans	153	314	211	397
Aggregate value of Company contributions to Company defined contribution pensions schemes		433		396
Accrued pension of highest paid director	555		493	
Gains realised on exercise of share options[2]	3,339	7,025	5,603	9,782

	2007 Number	2006 Number
Number of directors with accruing retirement benefits		
Defined contribution schemes[3]	2	2
Defined benefit schemes	6	5
Number of directors exercising share options	5	5
Number of directors receiving shares as part of long-term incentive schemes[4]	5	6

[1] Member of defined benefit scheme.
[2] Includes gains under the ShareSave plan
[3] Two directors were members of both defined contribution and defined benefit schemes (2006 two directors)
[4] Mike Terrett, who was appointed as an executive director on September 1 2007 did not receive any shares as part of long-term incentive schemes between the date of his appointment and December 31, 2007

3 Intangible assets

	Certification costs and participation fees £m	Software and other £m	Total £m
Cost:			
At January 1, 2007	363	57	420
Additions	120	35	155
At December 31, 2007	483	92	575
Accumulated amortisation			
At January 1, 2007	134	16	150
Provided during the year	6	9	15
At December 31, 2007	140	25	165
Net book value at December 31, 2007	**343**	**67**	**410**
Net book value at January 1, 2007	229	41	270

4 Tangible fixed assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost or valuation					
At January 1, 2007	341	1,192	—	217	1,750
Additions	19	47	20	71	157
Reclassifications	62	101	4	(167)	—
Disposals/write-offs	—	(76)	—	—	(76)
At December 31, 2007	422	1,264	24	121	1,831
Accumulated depreciation					
At January 1, 2007	96	664	—	—	760
Provided during the year	13	84	1	—	98
Disposals/write-offs	—	(68)	—	—	(68)
At December 31, 2007	109	680	1	—	790
Net book value at December 31, 2007	313	584	23	121	1,041
Net book value at January 1, 2007	245	528	—	217	990

Tangible fixed assets include	2007 £m	2006 £m
Net book value of finance leased assets	22	29
Non-depreciable land	57	57
Land and buildings at cost or valuation comprise		
Cost	232	150
Valuation at December 31, 1996	190	191
	422	341
Land and buildings at net book value comprise		
Freehold	305	236
Long leasehold	6	7
Short leasehold	2	2
	313	245
On an historical cost basis the net book value of land and buildings would have been as follows		
Cost	400	323
Depreciation	(159)	(151)
	241	172
Capital expenditure commitments – contracted but not provided for	67	87

The Company has followed the transitional provisions of FRS 15 *Tangible fixed assets*, to retain the book value of land and buildings, certain of which were revalued in 1996 as set out below

Group properties were revalued at December 31, 1996 as follows
i) Specialised properties, including certain of the Company'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 Company's requirements were revalued on an open market value basis.

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

Notes to the Company financial statements continued

5 Investments

	Subsidiary undertakings [1]	Joint ventures [2]					Other
	Shares at cost £m	Shares at cost £m	Loans £m	Total £m	Unlisted investments at cost £m	Parent company shares held under trust £m [3]	Total £m
At January 1, 2007	1,713	61	13	74	46	74	120
Additions	94	4	—	4	1	78	79
Fair value adjustments	—	—	—	—	—	15	15
Disposals/write-offs	—	—	—	—	—	(135)	(135)
At December 31, 2007	1,807 [4]	65	13	78	47	32	79

[1] The principal subsidiary undertakings are listed on page 90.
[2] The principal joint ventures are listed on pages 91 and 92.
[3] Shares in the parent company are held at fair value in a trust. At December 31, 2007 **5,838,501 shares** with a fair value of **£32m** (2006 16,654,181 shares with a fair value of £74m) were held
[4] The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited, one of its subsidiaries. At December 31 2007, this guarantee was **£25m** (2006 £12m)

6 Stocks

	2007 £m	Restated* 2006 £m
Raw materials	52	26
Work in progress	349	470
Long-term contracts work in progress	13	38
Finished goods	880	572
Payments on account	8	8
Inventory per balance sheet	1,302	1,114
Progress payments received against other inventory	(105)	(194)
Net inventory after progress payments	1,197	920

* Progress payments included in the prior year have been reclassified as follows. received against long-term contracts (£8m) offset against 'Long term contracts work in progress' above; received against other inventory (£194m) included within 'Other creditors' – see note 9

7 Debtors

	Falling due within one year		Falling due after one year	
	2007 £m	Restated* 2006 £m	2007 £m	2006 £m
Trade debtors	241	254	16	11
Amounts recoverable on contracts	99	55	189	233
Amounts owed by – subsidiary undertakings	1,112	333	—	—
Amounts owed by – joint ventures	251	201	13	10
Deferred tax assets (note 12)	—	—	102	—
Other debtors	217	136	6	34
Prepayments and accrued income	77	95	27	99
	1,997	1,074	353	387

* Prepayments and accrued income falling due within one year have been restated in the prior year from £94m to £95m on the adoption of UITF 41 *Scope of FRS 20* and UITF 44 *Group and Treasury Share Transactions*.

