



**Rolls-Royce**

**Rolls-Royce Group plc**  
Annual report 2008

**Technology creates  
global opportunities**



# Contents

## Directors' report

Rolls-Royce Group plc is incorporated as a public limited company and is registered in England under the UK Companies Act 1985 with the registered number 4706930. Rolls-Royce Group plc's registered office is 65 Buckingham Gate, London, SW1E 6AT.

The Directors present the Annual report for the year ended December 31, 2008 which includes the business review, corporate governance and audited financial statements for the year. References to 'Rolls-Royce', the 'Group', the 'Company', 'we', or 'our' are to Rolls-Royce Group plc and/or its subsidiaries, or any of them as the context may require. Pages 01 to 84, inclusive, of this Annual report comprise a Directors' report that has been drawn up and presented in accordance with English company law and the liabilities of the Directors in connection with that report shall be subject to the limitations and restrictions provided by such law.

## Business review

01	<b>Introduction</b>	12	Our strategy
02	<b>Chairman's statement</b>	13	Our business
04	<b>Chief Executive's review</b>	26	<b>Review of operations</b>
	The consistent strategy the Group has pursued for over 20 years has created a broadly based business which is resilient in the face of short-term challenges and which is well positioned for future growth.	27	Civil aerospace
		29	Defence aerospace
		31	Marine
		33	Energy
		35	Engineering and Technology
		37	Operations
		39	Services
		42	<b>Corporate responsibility</b>
		54	<b>Finance Director's review</b>

## Corporate governance

65	Board of directors	83	Other statutory information
69	Board committees	84	Annual report and the financial statements
70	Directors' remuneration report		
80	Internal control and risk management		
81	Shareholders and share capital		

## Financial statements

Contents listed on page 85

## Other information

146	Group five-year review
147	Shareholder information



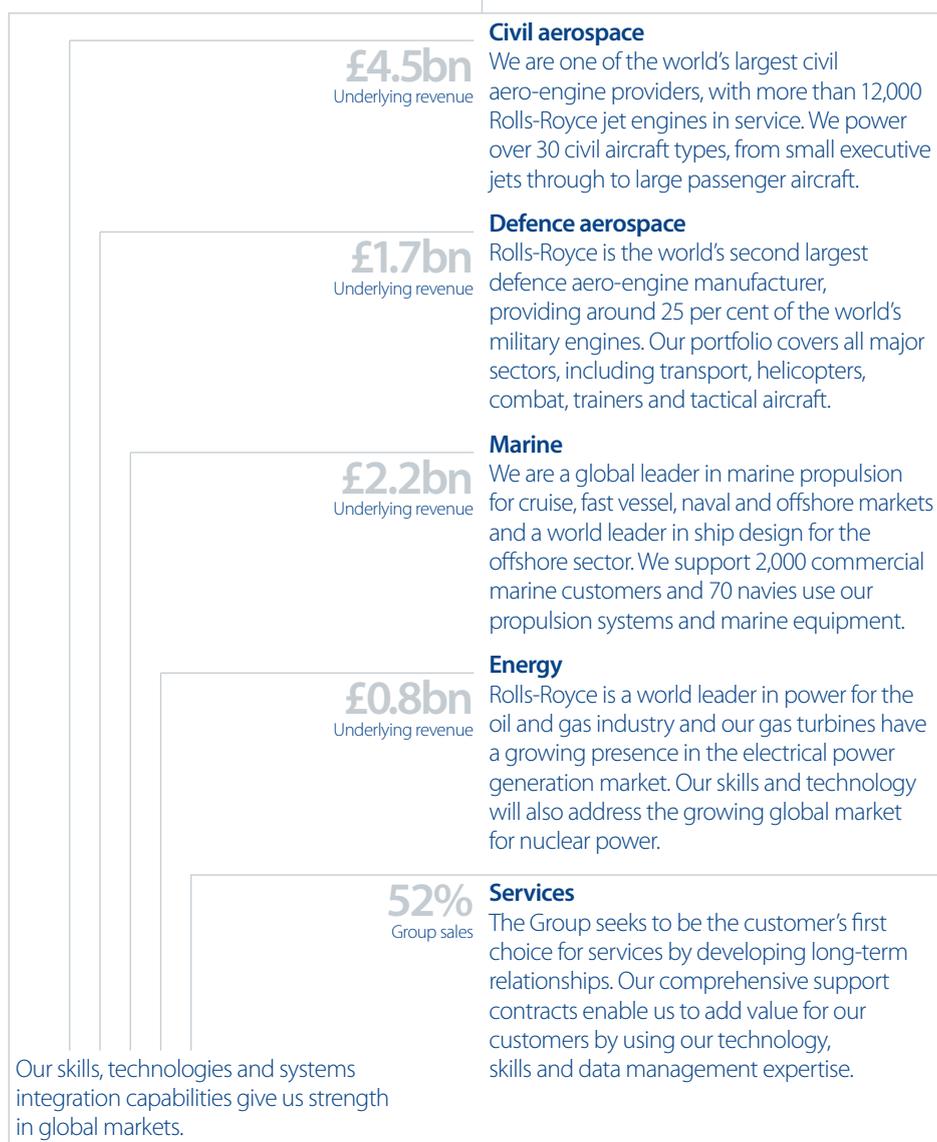
### Cautionary statement regarding forward-looking statements

This Annual report has been prepared for the members of the Company only. The Company, its Directors, employees or agents do not accept or assume responsibility to any other person in connection with this document and any such responsibility or liability is expressly disclaimed.

This Annual report contains certain forward-looking statements. These forward-looking statements can be identified by the fact that they do not relate only to historical or current facts. In particular, all statements that express forecasts, expectations and projections with respect to future matters, including trends in results of operations, margins, growth rates, overall market trends, the impact of interest or exchange rates, the availability of financing to the Group, anticipated cost savings or synergies and the completion of the Group's strategic transactions, are forward-looking statements. By their nature, these statements and forecasts involve risk and uncertainty because they relate to events and depend on circumstances that may or may not occur in the future. There are a number of factors that could cause actual results or developments to differ materially from those expressed or implied by these forward-looking statements and forecasts. The forward-looking statements reflect the knowledge and information available at the date of preparation of this Annual report, and will not be updated during the year. Nothing in this Annual report should be construed as a profit forecast.

**Rolls-Royce is a global business providing and supporting integrated power systems for use on land, at sea and in the air. The Group has a balanced business portfolio with leading market positions.**

	2008	2007	Change	2006	2005	2004
Order book – firm and announced (£bn)	<b>55.5</b>	45.9	21%	26.1	24.4	21.3
Underlying revenue (£m)*	<b>9,147</b>	7,817	17%	7,353	6,458	5,947
Profit before financing (£m)	<b>862</b>	512	68%	693	877	417
Underlying profit before tax (£m)**	<b>880</b>	800	10%	705	593	364
Underlying EBITDA (£m)	<b>1,244</b>	1,065	17%	979	933	717
Earnings per ordinary share (p)	<b>(73.63)</b>	33.67	(319%)	57.32	20.11	15.56
Underlying earnings per ordinary share (p)**	<b>36.70</b>	34.06	8%	29.81	24.48	15.62



\*Underlying revenues reflect actual US\$ exchange rates on settled derivative contracts.

\*\*Reconciliation of underlying results is provided in note 2 on page 99 and note 5 on page 103 of the consolidated financial statements.

**I am very pleased to report that in difficult market conditions, Rolls-Royce has again performed well in 2008. We delivered a strong underlying profit and cash performance and our order book increased from £45.9 billion in 2007 to £55.5 billion in 2008.**

We are proposing a final payment to shareholders of 8.58p per share making 14.30p for the full year, an increase of ten per cent, reflecting the Board's continuing confidence in the Group's business.

The adverse economic outlook inevitably creates huge challenges for all businesses and it is clear that Rolls-Royce will also be impacted. It is difficult to determine the precise scale of the impact on the Group until the severity of the current downturn is clearer. However, Rolls-Royce does enter this testing period with a number of significant advantages. We have pursued a consistent strategy, which has created a business that is well diversified in terms of its products, customers and geography. We also have a strong balance sheet with no net debt. Early action was taken to reduce operating costs and to put our pension schemes on a sustainable footing. We are therefore better prepared to deal with the uncertainties which undoubtedly lie ahead.

The Board is committed to improving the environmental performance of our products through continuous innovation and the development of new technologies. For example, since the first commercial jet engines were produced our engineering expertise has helped reduce aircraft fuel burn by 70 per cent and noise by 75 per cent. We are also committed to reducing the carbon footprint of our operations. We have invested in new facilities and implemented energy efficiency measures that have delivered a reduction in greenhouse gas emissions of some 30 per cent over the last decade. We are actively developing opportunities in civil nuclear power and other low carbon technologies.

The Board is determined to achieve and maintain best practice in all areas of corporate responsibility, including all aspects of health and safety.

Unfortunately over the past two years we have had to announce some redundancies. The Board does not make such decisions lightly, as we take our responsibilities to our people very seriously. However, in order to reduce our operating costs in response to the global economic upheavals, the Board felt these were decisions it had to take.

We attach particular importance to our businesses being run in a way which reflects the highest ethical standards. That is why we decided last year to establish a new Board committee, the Ethics Committee, under the chairmanship of Ian Strachan, to bring a better focus to this issue across the Group.

There have been a number of changes to the Board during the year. We have welcomed John McAdam and John Neill as new non-executive directors, both of whom will bring valuable experience to the Board. Helen Alexander has been appointed as Chairman of the Remuneration Committee. Carl Symon has retired from the Board during the year after nine years' service and I would like to thank him for his valuable contribution to the Group. Sadly, Boris Federov, a valued member of our International Advisory Board, died suddenly during the year.

I would like to congratulate John Rose who was recently made a Commandeur de la Légion d'honneur.

I would also like to thank the management and all our employees for their dedication, hard work and commitment to the success of the Group over what has been a very demanding year. I am also indebted to my fellow directors for the support they have given to me personally and to the Group over this period.

2009 will clearly be a very difficult year for the world economy but I strongly believe that our business is particularly well placed to respond to these challenges and to take advantage of the opportunities that will undoubtedly arise.

**Simon Robertson**  
Chairman  
February 11, 2009



Simon Robertson  
Chairman

## The Group performed well in difficult market conditions

The Group delivered a strong underlying profit and cash performance, and our order book increased by 21 per cent. The business is well diversified and we have a strong balance sheet with no net debt.



Sir John Rose  
Chief Executive

## Developing the business for the longer term

The consistent strategy the Group has pursued for over 20 years has created a broadly based business which is resilient in the face of short-term challenges and which is well positioned for future growth.

**Rolls-Royce performed strongly in 2008 in the face of increasingly challenging conditions.**

Our results demonstrate the value of our consistent strategy. The strength of our technology, the breadth of our product and service portfolio, our knowledge of the customer and the capabilities of our people continue to increase our resilience and enable us to develop the business for the longer term.

Our financial results reflect the strength of our business model. In 2008, Group sales increased to £9,082 million (2007 £7,435 million), with underlying sales growth of 17 per cent. The published loss before tax was £1,892 million (2007 profit £733 million). This loss was caused primarily by the effects of the marking to market of various financial instruments, as is explained further in the Finance Director's review on page 55, and the reported earnings do not reflect the underlying trading performance of the Group in 2008. Underlying profit before tax rose by ten per cent to £880 million (2007 £800 million). We ended the year with a net cash balance of £1,458 million (2007 £888 million) and a record order book of £55.5 billion (2007 £45.9 billion).

As I write, the global economic crisis continues to intensify and it is impossible to be precise about its ultimate severity and duration. What is certain is that all companies will be affected to varying degrees and it is clear that Rolls-Royce, its customers and suppliers will not be immune from this global crisis. However, as a strong power systems company, Rolls-Royce has a number of characteristics which give me confidence that we will be able to deal effectively with the very considerable challenges and uncertainties that lie ahead.

**A very different company**

It is worth recalling at the outset that the current crisis is not the first to which Rolls-Royce has had to respond.

In recent years our markets have been impacted by the events of September 11, 2001, the Gulf War in 2002 and the SARS epidemic in 2003.

As a business, we have also had to deal with a wide range of negative developments such as a weakening US dollar, high oil and commodity prices and delays in major new airframe programmes. All these challenges have been effectively managed by the Group.

The drivers of the current global economic crisis clearly differ significantly from previous downturns. However, Rolls-Royce itself is also a very different company.

Our turnover in 2001 was around £6 billion, with only 38 per cent of our revenues derived from services. We had a geared balanced sheet with average net debt of around £1 billion and a large and volatile pensions deficit. Our order book of £16.7 billion was concentrated on traditional Western markets such as the UK and the US. As a result, in the downturn that started in 2000 but was exacerbated by the tragedy of 9/11, the Group was less resilient than today.

Rolls-Royce is now well diversified by product, customer and geography. Our revenues have increased to over £9 billion with over 50 per cent now derived from services. Our order book has increased more than threefold to over £55 billion and is broadly spread across all the world's principal markets. Most significantly of all, we have a strong balance sheet with no net debt. Our long-term strategy of hedging currency risk has served us well, allowing a manageable and predictable deterioration in the sterling/US dollar achieved rate over the past five years.

Our large installed base of over 54,000 engines supports a growing services business. The scale of this services activity, together with the size of the order book and the longevity of our programmes, gives us much clearer visibility of future revenues. All these characteristics increase the Group's resilience and despite the uncertain outlook, give us confidence for the future.

In this more challenging environment, operational performance, cost reduction and matching capacity to load will be particularly important.

In January 2008, we took early action to reduce costs by taking the difficult decision to reduce staffing in support functions by 2,300 people. This programme has been completed at no net cost to the Group and in 2009 will reduce our costs by £100 million. A further proposed reduction of 1,500–2,000 jobs in 2009 is expected to be cost neutral in the year, while delivering similar savings in 2010. These programmes demonstrate our commitment to achieving and sustaining world-class levels of operational efficiency and improving our competitiveness.

### Developing the business

It is clearly impossible to provide a forecast of the precise impact that the global crisis will have on Rolls-Royce. However, it is clear that the Group's power systems portfolio – whether for use on land, at sea or in the air – provides products and services for which there will be a strong, global demand for the foreseeable future. Importantly, the sectors in which the Group operates are characterised by high barriers to entry because of the advanced technologies required and routes to market which have to be established and maintained. Rolls-Royce will be able to exploit these advantages over many years as the global economy recovers and resumes growth.

### A long-term business

The longevity of our programmes, the scale of our order book and the increasing importance of our services activity suggest that over the next ten years the Group can double in size through organic growth alone. In civil aerospace, for example, based on our understanding of the order book and the long-term programmes in which we are involved, we see a market potential for around 8,000 wide-bodied aircraft over the next 20 years, a very significant opportunity for our Trent engine family.



#### Organic growth – Trent aero engine

Rolls-Royce has developed the Trent aero engine into a market leading family of large engines.

### Investing for growth

Rolls-Royce has a strong track record of developing businesses by investing in organic growth, partnerships and acquisitions. Our civil aerospace business is a case in point. Our acquisition of the Allison Engine Company in 1995 helped Rolls-Royce build up a strong position in the corporate and regional jet market through the highly successful AE 3007 programme. Our joint venture with BMW in 1990 enabled us to establish a new centre of excellence in Germany for two shaft engines, an important strategic development which culminated in the Group buying out BMW's share of the joint venture in 1999. Collaboration also played a key role in the development of the Trent programme, with Rolls-Royce agreeing an important series of risk and revenue sharing partnerships with a wide range of global companies.