8 Borrowings

	Falling due within one year		Falling due after one year	
	2007 £m	Restated* 2006 £m	**2007 £m**	2006 £m
Unsecured				
Overdrafts	**347**	327	**—**	—
6 7/8% Notes 2007 €500m [1]	**—**	337	**—**	—
7 3/8% Notes 2016 £200m	**—**	—	**200**	200
5.84% Notes 2010 US$187m [2]	**—**	—	**97**	96
6.38% Notes 2013 US$230m [2]	**—**	—	**123**	121
6.55% Notes 2015 US$83m [2]	**—**	—	**46**	44
4 1/2% Notes 2011 €750m [1]	**—**	—	**534**	494
Secured				
Obligations under finance leases payable [3]				
Less than one year	**5**	7	**—**	—
Between one and two years	**—**	—	**3**	4
Between two and five years	**—**	—	**—**	2
	352	671	**1,003**	961
Repayable				
Between one and two years – by instalments			**3**	4
Between two and five years – by instalments			**—**	2
– otherwise			**631**	596
After five years – otherwise			**369**	359
			1,003	961

* Overdrafts of £276m included in 2006 have been reclassified and are offset against 'Cash at bank and in hand', as the Company has a legal right of offset. In the prior year 'Cash at bank and in hand' has been restated from £724m to £448m and 'Overdrafts' restated from £603m to £327m.

[1] These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable at variable rates of interest and at fixed exchange rates.
[2] These notes are subject of interest rate swap agreements under which the Company has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge. Until October 5, 2005 the borrowing was included in a net investment hedging relationship. From October 6, 2005 the borrowing has been included in a fair value hedging relationship in respect of the foreign exchange risk.
[3] Obligations under finance leases are secured by related leased assets.

9 Other creditors

	Falling due within one year		Falling due after one year	
	2007 £m	Restated* 2006 £m	**2007 £m**	2006 £m
Payments received on account [1]	**394**	489	**331**	161
Trade creditors	**385**	324	**—**	—
Amounts owed to subsidiary undertakings	**2,245**	1,037	**—**	—
Amounts owed to joint ventures	**265**	164	**4**	4
Amounts owed to parent and its subsidiaries	**407**	575	**—**	—
Corporate taxation	**106**	128	**—**	—
Other taxation and social security	**20**	25	**—**	—
Other creditors	**616**	626	**87**	191
Accruals and deferred income	**623**	479	**—**	—
	5,061	3,847	**422**	356
[1] Includes payments received from joint ventures	**195**	139	**25**	62

* 'Payments received on account' in the prior year have been restated from £295m due to the reclassification from 'Stocks' of £194m of progress payments received against other inventory. On the adoption of UITF 41 *Scope of FRS 20* and UITF 44 *Group and Treasury Share Transactions*, 'Amounts owed to parent and its subsidiaries' in the prior year have increased by £21m and 'Accruals and deferred income' in the prior year have decreased by £8m.

Notes to the Company financial statements continued

10 Other financial assets and liabilities

Details of the Company's policies on the use of financial instruments are given in the accounting policies on pages 74 and 75

The Company adopted FRS 25 and FRS 26 *Financial Instruments* prospectively from January 1, 2005

The fair values of derivative financial instruments held by the Company are as follows

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
At December 31, 2007					
Assets	**450**	**39**	**42**	**—**	**531**
Liabilities	**(153)**	**—**	**(3)**	**(317)**	**(473)**
	297	**39**	**39**	**(317)**	**58**
At December 31, 2006					
Assets	588	39	27	—	654
Liabilities	(80)	—	(11)	(354)	(445)
	508	39	16	(354)	209

Other financial liabilities are analysed as follows.

	2007 £m	2006 £m
Current liabilities	**(172)**	(92)
Non-current liabilities	**(301)**	(353)
	(473)	(445)

Foreign exchange and commodity financial instruments

The Company uses various financial instruments to manage its exposure to movements in foreign exchange rates The Company uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals) From January 1, 2005, the Company has not included foreign exchange or commodity financial instruments in any cash flow hedging relationships for accounting purposes. To hedge the currency risk associated with a borrowing denominated in US dollars, the Company has currency derivatives designated as part of a fair value hedge

Movements in the fair values of foreign exchange and commodity financial instruments were as follows

	Foreign exchange instruments			Commodity instruments		
	Total £m	Included in transition hedging reserve £m	Included in profit and loss account £m	Total £m	Included in transition hedging reserve £m	Included in profit and loss account £m
At January 1, 2006	193	479		31	5	
Fair value changes to derivative contracts not in accounting hedging relationships	595	—	595	34	—	34
Fair value changes to fair value hedges [1]	(26)	—	(26)	—	—	—
Fair value of contracts settled	(254)	—	—	(26)	—	—
Transferred to turnover	—	(227)	227	—	(5)	5
At January 1, 2007	**508**	**252**		**39**	—	
Fair value changes to derivative contracts not in accounting hedging relationships	**55**	—	**55**	**36**	—	**36**
Fair value changes to fair value hedges [1]	**(6)**	—	**(6)**	—	—	—
Fair value of contracts settled	**(260)**	—	—	**(36)**	—	—
Transferred to turnover	—	**(149)**	**149**	—	—	—
At December 31, 2007	**297**	**103**		**39**	—	

[1] Gain on related hedged items **£6m** (2006 £26m)

10 Other financial assets and liabilities continued

Interest rate financial instruments

The Company uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates Where the effectiveness of the hedge relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the hedging reserve and released to match actual payments on the hedged item

Movements in the fair values of interest rate financial instruments were as follows

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in profit and loss account £m
At January 1, 2006	64	69	(5)	
Changes during the year	(48)	(51)	3	(48)
At January 1, 2007	**16**	**18**	**(2)**	
Changes during the year	**23**	**24**	**(1)**	**24**
At December 31, 2007	**39**	**42**	**(3)**	

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

Financial risk and revenue sharing partnerships (RRSPs)

The Company has financial liabilities arising from financial RRSPs. These financial liabilities are valued at each reporting date using the amortised cost method This involves calculating the present value of the forecast cash flows of the arrangements using the internal rate of return at the inception of the arrangements as the discount rate

Movements in the amortised cost values of financial RRSPs are as follows

	2007 £m	2006 £m
At January 1	**354**	486
Cash paid to partners	**(62)**	(96)
Financing charge	**28**	31
Excluded from underlying profit.		
Exchange adjustments	**(3)**	(50)
Restructuring of financial RRSP agreements and changes in forecast payments	**—**	(17)
At December 31	**317**	354

Notes to the Company financial statements continued

11 Provisions for liabilities and charges

	At December 31, 2006 £m	Reclassification to debtors £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At December 31, 2007 £m
Deferred taxation (note 12)	47	**(47)**	**—**	**—**	**—**	**—**
Warranties and guarantees	22	**—**	**(1)**	**12**	**(2)**	**31**
Customer financing	81	**—**	**(20)**	**5**	**(37)**	**29**
	150	**(47)**	**(21)**	**17**	**(39)**	**60**

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.
Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 18 Timing of utilisation is uncertain.

12 Deferred taxation

	£m
At January 1, 2007	**158**
Amount charged to profit and loss account	**(42)**
Transfer from subsidiary	**(7)**
Amount charged to statement of total recognised gains and losses	**(104)**
Amount credited to equity	**47**
At December 31, 2007	**52**

There are other deferred tax assets totalling **£102m** (2006 £102m) that have not been recognised on the basis that their future economic benefit is uncertain

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

The analysis of the deferred tax position is as follows.

	2007 £m	2006 £m
Fixed asset timing differences	**(117)**	(115)
Other timing differences	**156**	74
Pensions and other post-retirement scheme benefits	**(50)**	205
Foreign exchange and commodity financial assets and liabilities	**(121)**	(182)
Losses	**123**	115
Advance corporation tax	**61**	61
	52	158
Included within		
Debtors – amounts falling due after one year	**102**	—
Provisions	**—**	(47)
Post-retirement scheme surpluses	**(58)**	—
Post-retirement scheme deficits	**8**	205
	52	158

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

13 Post-retirement benefits

Defined benefit schemes

For the defined benefit schemes the assets are held in separate trustee administered funds and employees are entitled to retirement benefits based on their final salaries and length of service

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2007 The most recent funding valuations were

Scheme	Valuation date
Rolls-Royce Pension Fund	March 31, 2006
Rolls-Royce Group Pension Scheme	April 5, 2007 [1]
Vickers Group Pension Scheme	March 31, 2007 [1]

[1] Preliminary

During 2007, the trustees of the defined benefit schemes, in consultation with the Company, have undertaken a review of their investment strategies As a result, revised investment strategies have been adopted that aim to hedge, on an economic basis, the majority of the interest rate and inflation risks associated with pension liabilities by investing a significant proportion of each schemes' assets in swap contracts, backed by short-term money market deposits (the liability-driven investment or LDI portfolio) Following the agreement of this revised strategy, new entrants are no longer able to join the schemes and the Company has paid additional contributions of £500m to the main schemes.

As described in note 1, for accounting purposes, the defined benefit schemes are valued in accordance with FRS 17 *Post-retirement benefits* In particular, FRS 17 requires the discount rate used for the valuation of forecast liabilities to be determined by reference to the market yield on high quality corporate bonds In contrast, for funding purposes, the discount rate is determined by reference to the expected rate of return on the scheme's assets, taking account of the specific investment strategy in place As a result of this difference in valuation methodologies, the amounts recognised in the balance sheet will differ from those that would have been recognised if the valuation had been undertaken using the assumptions used for funding purposes.

Accordingly, although the investment strategy aims to hedge interest rate and inflation risk on an economic basis, the net position recognised in the balance sheet for defined benefit schemes may vary over time as a result of actuarial gains and losses that arise due to this difference in valuation methodologies

The principal actuarial assumptions used at the balance sheet date were as follows.