#### Allison acquisition

Our acquisition of the Allison Engine Company provided a strong presence in the regional aircraft and US defence markets.



**Partnerships – BR700**

The BR700 engine series for corporate and regional jets was first developed in our joint venture with BMW. The latest engine variant is the BR725 for the Gulfstream G650 aircraft.

**A consistent approach**

We are taking the same approach to develop our marine business which was transformed by the acquisition of Vickers in 1999. We gained access to new capabilities including design and integration systems, propulsion and control equipment, a global sales and services network and routes to market for the offshore and merchant sectors. This combination of a strong ship design capability and the provision of high technology equipment and systems has enabled marine to improve its market access and broaden its product offering.

Defence aerospace has similarly been transformed from a narrowly focused business which was overly dependent on the UK to one which provides engines and service support on a global basis and across a wide range of sectors including fast jets, transport aircraft, unmanned vehicles, trainers and helicopters. We have more than 160 customers in 103 countries, with the USA now accounting for around 45 per cent of defence aerospace revenues.



**Vickers acquisition**

The Group already had a naval marine business but the acquisition of the Vickers group expanded our capability across the world in the commercial marine market.

**Exploring new opportunities as a power systems company**

Looking ahead, the Group can take full advantage of its strong systems integration capability based on its knowledge of technology, its close understanding of customers' needs and its ability as a power systems company to apply these integration skills in support of the customer. This will enable the Group to exploit its technological strengths in adjacent markets and to develop its existing businesses through partnerships and acquisitions.

A good example of this is civil nuclear. In 2008, we established a new business unit to address the rapidly expanding global market for nuclear power generation which we estimate could be worth around £50 billion per year within 15 years. The civil nuclear opportunity plays to our strengths.

It requires technological expertise, systems integration capabilities and a global supply chain, all of which we have developed during the 50 years we have designed, manufactured and supported nuclear reactors for the Royal Navy's submarine fleet.

We will also use this approach to take advantage of other opportunities to address distributed power and alternative energy.



#### **New opportunities**

Our experience in the design, manufacture and support of nuclear plant for submarines allows us to address the growing civil nuclear market.

### **World-class people**

In responding to the short-term challenges we are currently facing and in developing the business for the longer term, our people are our strongest asset.

Rolls-Royce is a power systems company, powered by the knowledge, experience and imagination of all our employees across the world. Our advantages are dependent on the contributions they make and in this increasingly challenging period I am particularly indebted to all of our people for everything they do in support of the business.

### **Future prospects**

The Group expects that in 2009 its global markets will be affected by reducing demand and the impact of financing constraints. We will continue to manage the consequences of airframe programme slippages.

Cash generation will be affected by the reduction in new orders and associated deposit intake and the impact on inventory of any delays or cancellations. There are also likely to be requests for customer and supplier financial support which will be considered by the Group on a case by case basis. In the current environment it is expected that in 2009 despite a cash outflow, the average net cash balance of the Group will increase. The Group's current view is that underlying revenues will continue to grow and underlying profits for the year will be broadly similar to those achieved in 2008.

#### **Sir John Rose**

Chief Executive  
February 11, 2009



Jay Striegle  
Product Reliability Engineer

## A competitive portfolio

We are Europe's largest defence aero-engine company, with a product range that spans the key market sectors and a position on the world's most important development programmes. We have 18,000 engines in service with 160 customers worldwide.



Paul Markwick  
Test Facility Manager –  
Nuclear

## New growth opportunities

Renewed global demand for civil nuclear power represents a significant growth opportunity for Rolls-Royce. We have developed a strong nuclear capability, through our experience of designing, manufacturing and supporting nuclear plant for naval submarines. We have now established a new business unit to address the civil nuclear opportunity directly.

**As a power systems company, Rolls-Royce focuses on supplying its customers with integrated systems to meet their power and propulsion needs. Our consistent strategy has five elements:**

#### **Address four global markets**

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

#### **Invest in technology, infrastructure and capability**

Over the past five years, we have invested £3.7 billion in research and development. We invest approximately £30 million annually in training and over £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 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 to generate attractive returns over many 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.

**The core characteristics which define our business and underpin the delivery of this strategy are:**

##### **Closeness to our customers**

We develop close relationships with our customers over many years. This allows us to offer solutions, often in partnership with our customers, to meet their specific requirements.

##### **Domain knowledge**

Underpinning our sales of equipment and related services is a deep knowledge of the overall environment in which our equipment is used. This allows us to provide the optimum level of service and focus our activities to meet our customers' needs and grow our business.

##### **Integrated systems**

We supply our customers with products, related services and whole systems. Our ability to integrate and optimise systems enables us to create value for customers in all our main markets.

##### **Technological superiority**

Our investments in technology and capability provide Rolls-Royce and our customers with competitive advantage.

##### **Operational excellence**

We aim to operate at the highest standards, to ensure that we continue to meet our customers' requirements in the quality, performance, durability and delivery of our products, systems and services.

##### **Organisational capability**

Because we are a global company we have the ability to recruit and retain capable people in many locations. Our investment in training and the varied career opportunities are key to our success in retaining high-quality people.

##### **Brand**

We have an exceptionally strong brand which is recognised globally and embodies qualities that create a common focus for all our people, wherever they are located.

## Market outlook

The Group operates in four long-term global markets – civil and defence aerospace, marine and energy. These markets create a total opportunity worth some two trillion US dollars over the next 20 years and:

- have very high barriers to entry;
- 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 aircraft retirements. While the market can be temporarily disrupted by external events, such as war, acts of terrorism, or economic downturns, 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 new military engines and through-life support will be worth US\$450 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.

### Marine

The Group forecasts demand for marine power and propulsion systems of US\$200 billion over the next 20 years. Demand will be greatest in the commercial sector, where the merchant market represents 40 per cent of the total and the offshore market, a further 40 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 means 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 derivative gas turbines.

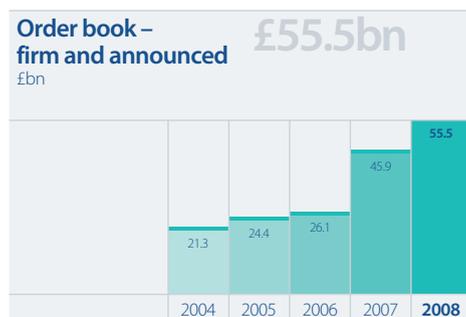
The Group's 20 year forecast values the total aero derivative gas turbine sales in the oil and gas and power generation sectors at US\$70 billion. Over this period, demand for associated aftermarket services is expected to be around US\$50 billion.

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

Note: A long-term conversion rate has been used where necessary in order to present all figures in US\$.

## 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.



## 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 on page 12. 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:

<p><b>Underlying revenue</b> £m</p> <table border="1"> <thead> <tr> <th>Year</th> <th>2004</th> <th>2005</th> <th>2006</th> <th>2007</th> <th>2008</th> </tr> </thead> <tbody> <tr> <td>Revenue (£m)</td> <td>5,947</td> <td>6,458</td> <td>7,353</td> <td>7,817</td> <td>9,147</td> </tr> </tbody> </table>	Year	2004	2005	2006	2007	2008	Revenue (£m)	5,947	6,458	7,353	7,817	9,147	<p>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.</p>
Year	2004	2005	2006	2007	2008								
Revenue (£m)	5,947	6,458	7,353	7,817	9,147								
<p><b>Underlying profit before financing</b> £m</p> <table border="1"> <thead> <tr> <th>Year</th> <th>2004</th> <th>2005</th> <th>2006</th> <th>2007</th> <th>2008</th> </tr> </thead> <tbody> <tr> <td>Profit (£m)</td> <td>417</td> <td>679</td> <td>748</td> <td>832</td> <td>919</td> </tr> </tbody> </table>	Year	2004	2005	2006	2007	2008	Profit (£m)	417	679	748	832	919	<p>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 99 of the consolidated financial statements.</p>
Year	2004	2005	2006	2007	2008								
Profit (£m)	417	679	748	832	919								
<p><b>Cash flow</b> £m</p> <table border="1"> <thead> <tr> <th>Year</th> <th>2004</th> <th>2005</th> <th>2006</th> <th>2007</th> <th>2008</th> </tr> </thead> <tbody> <tr> <td>Cash flow (£m)</td> <td>251</td> <td>552</td> <td>491</td> <td>62</td> <td>570</td> </tr> </tbody> </table>	Year	2004	2005	2006	2007	2008	Cash flow (£m)	251	552	491	62	570	<p>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. The figure in 2007 is shown after reflecting a £500 million special contribution to the Group's UK pensions schemes, as part of the restructuring of its pensions schemes.</p>
Year	2004	2005	2006	2007	2008								
Cash flow (£m)	251	552	491	62	570								

### Return on capital employed

%



Return on capital employed is calculated as the after-tax underlying profit, divided by the average net assets during the year, adjusted for net cash, the net post-retirement deficit and goodwill previously written off. It represents a measure of the return the Group is making on its investments.

### Net research and development charge

£m



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

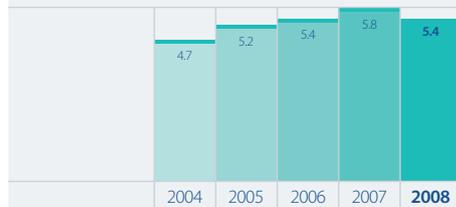
£m



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 continuously improve the Group's intellectual property.

### Net research and development expenditure as a proportion of underlying revenue

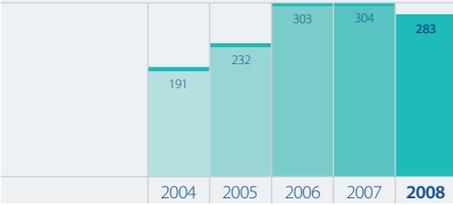
%



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 annually 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**

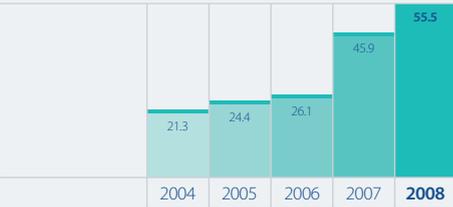
£m



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.

**Order book**

£bn



The order book provides an indicator of future business. It 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 and development**

**£30m**

Annual investment

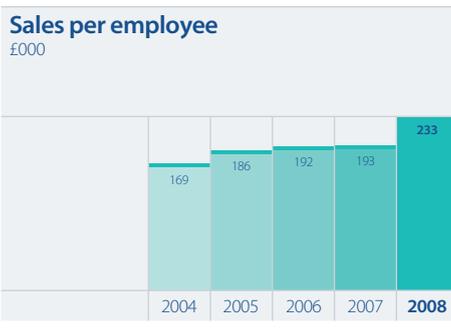
Training is a core element of the Group's investment in its capability and is measured as the expenditure on the training and development of employees, customers and suppliers. Effectiveness is ensured by using a range of external and internal sources, and by gathering user feedback.

**Employee engagement**

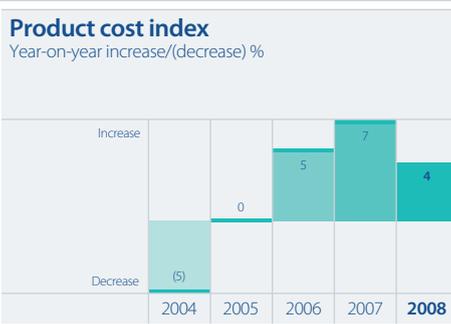
**39,000**

Employees in 2008

Regular surveys are undertaken to identify and address emerging issues. A full employee engagement survey is run every two years with smaller pulse surveys in between. Training and employee engagement surveys are discussed further in the corporate responsibility section of this review.



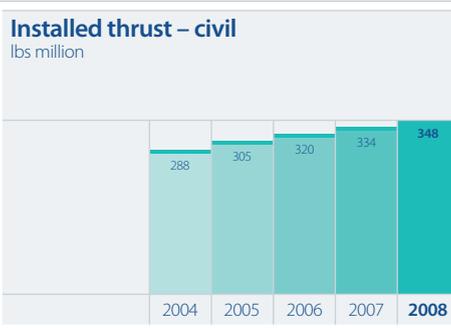
A measure of personnel productivity, this indicator measures published revenue generated per employee.



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 those of its suppliers.



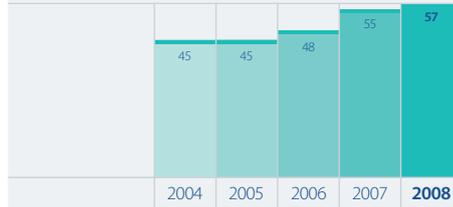
The Group's installed engine base represents an opportunity to generate future aftermarket business. This is measured as the number of Group products delivered during the year within each business except for marine, as its products do not lend themselves to this measure due to their diversity.



Installed thrust is the indicator of the amount of product in use by our customers and therefore the scale of opportunity this presents for our services business.

**Percentage of civil fleet under management**

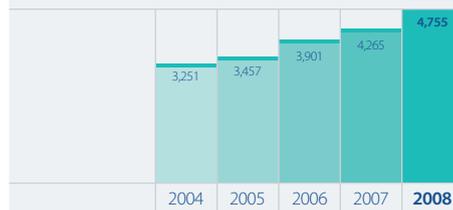
%



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 figure shown for civil aerospace for 2004 differs from that disclosed in the Annual report for that year as a result of reflecting this weighting.

**Underlying services revenue**

£m



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.

**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 Group's website, [www.rolls-royce.com](http://www.rolls-royce.com).



 Rolls-Royce

UT-Design™  
UT 755 CD

**Mari Kvalsund**  
Construction assistant,  
Ship Technology Offshore

## A track record of developing businesses

Marine is now the second largest Rolls-Royce business in revenue terms. Transformed by the acquisition of Vickers in 1999, it has become a world leader in specialist ship design and the provision and integration of high technology systems.

## 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 reports regularly to the Board on the key risks facing the business and the mitigating actions put in place to deal with them. The Group's consistent strategy and long-term programmes require that key sources of risk are identified in advance and are maintained under continuous review.

The risks described below are among those that the Group considers might have an impact on the Group's performance. This is notwithstanding other risks and uncertainties that are currently unknown to the Group or which the Group does not presently consider to be material. The principal risks reflect the global growth of the business, and the competitive and challenging business environment in which it operates. Risks, including those to the Group's reputation, are considered under four broad headings:

- Business environment risks
- Strategic risks
- Financial risks
- Operational risks

### Business environment risks

#### Cyclical downturn – global recession

The current challenging economic environment is a source of some uncertainty for the Group. The length and depth of the current recession and constraints caused by reduced liquidity from global capital markets may hinder the ability of customers and suppliers to make planned investments in all sectors. The Group's largest market, civil aerospace, is cyclical by nature, although services activity and revenues, now representing more than 60 per cent of the civil aerospace business annual revenue, have historically been less volatile in economic slowdowns and are considered more predictable and robust than the sales of engines for new aircraft.

The contribution from the Group's global activity in other non-civil aerospace markets is becoming more significant. It now represents around 50 per cent of Group revenues, and these markets are also less cyclical in nature.

The Group's broadly balanced power systems activities, access to global markets with greater diversification by sector, customer and geography and an improved balance between original equipment and services revenues are expected to help mitigate the effects of the slowing global economy.