	2007 %	2006 %
Rate of increase in salaries	5 0	4 4
Rate of increase of pensions in payment [1]	3.5	2 9
Discount rate	5.8	5 1
Expected rate of return on scheme assets	5 4	6 6
Inflation assumption	3.5	2 9

[1] Benefits accruing after April 5, 2005 are assumed to increase in payment at a rate of 2.4 per cent.

The discount rates are determined by reference to the market yields on AA rated corporate bonds. For the main schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve For less significant schemes the rate is determined as the market yield at the average duration of the forecast benefit payments. The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities

The overall expected rate of return is calculated by weighting the individual returns expected from each asset class (see below) in accordance with the actual asset balance in the schemes' investment portfolios.

The mortality assumptions adopted for the pension schemes are derived from the PA92 actuarial tables, with medium cohort, published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant scheme's actual experience The resulting range of life expectancies in the principal schemes are as follows

Life expectancy from age 65	
Current pensioner	17.5 years to 22 2 years
Future pensioner	19.5 years to 23 9 years

Other demographic assumptions have been set on advice from the relevant actuary, having regard to the latest trends in scheme experience and other relevant data The assumptions are reviewed and updated as necessary as part of the periodic actuarial valuation of the schemes.

Notes to the Company financial statements continued

13 Post-retirement benefits continued

Amounts recognised in the balance sheet

	2007 £m	2006 £m
Present value of funded obligations	**(6,335)**	(5,785)
Fair value of scheme assets	**6,626**	5,101
Unrecognised surplus [1]	**(113)**	—
Surplus/(deficit)	**178**	(684)
Related deferred tax (liability)/asset	**(50)**	205
Net asset/(liability) recognised in the balance sheet	**128**	(479)
Analysed as [2]		
Post-retirement scheme surpluses	**149**	2
Post-retirement scheme deficits	**(21)**	(481)
	128	(479)

[1] Where a surplus has arisen on a scheme in accordance with FRS 17 *Retirement benefits*, the surplus is recognised as an asset only if it represents a future economic benefit available to the Company Any surplus in excess of this benefit is not recognised in the balance sheet Surpluses have arisen in the schemes in 2007, largely as a result of differences between the actuarial and *FRS 17 Valuation assumptions*

[2] Comparatives have been restated to show the split between post-retirement scheme surpluses and deficits.

Changes in present value of defined benefit obligations

	2007 £m	2006 £m
At January 1	**(5,785)**	(6,102)
Transfer from subsidiary company	**(553)**	—
Current service cost	**(100)**	(97)
Past service cost	**(131)**	—
Finance cost	**(323)**	(284)
Contributions by employees	**(38)**	(38)
Net benefits paid out	**286**	259
Actuarial gains	**309**	477
At December 31	**(6,335)**	(5,785)

Changes in fair value of scheme assets

	2007 £m	2006 £m
At January 1	**5,101**	4,809
Transfer from subsidiary company	**572**	—
Expected return on assets	**367**	296
Contributions by employer	**677**	103
Contributions by employees	**38**	38
Benefits paid out	**(286)**	(259)
Actuarial gains	**157**	114
At December 31	**6,626**	5,101
Actual return on plan assets	**524**	410

The fair value of the scheme assets and the expected rates of return at December 31 were as follows

	2007		2006	
	Expected rate of return %	**Market value £m**	Expected rate of return %	Market value £m
LDI portfolio	**4 7**	**4,595**	—	—
Equities	**7.8**	**1,651**	7.5	3,526
Sovereign debt	**4 6**	**48**	4.5	537
Corporate bonds	**5 1**	**88**	4 9	1,009
Other	**4 9**	**244**	5 0	29
	5 4	**6,626**	6 6	5,101

The scheme assets do not include any financial instruments of the Rolls-Royce Group plc group, nor any property occupied by, or other assets used by, the group

The expected rate of return for LDI portfolios is determined by the implicit yield on the portfolio at the balance sheet date

The expected rates of return on individual categories of scheme assets are determined by reference to gilt yields. Equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25 per cent and 0 8 per cent per annum respectively

The expected rates of return above are the weighted average of the rates for each scheme

13 Post-retirement benefits continued

Future contributions
The Company expects to contribute approximately £253m to its defined benefit schemes in 2008

Sensitivities
As described above, the revised investment strategies are designed to hedge the risks from interest rates and inflation The principle remaining risks relate to the assumptions for mortality and increases in salaries If the age ratings in respect of the principal schemes were increased by one year the scheme liabilities would increase by £164m If the rate of increase in salaries were 0 5 per cent higher, scheme liabilities would increase by £112m

History of defined benefit schemes
The history of the schemes for the current and prior years is as follows