The Group has a robust balance sheet with positive net cash. The changes made to the UK defined benefit pension schemes should ensure a less volatile, more predictable funding requirement in the future.

#### External events or factors affecting air travel

The civil aerospace business remains an important contributor to the Group's revenues and profits. The willingness of passengers to travel by air is influenced by a range of factors, including economic conditions, health and security issues. Any prolonged reduction in air travel would impact airlines' revenues and cash flows, and potentially reduce their need for new engines, spare parts or aftermarket support services.

Exposure to this risk is mitigated by the Group's business strategy, which has driven it to become a global operation with a broader business base, with 50 per cent of revenues and 40 per cent of earnings now generated outside the civil aerospace business from its defence aerospace, marine and energy businesses.

The Group's crisis management plan and framework would be instrumental in responding to, and recovering from, wider external events such as the impact of terrorist activity or an influenza pandemic.

#### **Environmental impact of products and operations**

The Group recognises that its products and business operations have an impact on the environment, particularly related to climate change. Rolls-Royce is determined to be part of the solution to these environmental challenges and continues to make significant investment in innovative solutions for the aviation, marine and energy markets. The challenge is being addressed through the enhancement of current product ranges and affordable research and development into complementary technologies such as nuclear power, fuel cells and tidal energy. The Group continues to work closely with its customers, industry partners and other stakeholders to implement these development opportunities.

A robust governance structure headed by the Environment Council directs and monitors improvements in the environmental performance of the Group's products, and the Environmental Advisory Board reviews and makes recommendations on the environmental aspects of the Group's products and business operations (see pages 42 to 53).

### Strategic risks

#### **Delivery of aftermarket**

The Group's revenues are balanced between original equipment delivery and aftermarket services. The growth in product sales provides a large installed base, of which a high proportion has successfully been contracted under long-term post-sale support arrangements, so that aftermarket revenues now constitute a majority of forecast revenue. A significant failure to deliver the aftermarket commitments made to its customers and meet anticipated contractual profitability could have an adverse impact on the Group's financial results and reputation.

The Group places great importance on working closely in partnership with its customers to understand their operations and align the Group's service capability to meet their needs. Within the dedicated services organisation, management initiatives have developed robust processes, structures and networks to ensure required support levels can be delivered effectively and economically. Nevertheless, economic pressures on commercial aviation, as well as changes in regulations, could lead to reductions in utilisation rates and operational budgets, representing a continuing threat to the realisation of future revenues.

#### **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, all creating high barriers to entry. However, these factors alone do not protect the Group from competition, including pricing and technical advances made by competitors.

The Group has developed a balanced business portfolio and maintained a steady focus on improvement in operational performance, for example through the modernisation of its facilities. This, together with the establishment of long-term customer relationships and sustained investment in technology acquisition, allows the Group to respond to competitive pressures.

### Export controls

Rolls-Royce designs and supplies a number of gas turbine products and services for the defence aerospace market. Many countries in which the Group conducts its business operate legislation controlling the export of specified goods and technology intended or adaptable for military application. The Group is committed to complying with the requirements from national governments in all jurisdictions when exporting goods, parts, technologies or information, although globalisation of the Group's operations brings with it complexities of concurrent but differing national export control legislation. Non-compliance with export controls is recognised as a principal risk to both programme performance and the Group's reputation.

The exports committee, chaired by the Chief Operating Officer, directs the Group's strategy and policy on exports. Export control managers are embedded throughout the business and the Group will continue to implement any necessary changes to ensure that it maintains the capability necessary to monitor and comply with requirements.

### 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.

### Operational risks

#### Performance of supply chain

The Group's products and services are delivered through the effective operation of its facilities and key capabilities, including its supply chain. The Group's success in strengthening its market position places increased reliance on the performance of the supply chain. The Group manufactures approximately 30 per cent by value of its gas turbine products, the remainder being provided through external suppliers, including risk and revenue sharing partners. Meeting delivery commitments on schedule, cost and quality are critical to the achievement of business goals. The Group has a consistent focus on cost reduction and performance improvement and it continues to modernise its production facilities to improve productivity and reduce costs. Investment in developing world-class manufacturing processes is continuing in Asia, North America and Europe. This also drives development of the external supply chain through sourcing of parts from many new countries.

Global supply chains are inevitably complex with numerous inter-relationships with a wide variety of organisations. While the Group's strategy is to improve integration and simplify the internal and external elements of its supply chain by building strategic links with fewer, stronger suppliers, it is still prone to disruption from financial or physical causes. A major disruption in any of these elements would adversely affect the Group's ability to deliver its operational commitments and would have the potential to affect financial returns.

The planning for, and management of, any such interruption is addressed through the Group's business continuity management process. Substantial progress has been made in the deployment of business continuity management systems and structures to assess the likelihood and potential impacts of a catastrophic disruption to the Group's key facilities. In addition to the Group's comprehensive programme of business interruption insurance, significant investment is being undertaken to establish, where possible, dual sourcing of key components. Increased focus is also being applied to understanding and addressing sources of risk arising in the external supply chain, particularly those associated with financial instability. Procedures are in place to monitor, assess and respond in such circumstances.

### IT security

The continuing globalisation of the business and advances in technology have resulted in more data being transmitted across international communication links, posing an increased security risk. There is also the possibility of unintentional loss of controlled data by authorised users. In either case, adverse impacts upon operational effectiveness, the value of intellectual property, legislative compliance or the reputation of the Group might arise. The active sharing of information through industry and government forums and the continual upgrading of security equipment and software mitigate these risks.

### Ethics

The Group recognises the benefit that is derived from conducting business in an ethical and socially responsible manner. This approach extends from the sourcing of raw materials and components to the manufacture and delivery of 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. Shortcomings in any of these areas could damage the Group's reputation and disrupt its business.

The Group is committed to maintaining high ethical standards. A global code of business Ethics has been issued to employees and a face-to-face training and engagement programme is in place in order to strengthen employee awareness of the Group's values. The Group's ethical standards are also communicated to the Group's first-tier supply base through a supplier code of conduct. Concerns regarding potentially unethical behaviours can be reported in confidence via dedicated global telephone and internet channels. All such reports are followed up and will be monitored by the recently formed ethics committee.

### Programme risk

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

The Group seeks continuous improvement of all its processes and employs project management controls on a routine basis. All major programmes are subject to Board approval and are reviewed regularly by the Board with a particular focus on the nature and potential impact of emerging risks and the effective mitigation of previously identified threats.



Pete Jackson  
Engine fitter

## A long-term business

We power over 30 types of commercial aircraft, from business jets to the largest widebody airliners. Our Trent engine family is enjoying particular success. The Trent 900 has now been chosen by ten of the 13 operators that have ordered engines for the Airbus A380, the Trent 1000 for the Boeing 787 has been selected by around 50 per cent of operators and the Trent 700 has won 70 per cent of new orders for the Airbus A330. The Trent XWB remains the only engine on offer for the Airbus A350 XWB.

## Key businesses and activities

We focus on investing in technology and capabilities that can be successfully applied to our advanced products and services. We then market and sell these through our four main customer facing businesses: civil aerospace, defence aerospace, marine and energy.

Our manufacturing base is becoming increasingly global, as is our supply chain, as we seek to bring our products to market in the most efficient way. We have established a global service organisation with more than 50 locations around the world to bring us closer to our customers.

This section of the report reviews the year for each of the customer facing businesses, including our services activity, and the key functions of engineering and operations.

			
<p><b>Mark King</b> President – Civil Aerospace</p>	<p><b>Axel Arendt</b> President – Defence Aerospace</p>	<p><b>John Paterson</b> President – Marine</p>	<p><b>Tom Curley</b> President – Energy</p>
			
<p><b>Colin Smith</b> Director – Engineering and Technology</p>	<p><b>Mike Terrett</b> Chief Operating Officer</p>	<p><b>Tony Wood</b> President – Services</p>	

## Civil aerospace

- Agreements signed with risk and revenue sharing partners for 40 per cent of Trent XWB programme
- Trent 1000 ready for first flight of Boeing 787
- Successful entry into service of Trent 900 with Singapore Airlines and Qantas on the Airbus A380
- Successful entry into service of IAE V2500 SelectOne™
- Successful first run of BR725 for the new Gulfstream G650

Key financial data	2008	2007	2006	2005	2004
Underlying revenue £m	<b>4,502</b> +11%	4,038 +3%	3,907 +15%	3,406 +11%	3,072 +13%
Underlying profit before financing £m	<b>566</b> +0%	564 +9%	519 +14%	454 +118%	208 +24%
Net assets £m	<b>330</b>	2,468	2,165	1,617	1,740
<b>Other key performance indicators</b>					
Order book £bn	<b>43.5</b> +21%	35.9 +80%	20.0 +5%	19.0 +17%	16.2 +13%
Engine deliveries	<b>987</b>	851	856	881	824
Underlying services revenues £m	<b>2,726</b>	2,554	2,310	2,016	1,838
Underlying services revenues %	<b>61</b>	63	59	59	60
% of fleet under management	<b>57</b>	55	48	45	45

### Underlying revenue

**£4.5bn**

### Market opportunity over 20 years

**US\$1,250bn**

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 with 600 airline customers and 4,000 corporate operators.

The business continued to perform strongly in 2008 despite the impact of worsening economic conditions on customers and on the air travel market in general. Underlying revenue grew by 11 per cent. This result was driven by increases in new engine deliveries, which approached 1,000 units, and by continued growth of services revenues which accounted for over 60 per cent of total sales. The first half of 2008 continued to see strong order intake and, while order activity slowed in the second half of the year, the total order book for civil aerospace grew to £43.5 billion. Underlying profit was flat year-on-year.

In the corporate and regional market, the 3,000th AE 3007 engine was delivered. Meanwhile, the newest member of the Group's corporate engine family, the BR725 for the new Gulfstream G650 corporate aircraft, achieved first engine run on time in April. The G650 has enjoyed unprecedented market interest, reinforcing the Group's leading position in the corporate market.

V2500 SelectOne, the latest successful V2500 engine standard, produced by the International Aero Engines (IAE) consortium, in which Rolls-Royce is a major shareholder, entered service with IndiGo Airlines of India.

The Trent family continues to enjoy significant success. The Trent 900-powered Airbus A380 completed a year of service and demonstrated excellent reliability with Singapore Airlines (SIA) and Qantas.

Further orders for the engine were received from SIA and Thai Airways International. The Trent 900 has now been selected by ten of the 13 operators that have ordered the A380 and made an engine decision.

The Trent 700 continued to win over 70 per cent of orders placed for the Airbus A330. Significant additional orders were also placed for the Trent 1000 for the Boeing 787, which has now been selected by about 50 per cent of operators, and for the Trent XWB, which is currently the only engine offered for the Airbus A350 XWB.

Entry into service of the Boeing 787 has been delayed until 2010, but maturity testing of the Trent 1000 has continued with successful demonstration of endurance programmes equivalent to two years of service. The Trent XWB programme attracted considerable interest from risk and revenue sharing partners with agreements signed by the end of 2008 for around 40 per cent of the programme, with major partners including KHI and MHI of Japan, ITP of Spain, Volvo of Sweden, Hispano-Suiza of France and Parker Hannifin of the US.

We continued to secure services contracts, achieving a record year for CorporateCare™ sales and selling TotalCare™ with approximately 90 per cent of new Trent engine orders. A larger Operations and Data Centre was opened in September to support the growing large-engine fleet under Rolls-Royce service contracts, now totalling 5,300 engines.

We are actively exploring technologies and programmes that address environmental and sustainability issues relevant to our business. Through our Option 15-50 programme we continue to pursue a comprehensive range of leading technologies and engine architectures to meet these challenges.

Global air travel and air freight is already being affected by the economic downturn. The scale of the future impact is unclear, with airframe delays and concerns about customer financing adding to the uncertainties surrounding engine volumes.

The Group expects engine deliveries to fall in 2009 with an increasing risk of deferrals and cancellations, weaker volumes in the narrowbody and the corporate and regional sectors, and stable Trent deliveries for widebody aircraft.

Growth in services revenues will be modest in 2009, held back by lower utilisation levels, the impact of parked aircraft and some softening of uncontracted 'Time and Material' services revenues. As a consequence, underlying profits will be lower in 2009.



Technology creating global opportunities:

**IAE V2500 SelectOne**

Indian airline IndiGo was the launch customer for the IAE V2500 SelectOne suite of services.



Technology creating global opportunities:

**Trent 900**

Qantas became the second airline to put the Trent 900-powered Airbus A380 into service. The engine is the market leader on the airframe.

## Defence aerospace

- £700 million contract secured for UK strategic tanker aircraft
- US\$915 million contract for AE 2100 engines signed with Alenia
- Development of the F136 engine for the F-35 funded for 2009
- US\$131 million F-35 Rolls-Royce LiftSystem® contract awarded
- £258 million service and support contract for Gnome helicopter engines
- £198 million contract to support UK Pegasus engine fleet

Key financial data	2008	2007	2006	2005	2004
Underlying revenue £m	<b>1,686</b> +1%	1,673 +4%	1,601 +13%	1,420 +3%	1,374 -2%
Underlying profit before financing £m	<b>223</b> +12%	199 +3%	193 +7%	180 +1%	179 +22%
Net assets £m	<b>(197)</b>	(172)	20	55	131
<b>Other key performance indicators</b>					
Order book £bn	<b>5.5</b> +25%	4.4 +38%	3.2 -3%	3.3 0%	3.3 +22%
Engine deliveries	<b>517</b>	495	514	565	548
Underlying services revenues £m	<b>947</b>	877	853	787	768
Underlying services revenues %	<b>56</b>	52	53	55	56
% of fleet under management	<b>12</b>	11	11	8	5

### Underlying revenue

**£1.7bn**

### Market opportunity over 20 years

**US\$450bn**

Rolls-Royce is Europe's largest defence aero-engine company, serving 160 customers in 103 countries and with 18,000 engines in service.

We have a product range of 25 engines that power aircraft across the key market sectors of combat, transport, helicopters, trainers, patrol, maritime and reconnaissance.

During 2008, the business continued to strengthen its market position, winning key contracts across its product and service range, particularly in the growing transport aircraft and military support sectors.

This included the development of our innovative range of aftermarket services, known as MissionCare®, which enables Rolls-Royce to tailor support services solutions to customers' individual requirements.

The new operations facility in Bristol, UK, opened in the first quarter of 2008. It delivers a step change in engine assembly, development and logistics and, in combination with more flexible working practices, brings greater efficiencies to the manufacturing process.

In the combat aircraft market, the EJ200 powerplant for the Typhoon aircraft achieved several landmarks, with the 500th engine delivery and 100,000 flying hours in operational service.

We also made progress on both engine programmes for the Joint Strike Fighter. First flight of the F-35 STOVL (short take off and vertical landing) version, fitted with the Rolls-Royce LiftSystem®, took place in May and the first LiftSystem production contract was secured in December at a value of US\$131 million.

The F136 engine, jointly developed with GE for all F-35 variants, achieved US Government funding for 2009 and passed its test milestones prior to delivery of the first production standard engine in early 2009.

We also consolidated our market lead in the transport aircraft market, signing a US\$915 million agreement with Alenia Aeronautica for the AE 2100 engine in the C-27J Military Transport aircraft. This engine also won further orders for its application in the C-130J.