	2007 £m	2006 £m	2005 £m	2004 £m	2003 £m
Balance sheet					
Present value of defined benefit obligations	**(6,335)**	(5,785)	(6,102)	(4,321)	(4,105)
Fair value of scheme assets	**6,626**	5,101	4,809	3,283	3,049
Unrecognised surplus	**(113)**	—	—	—	—
Asset/(deficit)	**178**	(684)	(1,293)	(1,038)	(1,056)
Actuarial gains on scheme assets	**157**	114	503	92	253
Experience gains/(losses) on scheme liabilities	**309**	477	(745)	(113)	(436)
Movement in unrecognised surplus	**(113)**	—	—	—	—
Total amount recognised in the statement of total recognised gains and losses	**353**	591	(242)	(21)	(183)
Cumulative amount recognised in the statement of total recognised gains and losses [1]	**(395)**	(748)	(1,339)	(1,097)	(1,076)

[1] Since January 1 2002

Defined contribution schemes

The Company operates a number of defined contribution schemes.

The total expense recognised in the profit and loss account was **£3m** (2006 £2m)

14 Share capital

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At January 1, and December 31, 2007	**2,000**	**400**
Issued and fully paid		
At January 1, and December 31, 2007	**1,631**	**326**

15 Movements in capital and reserves

			Non-distributable reserves				
	Share capital £m	Share premium £m	Revaluation reserve £m	Transition hedging reserve [1] £m	Other reserves £m	Profit and loss account £m	Total equity £m
At January 1, 2007 (as previously reported)	**326**	**631**	**73**	**178**	**167**	**(179)**	**1,196**
Adoption of UITF 44 [2]	—	—	—	—	—	**(12)**	**(12)**
At January 1, 2007 (restated)	**326**	**631**	**73**	**178**	**167**	**(191)**	**1,184**
Transfers between reserves	—	—	**(2)**	—	—	**2**	—
Transfer from transition hedging reserve	—	—	—	**(149)**	—	—	**(149)**
Share-based payments adjustment	—	—	—	—	—	**16**	**16**
Total recognised gains relating to the year	—	—	—	—	—	**514**	**514**
Related tax movements	—	—	—	**47**	—	—	**47**
At December 31, 2007	**326**	**631**	**71**	**76**	**167**	**341**	**1,612**

[1] See accounting policies note 1 – hedge accounting
[2] Prior year has been restated on the adoption of UITF 41 *Scope of FRS 20* and UITF 44 *Group and Treasury Share Transactions.*

Notes to the Company financial statements continued

16 Operating lease annual commitments

	2007 £m	2006 £m
Leases of land and buildings which expire:		
Between one and five years	**4**	2
After five years	**4**	4
Other leases which expire		
Within one year	**1**	1
Between one and five years	**1**	1

17 Share-based payments

Share-based payment plans in operation during the year
The Company participated in the following share-based payment plans of Rolls-Royce Group plc in operation during the year:

Performance Share Plan (PSP)
This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market based performance condition (Total Shareholder Return – TSR).

ShareSave share option plan
Based on a three or five year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into. Vesting of the options is not subject to the achievement of a performance target. The scheme is HM Revenue & Customs approved.

Executive Share Option Plan (ESOP)
This plan involves the grant of market value share options to participants. The options are subject to a non-market based performance condition (growth in EPS). The options have a maximum contractual life of ten years. Following the introduction of the PSP, it is not intended to grant any further executive share options.

Annual Performance Related Award (APRA) plan deferred shares
Deferred shares awarded as part of the APRA plan. One third of the value of any annual bonus is delivered in the form of a deferred share award. The release of deferred share awards is not dependent on the achievement of any further performance conditions other than that participants remain an employee of the Group for two years from the date of the award in order to retain the full number of shares. During the two year deferral period, participants are entitled to receive dividends on the deferred shares.

Share Incentive Plan (SIP)
This is the 'Free Share' element of the Share Incentive Plan. Eligible employees may receive shares with a value of up to one and a half weeks' salary as part of any bonus paid. There are no conditions attached to the shares.

In accordance with the transitional provisions of FRS 20 *Share-based payment*, the Company has recognised an expense in respect of all grants under these plans made after November 7, 2002 and unvested at January 1, 2005.

The Company recognised a total expense of **£22m** (2006 £22m).

The movements in awards under the various share plans are shown in the tables below.

PSP	Number of shares awarded 2007 Millions	2006 Millions
Outstanding at January 1	**9.8**	7.1
Awarded during the year	**2.7**	3.0
Forfeited during the year	**(0.4)**	(0.3)
Additional entitlements arising from TSR performance	**0.9**	—
Vested during the year	**(4.3)**	—
Outstanding at December 31	**8.7**	9.8

ShareSave	2007 Number of share options Millions	2007 Weighted average exercise price Pence	2006 Number of share options Millions	2006 Weighted average exercise price Pence
Outstanding at January 1	**42.1**	**153p**	52.4	158p
Granted during the year	**7.4**	**416p**	—	—
Forfeited during the year	**(0.9)**	**219p**	(0.9)	168p
Exercised during the year	**(19.1)**	**116p**	(9.4)	140p
Outstanding at December 31	**29.5**	**241p**	42.1	153p
Exercisable at December 31	**—**	**—**	0.6	141p