Technology creating global opportunities:

**AE 2100 turboprop engine**

The Alenia C-27J aircraft is powered by the Rolls-Royce AE 2100 turboprop engine. Rolls-Royce has signed a US\$915 million contract with the aircraft maker.



Technology creating global opportunities:

**Gnome engines support**

Rolls-Royce is to support the Gnome engines that power the 96 Sea Kings in service with the Royal Air Force and Royal Navy in a ten year contract worth £258 million.

Defence aerospace's other major collaborative programme – the TP400 engine for the A400M military transport aircraft – made progress in the year. It has completed more than 2,000 hours of ground testing and has successfully undertaken its first flights on the flying testbed.

As a shareholder and sub-contractor of the AirTanker consortium, we secured a 27-year engine and support contract worth over £700 million from the UK Ministry of Defence (MoD) for the UK's Future Strategic Tanker Aircraft under an innovative private finance scheme. This Airbus A330M aircraft is powered by the civil Trent 700, representing new aftermarket opportunities for this engine in a defence environment.

Orders for our innovative aftermarket solutions included a US\$90 million engine availability contract for the T-45 Goshawk trainer with the US Navy, and the UK MoD's first full availability contract to support its Gnome-powered Sea King helicopter fleet at a value of £258 million.

In the helicopter sector, the RR300 was certified ahead of schedule and the first Rolls-Royce Honeywell LHTEC T800 engine was delivered to AgustaWestland for the UK Future Lynx Battlefield Reconnaissance programme.

Looking to the future, we are working on two important research and technology programmes for the US Air Force, Adaptive Versatile Engine Technology (ADVENT) and the Highly Efficient Embedded Turbine Engine (HEETE).

In the unmanned vehicle sector, we have been selected to provide the Integrated Power System for the UK's Mantis demonstrator, while we continue to work on the MoD Taranis unmanned combat vehicle demonstrator. The Rolls-Royce AE 3007 engine, which powers the Global Hawk high altitude unmanned aerial reconnaissance system, was selected for the new US Broad Area Maritime Surveillance programme.

Significant opportunities exist in the global defence market, particularly in the combat, transport, unmanned and helicopter sectors. The business also continues to develop innovative aftermarket solutions, with services now generating over 50 per cent of sales.

Further strong growth in engine deliveries for the military transport sector is expected to support another year of profit growth in 2009.

## Marine

- £901 million of sales in the offshore sector
- £96 million contract to power new Royal Navy aircraft carriers
- Order book grown to £5.2 billion
- Major global services expansion now under way

Key financial data	2008	2007	2006	2005	2004
Underlying revenue £m	<b>2,204</b> +42%	1,548 +19%	1,299 +18%	1,097 +14%	963 -4%
Underlying profit before financing £m	<b>183</b> +62%	113 +12%	101 +13%	89 +14%	78 0%
Net assets £m	<b>488</b>	563	619	674	651
<b>Other key performance indicators</b>					
Order book £bn	<b>5.2</b> +11%	4.7 +96%	2.4 +41%	1.7 +21%	1.4 +17%
Underlying services revenues £m	<b>712</b>	545	487	435	397
Underlying services revenues %	<b>32</b>	35	37	40	41
% of fleet under management	<b>35</b>	33	3	3	0
<b>Underlying revenue</b>	<b>Market opportunity over 20 years</b>				
<b>£2.2bn</b>	<b>US\$320bn</b>				

Marine is now the second largest Rolls-Royce business in revenue terms, with a world-class range of capabilities and expertise in naval surface ships, submarines, offshore oil and gas and merchant vessels. It has equipment installed on over 30,000 vessels, including those of 70 navies, representing a major opportunity for services growth.

The marine business has enjoyed a year of very strong growth. Our revenues since 2005 have doubled and increased by 42 per cent on 2007, driven by continuing growth in our offshore business which itself grew by 38 per cent in 2008. Marine profit has also increased by 62 per cent in 2008.

As our installed base of equipment grows, we are expanding our services capability and investing in new service centres globally to realise the significant opportunity that this represents. In addition, the expertise established in our aerospace businesses, including equipment health monitoring and long-term service agreements, is being applied to further increase marine's service revenues.

The offshore sector has been central to our 2008 performance, based on the success of our specialist UT-Design and integrated systems capability which is the industry benchmark. Driven by significant investment in deep water exploration and production by the oil and gas industry, the sector has generated record sales of £901 million in 2008.

We have been particularly successful in the Asian offshore market, winning orders valued at £666 million in 2008 including contracts worth £84 million to supply propulsion equipment for offshore vessels being built in China and Korea. Two further landmark orders were received from China: a £58 million contract with China Oilfield Services Ltd and a £13 million contract with BGP Marine China to design and equip an advanced seismic research vessel.

During 2008, we acquired Scandinavian Electric Holding, which has further increased our capability in the design and supply of power electric systems. This enhances our ability to provide systems for offshore vessels, thereby increasing our overall market size.

Our proven offshore system capabilities are also being utilised in the development of specialist merchant ships, such as the contract to design and power two vessels for Sea-Cargo AS which will be equipped with innovative gas-fuelled Bergen engines.

Our naval business also won a milestone order in 2008: a £96 million contract to provide power and propulsion equipment, including four MT30 gas turbines, for the UK's new aircraft carriers. As part of the Carrier Alliance, Rolls-Royce is supplying an integrated system which includes the propellers and propeller shafts as well as rudders, stabilisers and some electrical systems.

2008 was the 50th anniversary of our relationship with the UK Government on the design, production and support of nuclear plant for the Royal Navy's submarine fleet. The submarines business is primarily focused on service and support, underpinned by an innovative £1 billion service contract with the MoD signed in 2007.

In 2009, marine will establish a global headquarters in Singapore which will enhance our global position and bring us closer to key customers in Asia.

There were some modest cancellations in 2008 but a record order book, market leading positions in the offshore sector and demand for high specification vessels provide good visibility of revenues in 2009 and support continuing strong growth in profitability over the year.



Technology creating global opportunities:

**Ship design**

A UT-Design vessel, *Pacific Responder*, operating off the eastern coast of Australia on behalf of the country's Maritime Safety Authority. UT-Design offshore support vessels are the market leader in the industry.



Technology creating global opportunities:

**Nuclear power for submarines**

Rolls-Royce is responsible for the nuclear plant powering the submarines of the Royal Navy under a £1 billion service contract.

## Energy

- Industrial Trent achieved record sales of over US\$380 million
- Services business had record year with over 200 gas turbine packages now under TotalCare contracts
- Civil nuclear business established to address the growing global market
- Significant investment in production and test facilities

<b>Key financial data</b>	<b>2008</b>	2007	2006	2005	2004
Underlying revenue £m	<b>755</b> +35%	558 +2%	546 +2%	535 -1%	538 +2%
Underlying profit before financing £m	<b>(2)</b> -140%	5 +128%	(18) -1900%	1 +114%	(7) +61%
Net assets £m	<b>392</b>	370	387	390	453
<b>Other key performance indicators</b>					
Order book £bn	<b>1.3</b> +44%	0.9 +80%	0.5 +25%	0.4 0%	0.4 0%
Engine deliveries	<b>64</b>	32	44	61	47
Underlying services revenues £m	<b>370</b>	289	251	219	248
Underlying services revenues %	<b>49</b>	52	46	41	46
% of fleet under management	<b>9</b>	7	6	5	5
<b>Underlying revenue</b>	<b>Market opportunity over 20 years</b>				
<b>£0.8bn</b>	<b>US\$120bn</b>				

The energy business is a world-leading supplier of power systems for onshore and offshore oil and gas applications, and has a growing presence in the electric power generation sector. It supplies products to customers in over 120 countries.

Order intake remained strong in 2008, with services once again posting a record year and continuing to account for nearly 50 per cent of total energy sales.

African and Asian oil and gas markets were particularly active in 2008, with eight RB211 packages ordered for installation off the shores of West Africa, and six new compression sets for pipeline service in India. Other oil and gas RB211 packages were ordered for customers in China, Malaysia and Algeria.

Of particular significance was a year-end order, for eight Rolls-Royce driven compression sets from a unit of the Russian natural gas company, Gazprom. The new packages will be installed on the Nord Stream pipeline project running under the Baltic Sea from Russia to Germany. They are scheduled for delivery in 2010, with service expected to start in late 2011.

Market acceptance of the industrial Trent drove another record year in the global power generation sector, with orders received in excess of US\$270 million. These included 13 Trents for power generation service in Australia, Belgium, the Czech Republic, Germany, Hungary, New Caledonia and Slovakia.



Technology creating global opportunities:

**Offshore oil and gas**

Rolls-Royce is a world leader in the supply of gas turbine power for offshore oil and gas applications.



Technology creating global opportunities:

**Power generation**

Our industrial Trent gas turbine enjoyed a record year for sales with orders taken from Europe, Asia and North America.

In North America, we continued to establish the Trent's growing footprint in the high-demand north east US power generation market. Successful start-up and commissioning was completed for a Trent genset package at Lowell, Massachusetts, while construction continues for two Trent units at Braintree, Massachusetts for which start-up is scheduled in the second quarter of 2009. Reservations for an additional 18 Trent units in North America were also received.

The aftermarket business experienced another record year in 2008 with sales of £370 million. Over 200 Rolls-Royce gas turbine packages were covered by TotalCare agreements by year-end; this number is expected to increase to over 250 by mid-2009. Our product upgrades business also delivered another strong year, enhancing customer value by applying new gas turbine technology to increase the efficiency and power of in-service units. Over 40 Avon 200 gas turbine upgrades have been delivered over the past two years to increase the power and efficiency of these highly reliable machines, while demand for control system and centrifugal compressor upgrades also continues to grow as a result of enhanced product performance benefits.

As part of our strategy to accommodate growing production volume efficiently, we consolidated packaging operations into our Mount Vernon, Ohio facility and ceased operations at our Liverpool, UK facility. Two new lean assembly flow lines, dedicated to Trent and RB211 packages, were opened in 2008, and construction began on seven new gas turbine test beds which will become operational in the second quarter of 2009.

In 2009, further growth in original equipment revenues, particularly in the power generation sector, combined with increased services activity and lower investment in fuel cells, is expected to deliver a modest level of profit for the business.

While our energy business currently centres on the gas turbine, the skills and technical knowledge within the Group allow us to identify and explore new growth opportunities in the energy market.

The most significant of these in the near term is civil nuclear, where, through our experience of manufacturing and supporting nuclear reactors for the Royal Navy's submarine fleet, we have a strong and unique capability. In 2008, we established a new business to address the market arising from renewed global demand for nuclear power.

## Engineering and Technology

- Global research network expanded
- Further research work in US secured
- Europrop International TP400 flew for the first time
- WR-21, the world's most efficient marine gas turbine, entered service
- Trent 60 WLE dual fuel started service operation

Key performance indicators	2008	2007	2006	2005	2004
Gross research and development expenditure £m	<b>885</b>	824	747	663	601
Net research and development expenditure £m	<b>490</b>	454	395	339	282
Net research and development charge £m	<b>403</b>	381	370	282	288
Net research and development expenditure % of underlying revenue	<b>5.4</b>	5.8	5.4	5.2	4.7

The Group's engineering and technology activity includes our research and technology, product development and product upgrade operations across our four customer-facing businesses.

We have 9,600 people in our worldwide engineering network, with major centres in the UK, USA, Canada, Germany, Scandinavia, India and Singapore. In addition, the Group leverages resources through its global network of 29 University Technology Centres (UTC) in seven countries, which develop and acquire technologies for tomorrow's Rolls-Royce products. This network further expanded in 2008 with the opening of a UTC in Pusan, Korea, to develop high efficiency heat exchangers.

In 2008, we have continued to invest in a broad range of technology development and demonstration programmes. Research and development expenditure was £885 million, of which £490 million was funded from Group resources. The net charge to the income statement was £403 million. A significant proportion of this technology provides the foundation for products with reduced environmental impact while delivering increased value to our customers.

Building on our past research successes we filed 425 patent applications in 2008, a record year for the Group.



Technology creating global opportunities:  
**WR-21**  
 HMS *Daring* has entered service, powered by the world's most efficient marine gas turbine, the WR-21.



Technology creating global opportunities:  
**Factory of the Future**  
 Rolls-Royce has opened its 'Factory of the Future' near Sheffield, UK. It will demonstrate what can be achieved in the field of advanced manufacturing.

We have made good progress on two US Air Force premier technology programmes, ADVENT and HEETE, and won a further award for the Integrated Vehicle Energy Technology Program (INVENT).

In Europe, we successfully ran the Power Optimised Aircraft (POA) engine demonstrator, integrating electrically driven engine components which traditionally are powered mechanically. We also achieved encouraging noise level results from a rig test demonstrating the open rotor aero engine, which has the potential to deliver a step reduction in fuel consumption.

We continued, with partners, to develop two low-carbon energy technologies. The construction of the 500kW underwater tidal power turbine prototype has started and we also began system testing our solid oxide fuel cells. However, we have taken the decision to focus future fuel cells activity on the development of the technology rather than production and manufacturing verification in order to match product readiness with market demand.

Our focus on modern manufacturing continues with the opening of the Factory of the Future, the latest development of the Advanced Manufacturing Research Centre in Sheffield, UK. We are also making good progress on the Advanced Forming Research Centre in Glasgow, UK, and three other manufacturing research centres globally.

In defence aerospace, the Rolls-Royce LiftFan flew on the Joint Strike Fighter in conventional mode, ahead of full system testing in 2009. The TP400, developed by the Europrop International consortium, for the A400M military transport aircraft, flew for the first time on the flying testbed.

In civil aerospace, the Trent 900 demonstrated excellent reliability during its first full year in service with Singapore Airlines and is also in operation with Qantas. The Trent 1000 continues to build its maturity on the test bench, awaiting first flight of the Boeing 787. The first BR725 for the Gulfstream G650 ran on time and the engine is making good progress towards certification. The Trent XWB for the Airbus A350 XWB has now largely completed its preliminary design stage.

Our drive for improved in-service engine reliability continues, with engine health monitoring data and analysis techniques delivering globally competitive and improving levels of fleet reliability.

HMS *Daring*, the first of the WR-21 powered Royal Navy Type 45 destroyers, was handed over to the Royal Navy in 2008. The engine, with its intercooled and recuperated cycle, is the world's most efficient marine gas turbine.

The Littoral Combat Ship USS *Freedom* was commissioned for US Navy service, demonstrating successful integration of two MT30s, the most powerful marine gas turbine in the world, derived from the Trent 800 aero engine. The MT30s together with four Rolls-Royce Kamewa 153 S11 waterjets drive this 3,000 tonne ship at speeds in excess of 40 knots.

The long life nuclear core was successfully installed in the first Astute class submarine for the Royal Navy. With this reactor core the submarine can operate for its whole lifespan without refuelling.

## Operations

- Increased demand from all businesses managed effectively by the supply chain
- New product introductions included the BR725, MT30 and JSF LiftSystem
- Successfully rephased production on Trent 900 and Trent 1000 programmes
- Underlying revenues per employee up 18 per cent
- New joint ventures signed with both GKN plc and Goodrich Corporation

Key performance indicators	2008	2007	2006	2005	2004
Capital expenditure £m	<b>283</b>	304	303	232	191
Product cost index – year-on-year (increase)/decrease %	<b>(4)</b>	(7)	(5)	0	5
Sales per employee £'000	<b>233</b>	193	192	186	169

Our supply chain provides parts for both the original equipment and aftermarket areas of our business. It responded extremely positively to a significant increase in demand from all sectors, supporting a growth in underlying revenue of 17 per cent in 2008. New product introductions and the impact of programme slippages were also managed effectively.

Through our make/buy strategy, we continued to focus on making only those parts which are rich in intellectual property in order to maximise value. The strategy was underpinned by ongoing supply chain rationalisation and the development of strategic supplier relationships, exemplified by the agreement of risk and revenue sharing partnerships for 40 per cent of the Trent XWB programme.

Business process improvements and the ongoing roll out of new process systems like SAP and PLM continued to drive operational efficiency, for example enabling the reduction of 2,300 jobs in support functions. As a result, productivity measured as underlying revenues per employee, improved by 18 per cent on 2007. Our modern domestic factories continued to improve their productivity. However, commodity prices resulted in a product cost index rise of four per cent.

A range of new product introductions was managed during the year, with the first run of the BR725 engine for the Gulfstream G650, first flight of the F-35 STOVL variant for the Joint Strike Fighter (JSF) and plans established to deliver orders for the MT30 naval gas turbine and the JSF LiftSystem. We also successfully rephased our production programmes for the Trent 1000 and 900 engines in response to programme slippages on the Boeing 787 and Airbus A380.



Technology creating global opportunities:

### Global manufacturing

A BR725 in production at the Rolls-Royce facility in Germany. The BR725 is the latest variant of this successful two-shaft engine family. It has been developed to power the new Gulfstream G650 corporate jet.



Technology creating global opportunities:

### Trent 1000

The front fan of a Trent 1000 engine showing its swept wide-chord blade design. The Trent 1000 is the launch engine for the new Boeing 787 Dreamliner aircraft.

In the medium to long term, our record order book will drive a significant increase in the load on our supply chain, though the timing of this increased activity will be affected by programme slippages and the economic downturn. We are phasing the development of our new manufacturing facilities in Singapore and Crosspointe, US, to take account of these impacts in order to meet demand in a timely fashion.

In November 2008, we announced proposed global job reductions for 2009 of around 1,500-2,000, as a result of economic uncertainties and individual programme developments. We will continue to recruit graduates, apprentices and other employees in order to support areas of particular growth.

Our Business Process Improvement programme continued to direct spend on information technology. We continued to introduce our design and data management tool, PLM, and our planning and scheduling tool, SAP, notably into Hong Kong Aero Engine Services Limited (HAESL), our Hong Kong repair and overhaul joint venture. Our services processes will be further enhanced in 2009 with the application of the Maximo planning tool.

We expanded our capability during the year, establishing strategic joint ventures with GKN plc, to develop composite materials for fan blades, and Goodrich Corporation, to develop and manufacture engine controls.

Our success is based on operational excellence, strong partnerships and technological superiority. We would like to thank all our employees, suppliers and partners for their commitment to these core principles and for their hard work during the year.

**Services**

- Service revenues increased by 11 per cent to £4.8 billion
- 57 per cent of the civil aerospace fleet now under TotalCare support
- More than 8,000 engines and auxiliary power units covered by in-service monitoring
- Expansion of joint ventures in Hong Kong and Singapore
- Global repair services created, increasing focus on repair technology
- Expanded capability of global Operation Centres, including satellite sites with two major customers

Key performance indicators	2008	2007	2006	2005	2004
Underlying services revenue £m	<b>4,755</b>	4,265	3,901	3,457	3,251
Underlying services as percentage of Group revenue	<b>52</b>	55	53	54	55

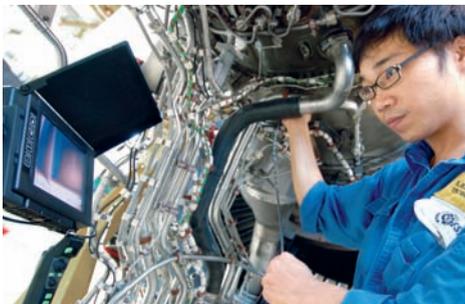
The Group's services business includes field services, the sale of spare parts, equipment overhaul services, parts repair, data management, equipment leasing and inventory management services. These services are typically sold as a package under our TotalCare banner.

Group service revenues increased by 11 per cent in 2008, driven by good progress across all sectors. Services represented 52 per cent of Group revenues. The strongest growth was recorded in marine, demonstrating the value of expanding our service network in this sector. Our latest service centre in Mumbai was opened in May and later in the year we entered into an agreement with Abu Dhabi Shipbuilders to provide waterjet services in the Middle East.

During 2008, we continued to invest in our civil aerospace service network, with extensions to both Singapore Aero Engine Services Limited (SAESL) and Hong Kong Aero Engine Services Limited (HAESL) under construction.

This capacity will come on stream in 2009 and 2011 respectively and is being funded without recourse to the joint venture shareholders. In its first full year of operation, the overhaul facility we have established with Lufthansa, N3, has made steady progress, successfully introducing Trent 700 capability and expanding its customer base. Our field support capability has also been enhanced with the opening of our eighth On-Wing Care centre, in Brazil, and we are developing capability in the UAE in conjunction with Mubadala Development Corporation. On-Wing Care services were provided for over 3,000 engines across the year.

We have continued to expand our services provision with the successful deployment of our Electronic Flight Bag (EFB), now in its third year. The EFB provides, among other applications, a key data acquisition capability to optimise overall aircraft and fleet fuel usage.



Technology creating global opportunities:

**Joint ventures**

HAESL is a joint venture company and part of the global Rolls-Royce repair and overhaul network.



Technology creating global opportunities:

**Long term service agreements**

A Rolls-Royce service representative with a customer at an RB211 power plant in Indonesia. The Group is increasingly signing long term service agreements with energy customers.

The TotalCare model encourages an integrated approach, which means we work closely with our customers to optimise the operation of their assets while carefully managing costs. We conduct in-service monitoring for over 8,300 engines worldwide, providing engine health monitoring and data analysis services in conjunction with our expanded Operations Centres. This enables real-time data acquisition and analysis to maximise operational performance for our customers in parallel with optimising support costs.

We are also increasing the focus on overhaul costs, reorganising our component repair activities during the year to establish Global Repair Services. This organisation takes a strategic approach to repair development and is investing in advanced repair processes.

Contract highlights for the year included agreements with US Airways to support its RB211-535 fleet with a TotalCare package and a similar contract with IAE for its V2500 fleet. TotalCare support arrangements now cover 57 per cent of the civil aerospace fleet. In defence aerospace we competed for and successfully retained the F405 US Navy contract, which we have been executing for the past five years, the new contract being for a further year with four one year extension options. Also notable were a number of helicopter contracts including a £258 million award from the UK MoD to support Gnome engines. In the energy business, ten long-term service agreements were won with a total value of £160 million. We expect to agree a further ten energy contracts covering 50 new gas turbine units that will be installed during 2009, taking the number of packages under long-term service agreements to over 250, or around 20 per cent of the fleet.

The upgrade and standardisation of our IT systems to support the services business continued and underpinned our expanded-capability Operations Centre, opened in the UK during 2008. We have also defined a suite of integrated Service Life Cycle Management processes and supporting IT tools that we are rolling out Group-wide in a multi-year programme. The highlight for the year was a flawless implementation of SAP at HAESL where the site achieved near record output in the month the system went live.

We remain confident that our service model is aligned with our customers' interests, encouraging us to focus on maximising the effectiveness of their assets. This alignment and focus drive the investment in capability and improved delivery that is the hallmark of our services business.



Tracy Graylish  
Help Desk Manager –  
Operations Centre

## Supporting customers with innovative services

We have developed a global network of service centres to support our customers. Increasingly, we are adopting long-term service agreements with customers in all our market sectors, allowing us to work in partnership to maximise the effectiveness of their assets.

### 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 manner creates competitive advantage through:

- attracting and retaining the best people;
- building goodwill and maintaining successful working relationships with customers, suppliers and governments; and
- supporting 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 39,000 employees in more than 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 ethics committee, consisting exclusively of independent non-executive directors;
- the health, safety and environment committee, chaired by the Chief Executive;
- the Environment Council, chaired by the Director – Engineering and Technology;
- the Environmental Advisory Board, chaired by a senior academic from the Massachusetts Institute of Technology;
- the Global Council, chaired by the Director – Human Resources;
- the Global Diversity Steering Group, chaired by the Chief Operating Officer; 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 to the Board. This group comprises the Director – Human Resources, Director – Public Affairs, Director of Risk and the General Counsel and Company Secretary. In addition, the corporate responsibility risk register uses the Group 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 21 to 24.

**External recognition**

Rolls-Royce is ranked in a number of external indices which benchmark corporate responsibility performance, see below:

 <p><b>ENVIRONMENT INDEX 2007</b></p>	<p><b>BitC BiE Index</b> In the 2008 Business in the Environment Index, Rolls-Royce was once again awarded Platinum status and maintained first position in the Aerospace and Defence sector.</p>
 <p><b>CORPORATE RESPONSIBILITY INDEX 2007</b></p>	<p><b>BitC Corporate Responsibility Index</b> In the 2008 Business in the Community Corporate Responsibility Index, Rolls-Royce achieved Gold status.</p>
 <p><b>Dow Jones Sustainability Indexes</b> Member 2008/09</p>	<p><b>Dow Jones Sustainability (World and European) Indexes</b> Rolls-Royce has retained its position in the Dow Jones Sustainability (World and European) Indexes for the seventh consecutive year. Achieving first position in the Aerospace and Defence sector during 2008 confirms the Group's position among the best in class for addressing a range of sustainability issues.</p>

Rolls-Royce has a long history of being a responsible business. We are committed to building on our track record and our obligation to behave responsibly.

## Our approach

Our approach to corporate responsibility is concentrated on four areas of activity:



### Business ethics

High ethical standards are at the heart of the way we do business. Ethical behaviour preserves and enhances our corporate reputation and we support a climate that empowers all of our employees to 'do the right thing.'



### Health, safety and the environment (HS&E)

With its heritage of technological and engineering excellence, Rolls-Royce is well placed to help society address the problems of climate change and energy security. We also believe that good HS&E performance is synonymous with good business performance and we aim to be recognised widely for the excellence of our HS&E performance.



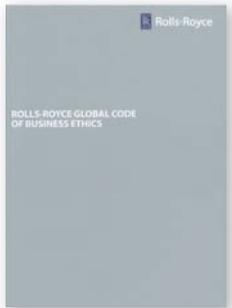
### Employees

We aim to create an inclusive working environment that attracts and retains the best people, enhances their flexibility, capability and motivation, and encourages them to be involved, continuously improving performance. In doing so we deliver on the commitment to all of our stakeholders of being trusted to deliver excellence.



### Society

Rolls-Royce has a firm, long-standing commitment to the communities in which we operate around the world. Sustained investment in communities makes a positive difference and delivers tangible benefits to our business. Corporate responsibility is also a key enabler in delivering our supply chain strategy globally.



#### Global code of business ethics

The code has been circulated to employees and is available in 16 different languages.



#### Confidential reporting line and website

A section on the Group intranet is dedicated to supporting business ethics and includes a confidential reporting procedure.

## Business ethics

The Board believes strongly that the Group's business should be conducted in a way that reflects the highest ethical standards. During 2008, we formed an ethics committee consisting exclusively of independent non-executive directors. The committee will provide a focus for development of the Group's global ethics strategy, our approach to business ethics and the management of ethical and reputational risk. Further details of the committee and its principal terms of reference can be found on page 69.

#### Global code of business ethics

Rolls-Royce has a global code of business ethics which sets out the principles for employees to follow when conducting business and guidance to achieve the required standards. The code is available in 16 languages and can be viewed on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).

#### Training and awareness programme

To ensure the code is embedded, we started a tiered training programme in 2008 that will continue during 2009. The programme includes face-to-face workshops that will be delivered to around 3,700 resource managers across the Group, including 1,200 trained in 2008. These sessions aim to increase awareness of the importance of ethical behaviour while equipping managers with the necessary tools to enable onward communication to their teams and to deal appropriately with ethics related issues or questions. Employee briefings will also be undertaken during 2009.

#### Confidential reporting line and website

An independently operated and confidential ethics reporting facility is available worldwide so employees can raise issues or concerns regarding business conduct outside of the normal management chain. This facility includes telephone numbers and an external website. Rolls-Royce staff can call any one of 30 telephone numbers in countries across the world to report any concerns they may have with regard to business conduct. Calls are made in total confidence and outside the normal management chain, being handled independently by the LRN – EthicsPoint partnership. The ethics committee monitors cases reported, the management of cases and the results from any investigations undertaken.



**HS&E performance**  
The Group places great emphasis on good HS&E performance.



**Third-party certification**  
We are committed to a programme of third-party certification for Occupational Health and Safety management systems across all our businesses by 2012.

## Health, safety and the environment (HS&E)

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 and we aim to have world-class levels of performance across Rolls-Royce sites. These aspirations are supported by a comprehensive strategy and initiatives endorsed by the Group Executive.

### HS&E management

The Group's arrangements for HS&E governance and management systems implementation are detailed in our Policy & Management Arrangements booklet available on [www.rolls-royce.com](http://www.rolls-royce.com). We believe that all cases of work related ill health, injuries and environmental incidents are avoidable.

A full review of the HS&E organisation has been completed during 2008. Improvements aim to increase both the efficiency and effectiveness of HS&E and include the appointment of regional HS&E directors, the development of shared services and the recruitment of high calibre HS&E professionals.

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, US, Canada and Brazil across all businesses. In addition, an independent audit of compliance with COSHH (Control of Substances Hazardous to Health) took place at several UK facilities.

The Group has recently committed to a programme of third-party certification to OHSAS 18001, the standard for Occupational Health and Safety management systems, across all businesses by 2012. This will provide independent assessment across all of the elements of our HS&E management systems. Both the ISO 14001 and the OHSAS 18001 international standards are supported within the Group by a comprehensive range of global standards and include pertinent areas such as risk management.

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 that processes are robust and fit for purpose.

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 continue to work with other companies, trade bodies, sectors and regulators to prepare for implementation.

Efforts have been focused on raising awareness within our supply chain, such that appropriate arrangements for compliance and business continuity, including the targeting of any future 'substances of very high concern', are introduced well ahead of deadlines. Within the aviation sector we have helped the development and launch of international standards for the phased declaration of substances in 'articles' supplied to us to facilitate future REACH compliance and, where required, industry-wide substitution programmes.

We continue to participate and meet our ongoing commitments under various climate change agreements such as the UK Emissions Trading Scheme, the EU Emissions Trading Scheme and the US Chicago Climate Exchange greenhouse gas emissions trading scheme.

**Operational performance**

To achieve our vision we continue to implement robust processes in order to deliver against a number of key objectives and targets by the end of 2009. These are detailed in our latest progress report 'Responsible Operations', which is available on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com). We are already making good progress against these targets across all of our operations and have plans in place to sustain this improving performance.

Our data collection and reporting is subject to independent assurance and recommendations for improvement by Deloitte LLP.