17 Share-based payments continued

ESOP	2007 Number of share options Millions	2007 Weighted average exercise price Pence	2006 Number of share options Millions	2006 Weighted average exercise price Pence
Outstanding at January 1	**12 1**	**191p**	43 1	149p
Forfeited during the year	**—**	**—**	(1 0)	216p
Exercised during the year	**(11 1)**	**193p**	(30 0)	131p
Outstanding at December 31	**1 0**	**177p**	12 1	191p
Exercisable at December 31	**1 0**	**177p**	3 0	118p

Deferred shares under APRA	Number of shares awarded 2007 Millions	2006 Millions
Outstanding at January 1	**2 7**	4 9
Awarded during the year	**1 0**	1 1
Additional shares accrued from conversion of B Shares	**0 1**	—
Vested during the year	**(2 0)**	(3 3)
Outstanding at December 31	**1.8**	2 7

Free shares under SIP	Number of shares awarded 2007 Millions	2006 Millions
Awarded during the year	**0 6**	0 6

Options were exercised on a regular basis during the year The average share price during the year was **510p** (2006 439p)

Fair values

The weighted average fair values per share for PSP awards, ShareSave grants, APRA deferred share awards, and SIP Free Share awards included in the expense for the year were as follows

	2007 Pence	2006 Pence	2005 Pence	2004 Pence	2003 Pence
PSP awards	**557p**	494p	282p	249p	—
ShareSave – 3 year grants	**230p**	—	131p	—	61p
ShareSave – 5 year grants	**264p**	—	154p	—	71p
ESOP	**—**	—	—	—	22 7p
APRA deferred share awards	**502p**	448p	260p	220p	—
SIP Free Share awards	**499p**	462p	257p	231p	—

Details of the assumptions used in the calculation of these fair values are set out below Expected volatility was based on the historical volatility of the Rolls-Royce Group plc share price over the seven years prior to the grant or award date Expected dividends were based on payments to shareholders over the five years prior to the grant or award date

PSP awards

The fair value of shares awarded under the PSP are calculated using the market value of shares at the time of the award, adjusted to take into account non-entitlement to dividends (or equivalent) during the vesting period and the TSR performance condition The PSP fair values were calculated using the following assumptions

	2007	2006	2005	2004
Weighted average share price	**501p**	444p	262p	233p
Expected dividends	**8.30p**	7 92p	7 81p	7 61p
Volatility	**29%**	32%	34%	35%
Correlation	**26%**	19%	19%	22%
Expected life	**3 years**	3 years	3 years	3 years
Risk free interest rate	**5.2%**	4 3%	4 9%	5 2%

The PSP has a TSR market-based performance condition, such that the Rolls-Royce Group plc TSR over the performance period will be compared with the TSR of the companies constituting the FTSE 100 index on the date of grant. If the Rolls-Royce Group plc TSR exceeds the median TSR of the FTSE 100 the number of shares that vest will be increased by 25 per cent. The fair value of an award of shares under the PSP has been adjusted to take into account this market-based performance condition using a pricing model based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting This adjustment increases the fair value relative to the share price at the date of grant.

Notes to the Company financial statements continued

17 Share-based payments continued

ShareSave awards

The fair value of options granted under the ShareSave plan are calculated using a binomial pricing model with the following assumptions

	2007	2005	2003
Weighted average share price	**553p**	351p	173p
Exercise price	**416p**	298p	142p
Volatility	**37%**	40%	43%
Expected dividends	**8.80p**	7.86p	7.61p
Expected life [1] – 3 year ShareSave	**3.3-3.8 years**	3.3-3.8 years	3.2-3 7 years
– 5 year ShareSave	**5.3-5.8 years**	5.3-5.8 years	5.2-5 7 years
Close periods			
From January 1	**6 weeks**	6 weeks	6 weeks
From July 1	**1 month**	1 month	1 month
Risk free interest rate	**5 0%**	4 4%	4 6%

[1] The binomial pricing model assumes that participants will exercise their options at the beginning of the six month window if the share price is greater than the exercise price. Otherwise it assumes that options are held until the expiration of their contractual term. This results in an expected life that falls somewhere between the start and end of the exercise window

Deferred shares under APRA and Free Shares under SIP

The fair value of shares awarded under these plans is calculated as the share price on the date of the award

ESOP

These fair values were calculated using the following assumptions

	2003
Weighted average share price	79p
Weighted average exercise price	78p
Volatility	43%
Expected dividends	7 61p
Expected life	4.5 years
Close periods	
From January 1	6 weeks
From July 1	1 month
Risk free interest rate	4 1%

18 Contingent liabilities

In connection with the sale of its products the Company will, on some occasions, provide financing support for its customers. The Company's contingent liabilities relating to financing arrangements are spread over many years and relate to a number of customers and a broad product portfolio