In summary, our 2007-2009 objectives and targets 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

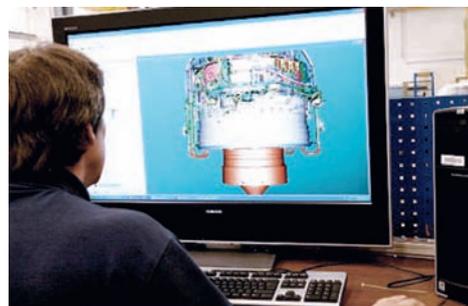
**58%**

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

There were no fatalities in the Group during 2008. It is with regret that we report the death of a contractor while working for a construction company on a new facility at our energy business in Mount Vernon, Ohio. The UK Health & Safety Executive has prosecuted the Group for two incidents during the year and preventative actions have already been taken to avoid reoccurrence of similar incidents in the future. One incident related to the disabling of an interlock device by a machine operator in our Sunderland (UK) manufacturing facility. The second involved the exposure of agency workers to sand during the decommissioning of a foundry in Derby (UK). The sand contained an additive which is known to be an irritant.



**Environment campaign**  
The Group is committed to continuous improvement in its environmental performance.



**EFE programme**  
Rolls-Royce has a leading role in the Environmentally Friendly Engine research programme.

**Product environmental performance**

Rolls-Royce has a heritage of environmental innovation which means the Group is well placed to help society address the problems of climate change and energy security. We are determined to play a significant role in overcoming these challenges.

The priority we attach to the environment is reflected in the profile of our research and development expenditure, investing more than £800 million every year of which at least two-thirds is directed at reducing the environmental impact of our products and operations.

Thanks to our technological expertise, we have significantly reduced the fuel consumption of our civil engines since the first jet airliners entered into service along with substantial reductions in smoke and noise. For example, the Trent 1000 engine is 25 per cent more efficient than the first RB211 engine.

The Trent 900 and 1000 engines, for the Airbus A380 and Boeing 787 respectively, and in future the Trent XWB for the Airbus A350 XWB, help us make progress towards meeting our ACARE (Advisory Council for Aeronautics Research in Europe) goal of a 15-20 per cent reduction in engine fuel burn by 2020 compared to 2000 levels.

We are taking a leading role in research, including the Environmentally Friendly Engine (EFE), a joint Government, industry and university programme, aimed at improving the environmental performance of an aero engine. In 2008, the European Commission approved the launch of the Clean Sky, Joint Technology Initiative, in which Rolls-Royce will lead a €400 million engine research programme over the next seven years.

Environmental performance is fundamental across all of our businesses. For example, in the marine sector, our market leading Azipull thrusters use 16 per cent less fuel than conventional thrusters. This means that ships use less energy resulting in lower emissions.

The Group is investing in other renewable energy sources such as tidal power, working in partnership with the UK Energy Technologies Institute. In addition, we are working with fuel companies to ensure that future biofuels meet our requirements, with the important caveats that they are sustainable, do not compete with the growth of food crops and are used in the most effective way to maximise the reduction in greenhouse gas emissions.

Nuclear power will represent an important component of future low-carbon electricity generation, sitting alongside renewables and other measures. In 2008, Rolls-Royce established a new civil nuclear business unit in response to the opportunities presented by future expansion of civil nuclear power.

The Group believes that technology must be applied on an industrial scale, through companies such as Rolls-Royce with its global reach, to achieve significant reductions in emissions to address climate change. The Group's report on environmental performance, 'Powering a better world', is available on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).



¹ SFC: fuel consumption normalised for engine power  
ACARE: Advisory Council for Aeronautics Research in Europe



#### Employee engagement

The Group is committed to a programme of surveys to monitor and improve engagement with employees.



#### Global Council

Our Global Council meets twice a year and includes employee representatives from around the world.

## Employees

At the end of 2008, Rolls-Royce employed 38,900 permanent staff in over 50 countries.

The long life cycle of the Group's products makes it imperative that we have a skilled workforce that is committed to delivering excellence to customers over the long term. To achieve this, we aim to create an inclusive 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.

### 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 or delegates from around the world with senior management from each business and function. In addition, an executive committee of eight elected delegates meets regularly throughout the year to support regular dialogue and timely consultation between council meetings. In 2008, full council meetings were held in Berlin (Germany) and Derby (UK).

In 2008, we conducted the annual Corporate Storyboard, an interactive Group-wide briefing on corporate direction and performance. Delivered face-to-face to all employees globally, the storyboard ensures all employees across the business have a good understanding of the Group's key objectives and the individual contribution each can make. The initiative builds on the success of the first Strategy Storyboard, which was widely welcomed by our employees.

During 2008, our Employee Engagement Survey was redesigned and incorporated into a two-year rolling global engagement programme. This will improve our ability to test, identify necessary actions and better understand employees' level of engagement across the organisation and will be vital in signalling the areas to focus on to improve engagement within the organisation. The new survey was launched in January 2009.

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 have currently committed 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.



**Attracting employees in Asia**

We continue to make good progress in attracting employees in Asia.



**Encouraging diversity**

Rolls-Royce is committed to developing a diverse workforce.

**Encouraging diversity**

The Group is committed to developing a diverse workforce and equal opportunities for all. This includes encouraging more women and people from minority backgrounds to pursue engineering careers. During 2008, we recruited graduates for our worldwide graduate programme from 32 nationalities and apprentices in the UK and Germany for our apprentice programme from nine nationalities. Our global governance framework for diversity includes a senior executive Global Diversity Steering Group that provides leadership and shapes strategic direction.

In Asia we continue to make good progress in attracting the highest quality leadership talent. Several key management roles in Asia have provided the opportunity to recruit new senior local management. As the demand signal for early career high potential talent strengthens in the region, we have also engaged with several universities in China, India and Singapore to encourage students to apply for our graduate recruitment and development programme.

Launched in 2006, our UK Women's Network continues to grow, focusing on personal and professional skills development as well as providing support through networking and mentoring frameworks.

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

**Learning and development**

2008 was a year of transformation for Learning and Development. A new global Centre of Excellence, staffed by experienced professionals, supports businesses with the identification of strategic training priorities together with the design and procurement of new development initiatives.

The implementation of 'My Learning', a global customised Learning Management System, enables us to define behavioural and technical competencies by role and align learning and development to competency profiles resulting in a more focused, speedier and personalised training service.

We continue to develop our delivery of face-to-face and online learning for our employees. During 2008, we have provided 3,400 days of leadership training, 39,000 hours of online learning and 4,600 days of engineering systems training. We continue to deliver global programmes such as business ethics training, delivered to 1,200 senior leaders in 2008, and the Corporate Storyboard rollout to employees using trained facilitators.

**Resourcing and deployment**

The creation of a new global Centre of Excellence for Resourcing and Deployment consolidates our approach to strategic workforce planning, recruitment and performance management and the development of employee capability.

We pursue professional depth and capability across all of our functions and the Centre of Excellence spreads best practice globally, primarily through development cell activity.

Development cells are regular forums held with senior leadership teams through which we manage our leadership succession and individual career development. Discussions are directly aligned to the development of resourcing plans which identify the need for managerial, MBA, graduate and apprentice resourcing requirements.

During 2008, we recruited 141 graduates and 233 apprentices and technicians worldwide and an additional 278 students were employed on short-term training projects in the UK and North America. We remain in the upper quartile of The Times Top 100 Graduate Employers' survey and have moved to first position for engineering companies. Over 400 employees have benefited from financial support and time off work to attend further education programmes at local colleges and universities, and we provided £460,000 to finance this type of learning. Overall we have invested £30 million in the education, training and professional development of employees during the year.

### Health and wellbeing

The Group is committed to promoting best practice in occupational health and now provides professional expertise through highly regarded outsourced providers. The primary objective of the Group's occupational health strategy remains a culture of prevention rather than cure.

The strategy maintains four key areas of focus:

- screening and surveillance;
- rehabilitation;
- health promotion; and
- education.



**'Know your body metrics' health promotion campaign**  
Produced to raise awareness and understanding of cardiovascular risk factors.

We have demonstrated good progress against our screening and surveillance targets. These are detailed in our report 'Responsible Operations', published in April 2007 which is available on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).

791 employees in our operations functions completed the Health Risk assessment pilot programme. The greatest return from this tool was encouraging the majority who were at low risk to maintain their health and wellbeing.

An 'Owners Handbook' health manual produced in conjunction with the Men's Health Forum was issued to all employees in 2007 and 2008. This covered all aspects of general lifestyle and wellbeing for both men and women.

A 'Know your body metrics' health promotion campaign was rolled out in 2007 and carried on into 2008 to raise awareness and understanding of cardiovascular risk factors. Over 3,000 employees have been screened at travelling wellness booths. This has been our most successful campaign to date during which 14 per cent were referred onward as the result of cholesterol levels and five per cent for glucose levels.

An anonymous online questionnaire found that the 'Owners Handbook' and the 'Know your body metrics' booklet were rated as 'good to excellent' by more than 80 per cent of respondents. Some 45 per cent said they had made beneficial lifestyle changes as a result of the information.

A pilot programme in one of our business units is taking place with the Sainsbury Centre for Mental Health based on the successful Australian programme entitled 'beyondblue', designed to help managers to identify depression in the workplace by involving them in a series of management training and awareness sessions. A health promotion campaign on sleep and fatigue was also undertaken in the autumn of 2008.



**'Owners Handbook' health manual**  
Produced in conjunction with the Men's Health Forum covering all aspects of general lifestyle and wellbeing for both men and women.

## Society

### Suppliers

The Group sets and manages 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.

The Group continues 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.

The expansion of sourcing in Asia and the Americas continues, along with supplier training and the sharing of best practice. During 2008, we expanded our supplier training programme by 25 per cent.

Promotion of 'lean' techniques and waste elimination continues, such as our drive to reduce packaging waste. We have also run a pilot programme, engaging 30 suppliers, which has identified significant environmental benefits which we will continue to develop.

Continuing our success in recycling metals within our manufacturing facilities, including 1,250 tonnes in 2008, we are now working with our suppliers to support them in recycling their waste metals. We have also introduced metal recycling opportunities as a consideration in our sourcing decision process.

Building on internal success, we have conducted trials with 11 suppliers to embed process basics such as HS&E, visual management and workplace organisation. Self-assessment allows suppliers to create programmes to improve their performance and the feedback has been very encouraging.

Rolls-Royce supports the voluntary MoD Charter on Sustainable Procurement. The Charter defines sustainable procurement as meeting demand for goods, services, works and utilities in a way that achieves value for money with minimal adverse impacts on the environment and society. We will monitor progress over the coming years across all elements of the maturity matrix, one of which is engaging suppliers.

The use of e-business conferencing has doubled during 2008, improving global co-working particularly in the area of supply chain management.

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 long-standing 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, 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 2008, we conducted our fifth 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 £6.8 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 £1.6 million, of which £1.1 million were made in the UK. These included support for Community Foundations, The Prince's Trust and Help for Heroes. Elsewhere, Rolls-Royce made charitable donations of £300,000 in North America, £100,000 in Germany and £100,000 in other regions. These donations included support for the work of United Way in North America and for the victims of the earthquake in China, among others.



Prince's Trust



#### Charitable donations

The Group made charitable donations amounting to £1.6 million, of which £1.1 million were made in the UK. These included support for Community Foundations, The Prince's Trust and Help for Heroes.

A further £2.7 million was contributed in sponsorships and educational programmes, including the Smithsonian National Air and Space Museum in North America, the Brandenburg Summer Festival in Germany, and sponsorship of the Cub Scout Scientist Badge in the UK.

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 education programme, the Rolls-Royce Science Prize, recognises excellent and innovative science teaching in the UK and Northern Ireland. This year's winner, St Anne's Primary School in Antrim, Northern Ireland, received a total of £20,000 for their project on the treatment and uses of water. In all, £120,000 was awarded to 59 schools to improve science teaching and learning.

During 2008, the Science Prize programme was extended through the sponsorship of Project ENTHUSE. This project will provide free professional development courses to teachers in the UK through the National Science Learning Centre.

#### Employee time

Employee time contributed during 2008 is estimated at a value of at least £1.7 million, with more than 4,000 employees participating in activities such as community projects and team building activities with societal benefits.



#### Science Prize

The Rolls-Royce Science Prize continues to attract entries from schools all over the UK.

A number of employees in the UK, North America and Germany completed a substantial community project as part of their personal development. Over 150 employees took part in 15 projects during the year, which are recognised at the Group's Annual Learning and Development Awards.

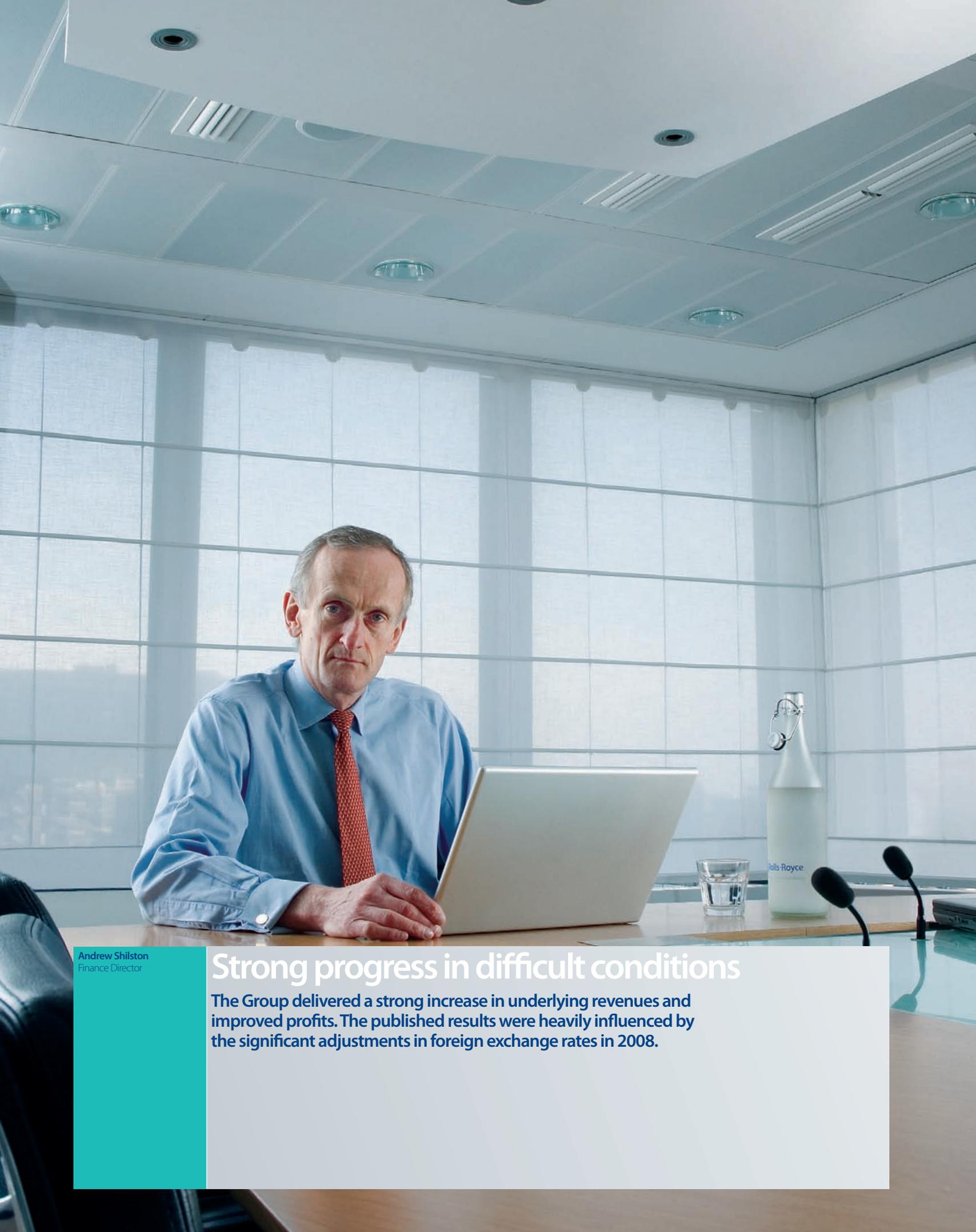
A UK project with arts partner sinfonia ViVA was awarded the Arts & Business People Development Award 2008, which recognised our innovative approach to managing business change through an arts-based programme for team building.

#### Employee giving

In addition to the Group's own contributions, Rolls-Royce finances the administration of a Payroll Giving Scheme for UK employees, enabling them to make tax-free donations to their chosen charities. During 2008, employees gave almost £444,000 to more than 350 charitable causes of their choice. The scheme is recognised as Gold Award standard by the UK Government's Payroll Giving Quality Mark, with approximately 16 per cent of employees participating in the scheme. In North America, employees have contributed £172,000 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 places on Group training courses and the loan of engines and components.



**Andrew Shilston**  
Finance Director

## Strong progress in difficult conditions

The Group delivered a strong increase in underlying revenues and improved profits. The published results were heavily influenced by the significant adjustments in foreign exchange rates in 2008.

## Introduction

The progress made by the Group in 2008 should be viewed against a rapidly deteriorating external environment with significant negative pressures starting to influence many industries and companies.

The Group delivered a strong 17 per cent increase in underlying revenues, a ten per cent increase in underlying profit before tax to £880 million and a further £570 million cash inflow which benefited from retranslation effects. The strong improvement in profits was achieved despite some significant headwinds, notably a further eight cents deterioration in the GBP/USD achieved rate that cost the Group £104 million in 2008; and there was a four per cent increase in unit costs.

The published results were heavily influenced by the significant adjustments in foreign exchange rates in 2008, especially the GBP/USD and the GBP/EUR which are explained below.

The Group benefited from a strong financial position and credit rating with net cash of £1,458 million at the year end and with average net cash throughout the year of £375 million. The changes made to the Group's UK pension schemes in 2007 mean that the deficit has remained stable and modest and the schemes ended the year with a net deficit of £142 million, as detailed in note 18 of the financial statements on page 126. The very unusual circumstances that have developed through 2008 in global debt markets have, however, caused a large, unrecognised surplus to develop on the UK defined benefit pension schemes.

The redemptions on the Group's existing bond financing, at around £1.0 billion, are well spread with no material maturities in 2009, US\$187 million due in the second half of 2010 and a €750 million note due in 2011 as shown in the chart below. The Group had a further £650 million in term funding available to it that was undrawn at the year end.

### Maturity profile of outstanding Group debt facilities

£m



## Foreign exchange effects on published results

The pace and extent of currency movements have had a significant effect on the Group's financial reporting in 2008, with the sterling exchange rate with the US dollar and the euro having the biggest impact. These movements have influenced both the reported income statement and the cash flow and closing net cash position, (as set out in note 2 and the cash flow statement in the financial statements), in the following ways:

**1. Income statement** – the most important impact was the end of year mark to market of outstanding financial instruments (foreign exchange contracts, interest rate, commodity and jet fuel swaps). The principal adjustments related to the GBP/USD hedge book.

The principal movements in 2008 were as follows:

	Open	Close
GBP – USD	£1 – \$1.991	£1 – \$1.438
GBP – EUR	£1 – €1.362	£1 – €1.034
Oil – Spot Brent	\$93/bbl	\$49/bbl

The impact of this mark to market is included in net financing in the income statement and caused a net £2.5 billion cost, contributing to a published loss before tax of £1,892 million. These adjustments are non-cash, accounting adjustments required under IAS39 *Financial Instruments: Recognition and Measurement*. As a result, reported earnings do not reflect the economic substance of derivatives that have been settled in the financial year, but do include the unrealised gains and losses on derivatives that will only affect cash flows when they are settled at some point in the future to match trading cash flows.

Underlying earnings are presented on a basis that shows the economic substance of the Group's hedging strategies in respect of transactional exchange rates and commodity price movements. Further details and information are included within the section on key performance indicators on page 15 and in notes 2 and 5 of the financial statements.

The achieved rate on selling net US dollar income will be similar in 2009 to that in 2008 and will gradually improve thereafter as the Group is able to absorb the lower value of sterling in its hedge books into the achieved rate. The revaluation costs, which are measured at a point in time, do not, therefore, represent additional currency headwinds. The improving average rate in the hedge book will lead to improving achieved rates over time.

**2. Cash flow and balance sheet** – the Group maintains a number of currency cash balances which vary throughout the financial year. Given the significant movements in foreign exchange rates in 2008, a number of these cash balances were inflated by the effects of retranslation at the year end, causing an increase of £439 million in the 2008 cash flow and hence the closing balance sheet cash position.

## Summary

The Group's revenues increased by 22 per cent in 2008 to £9,082 million with 84 per cent of revenues from customers outside the UK.

- Underlying growth of 11 per cent in civil aerospace revenues was supported by strong growth from original equipment with 987 engines delivered in the year, a 16 per cent increase over 2007, and growth across all sectors – widebody, narrowbody and corporate and regional. Services revenues increased by seven per cent over 2007.
- Underlying defence aerospace revenues were similar to 2007 with new equipment revenues down seven per cent and services revenues increasing by eight per cent over 2007.

- The marine business continued to grow rapidly in 2008 with underlying revenues increasing 42 per cent from 2007 to £2,204 million, driven by strong demand for product and support in the offshore oil and gas sector. Overall new equipment revenues increased by 49 per cent to £1,492 million with services revenues increasing 31 per cent to £712 million.
- The energy business made good progress in the year with underlying revenues up 35 per cent, supported by good growth in both original equipment and services activities.

Overall underlying services revenues increased by 11 per cent in 2008 to £4,755 million and accounted for 52 per cent of Group revenues for the year.

Underlying profit margins before financing costs reduced slightly from 10.6 per cent in 2007 to ten per cent in 2008. The reduction in margin was the result of an increased proportion of original equipment to service revenues, increased unit costs and further headwinds on foreign exchange. These were partially offset by the benefits of increased volumes, improving productivity and cost reduction activity. Underlying financing costs remained relatively stable at £39 million (2007 £32 million) including net interest of £10 million and finance costs associated with financial risk and revenue sharing partnerships.

Restructuring charges in 2008 increased to £82 million (2007 £52 million) as the Group continued its focus on operational improvements, including the reduction in the number of people working in support functions. These costs are included within operating costs.

A final payment to shareholders of 8.58p per share, in the form of C Shares, is proposed, making a total of 14.30p per share, a ten per cent increase over the 2007 total.

## Order book

The order book at December 31, 2008, at constant exchange rates, was £55.5 billion (2007 £45.9 billion) with strong growth across all divisions.

This included firm business that had been announced but for which contracts had not yet been signed of £6.1 billion (2007 £7.1 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 26 per cent of the order book, having increased by £1.4 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 11 per cent on an underlying basis in 2008 and accounted for 52 per cent of Group revenue.

In particular, TotalCare packages in the civil aerospace sector now cover 57 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 £848 million (2007 £550 million).

## Cash

Cash inflow during the year was £570 million (2007 £562 million, before the special injection of £500 million into the UK pension schemes).

Continued growth in underlying profits and good cash conversion were supported by increases in customer deposits and progress payments of £400 million and the benefit of £439 million from year-end currency revaluations.

Working capital increased by £38 million during the year with increased inventory of £208 million, offset by reduced financial working capital of £170 million. Inventory increased in the year to support growth across all businesses and to minimise disruption during the transition to new operational facilities. Some reductions in deposits are expected in 2009.

Cash investments of £675 million in property, plant and equipment and intangible assets and payments to shareholders of £200 million represented the major cash outflows in the period. Tax payments increased in the year to £117 million (2007 £71 million).

As a consequence average net cash was £375 million (2007 £350 million). The net cash balance at the year end was £1,458 million (2007 £888 million).

## Taxation

The overall tax credit on the loss before tax was £547 million (2007 £133 million charge), a rate of 28.9 per cent (2007 18.1 per cent). The tax credit in 2008 mainly reflects the loss caused by the mark to market of outstanding financial instruments at the year end.

The tax charge on underlying profit was £217 million (2007 £193 million) a rate of 24.7 per cent (2007 24.1 per cent).

The overall tax credit was increased by £25 million in respect of the expected benefit of the UK research and development tax credit. This reduced the underlying tax charge by the same amount. In addition, £11 million of provisions for prior years' tax liabilities were written back following settlement of a number of outstanding tax issues. The underlying tax rate is expected to increase to around 26 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 of negotiation or litigation.

The Group believes that it has a duty to shareholders to seek to minimise its tax burden but to do so 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 following a policy of full disclosure in order to effect the timely settlement of its tax affairs and to remove uncertainty in its business transactions. Where appropriate, the Group enters into consultation with tax authorities to help shape proposed legislation and future tax policy.

Transactions between Rolls-Royce subsidiaries and associates in different jurisdictions are conducted on an arms-length basis and priced as if the transactions were between unrelated entities, in compliance with the OECD Model Tax Convention and the laws of the relevant jurisdictions.

Before entering into a transaction the Group makes every effort to determine the tax effect of that transaction with as much certainty as possible. To the extent that advance rulings and clearances are available from tax authorities, in areas of uncertainty, the Group will seek to obtain them and adhere to their terms.

## Pensions

The charges for pensions are calculated in accordance with the requirements of IAS 19 *Employee Benefits*.

The decision by the trustees of each of the principal UK defined benefit schemes, in consultation with the Group, to adopt a lower risk investment strategy during 2007 has served its members and the Group well during 2008.

The combination of:

- i) reducing the overall UK pensions asset allocation to equities from approximately 80 per cent to 20 per cent;
- ii) hedging the majority of interest rate and inflation risks associated with the pension liabilities, using swap contracts backed by short-term money market assets; and
- iii) an incremental £500 million cash contribution from the Group to the main UK defined benefit schemes in 2007,

has significantly reduced volatility and losses as equity prices and interest rates have fallen.

Reducing the volatility of the pension schemes is the primary objective of the revised investment strategy to enable the trustees and the Group to plan a schedule of more stable contributions with greater confidence of the schemes being fully funded in the future.

Further information and details of the pensions' charge and the defined benefit schemes' assets and liabilities are shown in note 18 to the financial statements. The net deficit, after taking account of deferred tax, was £93 million (2007 £88 million). Changes in this net position are affected by the assumptions made in valuing the liabilities and the market performance of the assets.

## 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 £885 million (2007 £824 million). Net research and development charged to the income statement was £403 million (2007 £381 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 charged within the income statement in 2009.

The continued development and replacement of operational facilities contributed to the total investment in property, plant and equipment of £283 million (2007 £304 million). Investment in 2009 is anticipated to be slightly reduced from the 2008 level as the investments in new facilities in the US and Singapore are rephased to reflect the timing of major new airframe programmes.

Investment in training was £30 million (2007 £30 million).

## Intangible assets

The Group carried forward £2,286 million (2007 £1,761 million) of intangible assets. This comprised purchased goodwill of £1,008 million, engine certification costs and participation fees of £403 million, development expenditure of £456 million, recoverable engine costs of £213 million and other intangible assets of £206 million.

Expenditure on intangible assets is expected to increase modestly in 2009.

## 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 partnerships.

### 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 common 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 partnerships (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 engine 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. Partners share financial investment in the programme, in general they share:

- market risk as they receive their return from future sales;
- currency risk as their returns are denominated in US dollars;
- sales financing obligations;
- warranty costs; and
- where they are manufacturing or development partners, 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 in the accounting policies on page 91.

In 2008, the Group received other operating income of £79 million (2007 £50 million).

Payments to RRSPs are recorded within cost of sales and increase as the related programme sales increase. These payments amounted to £268 million (2007 £199 million).

The classification of financial RRSPs as financial instruments has resulted in a liability of £455 million (2007 £315 million) being recorded in the balance sheet and an associated underlying financing cost of £26 million (2007 £26 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 (see page 69) 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 described on page 80.

## Counterparty credit risk

The Group has an established policy for 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 it 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 a short-term credit rating of 'A-1' from Standard & Poor's or better and 'P-1' from Moody's. Counterparty diversification is achieved with suitable risk-adjusted concentration limits. Investment decisions are refined through a system of monitoring real-time equity and credit-default swap (CDS) price movements of potential investment counterparties which are compared to other relevant benchmark indices and then risk-weighted accordingly.

During 2008, the Group did not experience any capital losses relating to its investments as a result of the credit crisis.

The Group increased its borrowing facilities during 2008 with the addition of a new £200 million loan facility from the European Investment Bank (EIB) relating to research and development. As at December 31, 2008 the Group had total committed borrowing facilities of £1.7 billion (2007 £1.5 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.

The Group's £250 million bank revolving credit facility contains a rating price grid, which determines the borrowing margin for a given credit rating. The Group's current borrowing margin would be 20 basic points (bp) over sterling LIBOR if drawn. The borrowing margin on this facility increases by approximately 5bp per one notch rating downgrade, up to a maximum borrowing margin of 55bp. The facility was not drawn during 2008.

There are no rating price grids contained in the Group's other borrowing facilities.

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

## Credit rating

The Group subscribes to both Moody's Investors Service and Standard & Poor's for its official publicised credit ratings. As at December 31, 2008 the Group's 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 an investment grade credit rating, which it views as necessary for the business to operate effectively.

The Group's objective is to maintain an '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 and manages its translational exposures through the currency matching of assets and liabilities where applicable. The matching is reviewed regularly, with appropriate risk mitigation performed 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 26 per cent of Group revenues in 2008 (2007 25 per cent). US dollar income converted into euros represented four per cent of Group revenues in 2008 (2007 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**

	2008	2007
USD per GBP		
– Year-end spot rate	<b>1.438</b>	1.991
– Average spot rate	<b>1.854</b>	2.001
EUR per GBP		
– Year-end spot rate	<b>1.034</b>	1.362
– Average spot rate	<b>1.258</b>	1.461

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 2008 the Group had US\$17.1 billion of forward cover (2007 US\$9.4 billion).

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates. Note 16 to the financial statements includes the impact of revaluing forward currency contracts at market values on December 31, 2008, showing a negative value of £2,181 million (2007 positive value of £379 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, on a similar basis to that adopted for currency risks, 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 corporate governance section. 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 were divided approximately 55:45 between AVGs and credit guarantees in 2008 (2007 55:45). 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 23 to the financial statements describes the Group's contingent liabilities. There were no material changes to the Group's gross and net contingent liabilities during 2008.

## Accounting standards

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU. No standards or interpretations that become effective during 2008 had a significant impact on the Group's financial statements.

A summary of other changes, which have not been adopted in 2008, is included within the accounting policies in note 1 to the financial statements.

## Share price

During the year the Company's share price decreased by 39 per cent from 546p to 335.5p, compared to a 28 per cent decrease in the aerospace and defence sector and a 31 per cent decrease in the FTSE100. The Company's shares ranged in price from 547p in January to 249p in October.

The number of ordinary shares in issue at the end of the year was 1,844 million, an increase of 24 million of which 12 million related to share options and 12 million related to conversion of B Shares into ordinary shares.

The average number of ordinary shares in issue was 1,820 million (2007 1,800 million).