Contingent liabilities are disclosed on a discounted basis. As the directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a present value However, the amounts are discounted at the Company's borrowing rate to reflect better the time span over which these exposures could arise. The contingent liabilities are denominated in US dollars. As the Company does not adopt cash flow hedge accounting for forecast foreign exchange transactions, this amount is reported together with the sterling equivalent at the reporting date spot rate

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions, at December 31, 2007 amounted to **$1,227m, £616m** (2006 $1,109m, £566m) Taking into account the net realisable value of the relevant security including unrestricted cash collateral of **$120m, £60m** (2006 $114m, £58m), the discounted value of the net contingent liabilities amounted to **$279m, £140m** (2006 $243m, £124m) Sensitivity calculations are complex, but for example, if the value of the relevant security was reduced by 20 per cent, a net contingent liability with a discounted value of approximately **$434m, £218m** (2006 $361m, £184m) 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 relevant financing will only be put in place at the appropriate time

Contingent liabilities exist in respect of guarantees provided by the Company in the ordinary course of business for product delivery, performance and reliability The Company has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. The Company is party to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Company is no longer fully insured against known and potential claims from employees who worked for certain of the Company's UK based businesses for a period prior to the acquisition of those businesses by the Company 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 Company

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee At December 31, 2007, there were Company guarantees in respect of joint ventures amounting to **£11m** (2006 £12m)

The Company participates in a Cash Pooling Arrangement. Under the Pooling Arrangement the Company benefits from more favourable interest rates than would be available outside of the Pooling Arrangement as well as more streamlined treasury functions. As part of the Pooling Arrangement, the Company cross-guarantees the borrowings of other pooling participants At December 31, 2007 these guarantees amounted to **£19m** (2006 £40m)

19 Related party transactions

The Company is a wholly owned subsidiary of Rolls-Royce Group plc and therefore has taken advantage of the exemption in FRS 8 *Related party disclosures*, not to disclose related party transactions with its parent company and other group companies

The aggregated balances with joint ventures are shown in notes 7 and 9

20 Ultimate holding company

The ultimate holding company is Rolls-Royce Group plc, incorporated in Great Britain The financial statements for Rolls-Royce Group plc may be obtained from the Company Secretary, Rolls-Royce Group plc, 65 Buckingham Gate, London SW1E 6AT

Principal subsidiary undertakings

At December 31, 2007

Incorporated within the UK – directly held unless marked*

Civil aerospace	
Data Systems & Solutions Limited*	*Advanced controls and predictive data management*
Rolls-Royce Aircraft Management Limited	*Sales finance and other financial services*
Rolls-Royce Leasing Limited	*Engine leasing*
Rolls-Royce Total Care Services Limited	*Aftermarket support services*
Marine	
Rolls-Royce Marine Electrical Systems Limited*	*Marine electrical systems*
Rolls-Royce Marine Power Operations Limited	*Nuclear submarine propulsion systems*
Energy	
Rolls-Royce Fuel Cell Systems Limited	*Development of fuel cell systems*
Rolls-Royce Power Development Limited	*Provision of project development capabilities*
Corporate	
Rolls-Royce International Limited	*International support and commercial information services*
Rolls-Royce Power Engineering plc	*Power generation and marine systems*

The above companies operate principally in the UK and the effective Group interest is 100 per cent, other than Rolls-Royce Fuel Cell Systems Limited in which it is 80 per cent

Incorporated overseas – directly held unless marked*

Civil aerospace		
Brazil	Rolls-Royce Brasil Limitada	*Repair and overhaul*
France	Rolls-Royce Technical Support SARL*	*Project support*
Germany	Rolls-Royce Deutschland Ltd & Co KG*	*Design, development and manufacture of aero engines*
Italy	Europea Microfusioni Aerospaziali S.p.A.	*Manufacture of castings*
US	Data Systems & Solutions LLC*	*Advanced controls and predictive data management*
US	Rolls-Royce Corporation*	*Design development and manufacture of gas turbine engines*
US	Rolls-Royce Engine Services – Oakland Inc.*	*Repair and overhaul*
Defence aerospace		
US	Rolls-Royce Defense Services Inc.*	*Repair and overhaul*
Marine		
China	Rolls-Royce Marine (Shanghai) Limited*	*Manufacture and supply of marine equipment*
Finland	Rolls Royce OY AB*	*Manufacture of winches and propeller systems*
India	Rolls-Royce Energy Systems India Private Limited*	*Project management and customer support*
Norway	Rolls-Royce Marine AS*	*Design and manufacture of ship equipment/holding company*
Norway	Ulstein Holding AS*	*Holding company*
Sweden	Rolls-Royce AB*	*Manufacture of propeller systems*
US	Rolls Royce Commercial Marine Inc.*	*Aftermarket support services*
US	Rolls Royce Naval Marine Inc.*	*Design and manufacture of ship propellers*
US	Seaworthy Systems Inc.*	*Marine support services*
Energy		
Canada	Rolls-Royce Canada Limited*	*Industrial gas turbines and aero-engine sales, service and overhaul*
Singapore	Rolls-Royce Pte Limited*	*Engine and turbine compression systems, spares*
US	Rolls-Royce Energy Systems Inc.*	*Turbine generator packages*
Corporate		
Guernsey	Nightingale Insurance Limited*	*Insurance services*
India	Rolls-Royce Operations (India) Private Limited*	*Provision of support services*
US	Rolls-Royce North America Holdings Inc.*	*Holding company*

The above companies operate principally in the country of their incorporation
The effective Group interest is 100 per cent, other than Europea Microfusioni Aerospaziali S.p.A. in which it is 51 per cent.

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

Principal joint ventures
At December 31, 2007

Incorporated within the UK – directly held

	Class	% of class held	% of total equity held
Civil aerospace			
Alpha Partners Leasing Limited	A Ordinary	100	50
Engine leasing	B Ordinary	—	
TRT Limited	A Ordinary	—	49.5
Turbine blade repair services	B Ordinary	100	
Turbine Surface Technologies Limited	A Ordinary	—	50
Turbine surface coatings	B Ordinary	100	
Defence aerospace			
Airtanker Holdings Limited	Ordinary	20	20
Strategic tanker aircraft PFI project			
Rolls-Royce Snecma Limited (UK & France)	A Shares	—	50
Engine collaboration	B Shares	100	
Rolls-Royce Turbomeca Limited (UK & France)	A Shares	—	50
Adour and RTM322 engines collaboration	B Shares	100	
Turbo-Union Limited (UK, Germany & Italy)	Ordinary	40	40
RB199 engine collaboration	A Shares	37.5	
Energy			
Genistics Holdings Limited	A Ordinary	100	50
Trailer-mounted field mobile generator sets	B Ordinary	—	
Rolls Wood Group (Repair and Overhauls) Limited	A Ordinary	100	50
Repair and overhaul	B Ordinary	—	

Principal joint ventures continued

Incorporated overseas – directly held unless marked*

		Class	% of class held	% of total equity held
Civil aerospace				
China	Xian XR Aero Components Co Limited *Manufacturing facility for aero-engine parts*	Ordinary	49	49
Germany	N3 Engine Overhaul Services Verwaltungsgesellschaft mbh* *Repair and overhaul*	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited* *Repair and overhaul*	Ordinary	45	45
Israel	TechJet Aerofoils Limited* *Manufacture of compressor aerofoils*	A Ordinary B Ordinary	50 50	50
Singapore	International Engine Component Overhaul Pte Limited* *Repair and overhaul*	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%)* *Repair and overhaul*	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA *Manufacture and maintenance of aero engines*	Ordinary	46.9	46.9
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & US) *V2500 engine collaboration*	A Shares B Shares C Shares D Shares	100 — — —	32.5
US	Alpha Leasing (US) LLC*, Alpha Leasing (US) (No 2) LLC*, Alpha Leasing (US) (No. 4) LLC* *Engine leasing*	Partnerships	50	—
US	Rolls-Royce & Partners Finance (US) LLC* *Engine leasing*	Partnership	50	—
US	Texas Aero Engine Services, LLC* *Repair and overhaul*	Partnership	50	—
US	Williams-Rolls Inc (UK & North America)* *Small engine collaboration*	Common	15	15
Defence aerospace				
Germany	EPI Europrop International GmbH (effective interest 35.5%) *A400M engine collaboration*	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) *EJ200 engine collaboration*	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) *MTR390 engine collaboration*	Ordinary	33.3	33.3
US	GE Rolls-Royce Fighter Engine Team LLC* *F136 development engine for the Joint Strike Fighter (JSF) Programme*	Partnership	40	40
Corporate				
US	Exostar LLC* *Business to business internet exchange*	Partnership	17.6	—

Unincorporated overseas – held by subsidiary undertakings

Defence aerospace	
US	Light Helicopter Turbine Engine Company (LHTEC) *Rolls-Royce Corporation has a 50 per cent interest in this unincorporated partnership which was formed to develop and market jointly the T800 engine*

The countries of principal operations are stated in brackets after the name of the company, if not the country of incorporation

Independent auditors' report

To the members of Rolls-Royce plc

We have audited the Group and parent Company financial statements (the 'financial statements') of Rolls-Royce plc for the year ended December 31, 2007 which comprise the Group consolidated income statement, the Group and parent Company balance sheets, the Group consolidated cash flow statement, the Group consolidated statement of recognised income and expense and the related notes. These financial statements have been prepared under the accounting policies set out therein

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU, and for preparing the parent Company financial statements in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities on page 3

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland)

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation We also report to you whether in our opinion the information given in the Report of the directors is consistent with the financial statements. The information given in the Report of the directors includes that specific information presented in the business review that is cross referred from the business review section of the Report of the directors

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed

We read the other information contained in the Annual report and consider whether it is consistent with the audited financial statements We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) 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 and Company'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 Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at December 31, 2007 and of its profit for the year then ended
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation
- the parent Company financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the parent Company's affairs as at December 31, 2007,
- the parent Company financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Report of the directors is consistent with the financial statements

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants, Registered Auditor
London
February 6, 2008