## Andrew Shilston

Finance Director  
February 11, 2009

<b>65</b>	<b>Board of directors</b>	<b>80</b>	<b>Internal control and risk management</b>
65	Biographies	80	Directors' responsibility for internal control
66	Group Executive and Advisory Boards	80	Organisation structure
67	Composition of the Board	80	The risk management system
67	Independence of the non-executive directors	80	Systems of internal control
67	Role of the Board	<b>81</b>	<b>Shareholders and share capital</b>
67	Directors' induction, training and information	81	Share capital and voting rights
68	Board effectiveness	81	Payments to shareholders
68	Conflicts of interest	81	Communication with shareholders
68	Indemnity	81	Share class rights
<b>69</b>	<b>Board committees</b>	82	Restrictions on transfer of shares and limitations on holdings
69	Attendance at meetings of the Board and its principal committees in 2008	82	Shareholder agreements and consent requirements
69	Remuneration committee	82	Authority to issue shares
69	Nominations committee	82	Authority to purchase own shares
69	Audit committee	82	Voting rights
69	Ethics committee	82	Major shareholdings
69	Risk committee	<b>83</b>	<b>Other statutory information</b>
<b>70</b>	<b>Directors' remuneration report</b>	83	Political donations
70	Introduction	83	Change of control
70	The remuneration committee	83	Essential commercial relationships
70	Remuneration policy	<b>84</b>	<b>Annual report and the financial statements</b>
70	The main components of remuneration	84	Statement of directors' responsibilities
72	Service contracts	84	Going concern
72	External directorships of executive directors	84	Disclosure of information to auditors
73	Non-executive directors	84	Responsibility statement
73	Performance graph		
74	Aggregate directors' remuneration		
74	Directors' emoluments		
74	Payments made to former directors of the Company		
75	Pensions		
76	Directors' share interests		
78	Share options		
78	Long-term incentive awards		

Rolls-Royce attaches the highest priority to corporate governance, the system by which the Company is directed, managed and controlled in the interests of all its stakeholders. The strength of the Company's corporate values, its reputation and its ability to achieve its objectives are influenced by the effectiveness of the Company's approach towards corporate governance.

The Company is subject to the Combined Code on Corporate Governance published in June 2006 by the Financial Reporting Council (the Combined Code). A copy of the code can be obtained free of charge from FRC publications, telephone: +44 (0)20 8247 1264, email: [customer.services@cch.co.uk](mailto:customer.services@cch.co.uk) and online at: [www.frcpublications.com](http://www.frcpublications.com).

The Board confirms that throughout 2008, the Company complied with the Combined Code. This report explains how the Company discharges its corporate governance responsibilities.

# Board of directors

At February 11, 2009

## Simon Robertson

### Non-executive Chairman

Chairman of the nominations committee

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 and a Trustee of The Eden Project and the Royal Opera House Endowment Fund. He is the former President of Goldman Sachs Europe Limited. Age 67.

## Sir John Rose

### Chief Executive

A member of the nominations committee

Appointed to the Board in 1992, having joined Rolls-Royce in 1984, and has been Chief Executive since 1996. He is a Trustee of The Eden Project. Age 56.

## Helen Alexander CBE

### Non-executive director

Chairman of the remuneration committee and a member of the ethics and nominations committees

Appointed to the Board in September 2007, she is a Senior Adviser of Bain Capital and a non-executive director of Centrica plc. She is Chair of the Advisory Board, Said Business School, Oxford University, a Trustee of the Tate Gallery and a governor of St Paul's Girls' School. Former CEO of the Economist Group from 1997 to 2008, she was awarded a CBE for services to publishing in 2004. She was Chairman of PPA, the magazine industry trade association, from 2006 to 2008. Age 52.

## Peter J Byrom BSc, FCA

### Non-executive director

A member of the remuneration, ethics and nominations committees

Appointed to the Board in 1997, he is Chairman of Domino Printing Sciences 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 64.

## Iain C Conn

### Non-executive director, Senior Independent Director

A member of the audit and nominations committees

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 Business School. Age 46.

## Professor Peter Gregson

### Non-executive director

A member of the remuneration and nominations committees

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. Age 51.

## 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 PrivateBank 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 63.

## Dr John McAdam

### Non-executive director

A member of the remuneration and nominations committees

Appointed to the Board in February 2008, he is Chairman of United Utilities PLC and Rentokil Initial plc, the Senior Independent Director of J Sainsbury plc and a non-executive director of Sara Lee Corporation. He was the Chief Executive of ICI plc until ICI's acquisition by Akzo Nobel. Age 60.

## John Neill CBE

### Non-executive director

A member of the audit and nominations committee

Appointed to the Board in November 2008, he is the Chief Executive of the Unipart Group of Companies. He is a member of the Council and Board of Business in the Community and is a non-executive director of Charter plc. He is Vice President of the Society of Motor Manufacturers and Traders, BEN, the automotive industry charity and The Institute of the Motor Industry. Age 61.

## John Rishton

### Non-executive director

Chairman of the audit committee and a member of the ethics and nominations committees

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 50.

## Andrew B Shilston MA, ACA, MCT

### Finance Director

Appointed to the Board in 2003 having joined Rolls-Royce in 2002, he was a non-executive director of Cairn Energy PLC until May 2008 and he was Finance Director of Enterprise Oil plc from 1993 until 2002. Age 53.

## 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 53.

## Ian C Strachan

### Non-executive director

Chairman of the ethics committee and a member of the audit and nominations committees

Appointed to the Board in 2003, he is a non-executive director of Johnson Matthey plc, Xstrata plc, Transocean Inc and Caithness Petroleum Limited. He is the former Chief Executive of BTR plc, former Deputy Chief Executive (1991 to 1995) and Chief Financial Officer (1987 to 1991) of Rio Tinto plc, former non-executive Chairman of Instinet Group Inc and former non-executive director of Commercial Union and Reuters Group plc. Age 65.

## Mike J Terrett

### Chief Operating Officer

Appointed to the Board in 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 52.

## 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 48.

## The Group Executive

The Group Executive is responsible for the management of the Group within the strategy determined by the Board. It is chaired by Sir John Rose, Chief Executive, and its other members are:

<b>Axel Arendt</b>	President – Defence Aerospace	<b>Dr Mike Lloyd</b>	Director – Manufacturing
<b>Charles Blundell</b>	Director – Public Affairs	<b>Alain Michaelis</b>	President, Gas Turbine Supply Chain & Deputy Chief Operating Officer
<b>Tom Brown</b>	Director – Human Resources	<b>Dr Mike Orris</b>	Chief Procurement Officer
<b>Miles Cowdry</b>	Director – Global Corporate Development	<b>John Paterson</b>	President – Marine
<b>Tom Curley</b>	President – Energy	<b>Tim Rayner</b>	General Counsel and Company Secretary
<b>James Guyette</b>	President and Chief Executive Officer of Rolls-Royce North America Inc.	<b>Andrew Shilston</b>	Finance Director
<b>Dr Michael Haidinger</b>	President – Rolls-Royce Deutschland Ltd & Co KG	<b>Colin Smith</b>	Director – Engineering and Technology
<b>Lawrie Haynes</b>	President – Nuclear	<b>Mike Terrett</b>	Chief Operating Officer
<b>Mark King</b>	President – Civil Aerospace	<b>Tony Wood</b>	President – Services

## International Advisory Board

The International Advisory Board (IAB), formed in 2006, advises the Group on emerging political, business and economic trends. Membership of the IAB is as follows:

<b>Lord Powell of Bayswater</b>	Chairman of IAB, former Foreign Affairs and Defence Adviser to Prime Ministers Margaret Thatcher and John Major	<b>Mustafa Koç</b>	Chairman of Koç Holding AS
<b>Bernard Duc</b>	Senior Partner, HMI Ltd (Hong Kong), Chairman of the Rolls-Royce South East Asia Advisory Board, former Deputy Chairman of the Rolls-Royce European Advisory Board	<b>Taizo Nishimuro</b>	Chairman of Tokyo Stock Exchange Group Inc. and former Chairman of Toshiba Corporation
<b>Sir Rod Eddington</b>	Non-executive Chairman, Australia & New Zealand JPMorgan Chase Bank NA and former Chief Executive, British Airways Plc	<b>Lubna Olayan</b>	CEO of the Olayan Financing Company
<b>Dr Fan Gang</b>	Professor at China's Academy of Social Sciences and Head of National Economic Research Institute	<b>Eduardo Serra</b>	Former Spanish Defence Minister
<b>Carla Hills</b>	Chair and CEO, Hills & Company, International Consultants, former US Trade Representative, former Secretary of Housing and Urban Development, former Assistant Attorney General	<b>Ratan Tata</b>	Chairman of Tata Sons Ltd
<b>General Sir Mike Jackson</b>	Former Chief of the General Staff, UK Ministry of Defence	<b>Matthias Wissmann</b>	Former Minister for Transport and Research in Germany, President of the Association of the German Automotive Industry (VDA), Vice-Chairman of the Federation of German Industries (BDI) and Senior International Counsellor at WilmerHale
		<b>Lee Hsien Yang</b>	Chairman, Fraser & Neave Limited
		<b>Ernesto Zedillo</b>	Former President of Mexico, Director, Yale Center for the Study of Globalization

## South East Asia Advisory Board

The South East Asia Advisory Board (SEAAB), formed in 1987, advises the Group on political, economic and business trends in Singapore, Thailand, Malaysia and the Philippines. Membership of the SEAAB is as follows:

<b>Bernard Duc</b>	Chairman of the SEAAB, Senior Partner, HMI Ltd (Hong Kong) former Deputy Chairman of the Rolls-Royce European Advisory Board	<b>Edward W Rubin</b>	Chairman of a Hong Kong-based private investment company, Non-Executive Director of Singapore-listed Noble Group Ltd
<b>Chatrachai Bunya-Ananta</b>	Member of the National Legislative Council of Thailand Former Senator of Thailand Former President of Thai Airways International plc	<b>Soedibyo</b>	Brigadier-General (retired) Senior Fellow, Institute for Strategic Studies of Indonesia. Former Vice-Assistant to the Commander-in-Chief Indonesian Air Force for Policy & Planning
<b>Dato' Jaffar Indot</b>	Independent Non-Executive Director, Shell Refining Company (FO) Berhad Chairman, Malaysian Dutch Business Council President, Federation of Family Planning Associations Malaysia	<b>Prof (Mrs) Tan Sook Yee</b>	Member of the Panel of the Strata Titles Board ex-Professor of Law, National University of Singapore
<b>H E Ambassador Jose V Romero, Jr</b>	Chairman/President, Philippine Council for Foreign Relations, Former Philippines Ambassador to Italy	<b>Dr Bernardo M Villegas</b>	University Professor, University of Asia and the Pacific, Manila, Philippines, Visiting Professor in Economics, IESE Business School, Barcelona, Spain

### Composition of the Board

Simon Robertson chairs the Board of directors and Sir John Rose is the Chief Executive. The division of responsibilities between them is set down in writing and agreed by the Board. Iain Conn is the Company's Senior Independent Director.

There are currently 14 directors on the Board comprising the non-executive Chairman, the Chief Executive, four other executive directors and eight non-executive directors.

The quality and broad experience of the directors, the balance of the Board's composition and the dynamics of the Board as a group, ensure the Board's effectiveness and also prevent any individual or small group dominating the Board's decision making.

Each executive director receives a service contract on appointment (see page 72 for further information) and each non-executive director receives a letter setting out the conditions of his or her appointment.

Non-executive directors are appointed for an initial term of three years, which may be extended subsequently with the agreement of the Board, although reappointment is not automatic. Executive directors are employees who have executive responsibilities in addition to their duties as directors. Non-executive directors are not employees and do not participate in the daily business management of the Group.

During the year, there were a number of Board changes: Dr John McAdam was appointed as a non-executive director on February 19, 2008; Carl Symon retired as a non-executive director at the Annual General Meeting (AGM) on May 7, 2008 and was succeeded by Helen Alexander CBE as chairman of the remuneration committee; and John Neill CBE joined the Board as a non-executive director on November 13, 2008.

Under the Company's Articles of Association, one third of the directors are subject to re-election every year, with each director also being subject to re-election at intervals of not more than three years. Any director appointed during the year is separately required to retire and seek election by the shareholders at the next AGM. The Board also requires any non-executive director who has served on the Board for more than nine years to be subject to annual re-election at the AGM.

John Neill CBE, having been appointed to the Board during the year, will seek election by shareholders at the AGM. The directors retiring under the annual re-election provisions contained in the Articles of Association are Iain Conn, James Guyette, John Rishton and Simon Robertson. They all offer themselves for re-election.

Peter Byrom, having served more than nine years on the Board, is subject to annual re-election by shareholders. No other non-executive director has served for more than nine years on the Board. In recommending Peter Byrom for re-election, the Board took account of the desirability of retaining a non-executive director with long experience on the Rolls-Royce Board. The Board believes strongly that in a long-term, complex and technologically advanced business it is essential that non-executive directors have the opportunity to acquire, over a number of years, the experience and knowledge of the business and the sectors within which the Group operates.

The Articles of Association also provide that no person may be appointed to the office of chairman (in an executive capacity) or to the office of chief executive, managing director or joint managing director of the Company, unless the individual is a British citizen. No person may be appointed to the office of director of the Company if, immediately following such appointment, the number of directors of the Company who are not British citizens would exceed one half of the total number of directors of the Company for the time being.

Subject to the provisions of relevant statutes, the Company's Memorandum and Articles of Association and any directions given by special resolution, the directors may exercise all the powers of the Company.

### Independence of the non-executive directors

The Board applies a rigorous process in order to satisfy itself that its non-executive directors remain independent. The Combined Code does not regard the Chairman as being independent in view of his unique role in corporate governance. However, on his appointment as Chairman on January 1, 2005, Simon Robertson met the criteria for independence contained in the Combined Code. His other significant commitments are described on page 65. The Board reviews the independence of the non-executive directors every year, based on the criteria in the Combined Code. This review was undertaken in 2008, and the Board concluded that all the non-executive directors (other than the Chairman) were independent in character and judgement. The Board determined that Peter Byrom remains independent in character and judgement notwithstanding that he has served on the Board for more than nine years, that there are no relationships or circumstances which are likely to affect his independent judgement and that he is in no way dependent on the remuneration he receives from the Company.

### Role of the Board

The Board is responsible to all the Company's stakeholders for its conduct and for the performance of the Company.

The day-to-day running of the Company is delegated by the Board to the executive team under the leadership of Sir John Rose, the Chief Executive.

The Board retains responsibility for the approval of certain matters which affect the shape and risk profile of the Company, as well as such items as the annual budget and performance targets, the published accounts, payments to shareholders, major capital investments and any substantial change to balance sheet management policy. This division of responsibilities between the Board and the executive team is set out in detail in a schedule approved annually by the Board, which defines those decisions which can only be taken by the Board itself.

The Board has approved the following statement summarising its core responsibilities:

#### *Primary goal*

The primary goal of the Board is to ensure that the Company's strategy creates value for the long-term investor within an acceptable risk profile.

#### *The Board's tasks*

In line with its primary goal, the Board's principal tasks are to:

- ensure the development of the Company's strategy and keep it under rigorous review;
- monitor the implementation of the strategy, ensuring that the necessary financial and human resources are in place to deliver it and that effective controls exist to manage risk;
- safeguard the values of the Company, including its brand and corporate reputation and the safety of its products;
- oversee the quality and performance of management and ensure through effective succession planning and remuneration policies that it is maintained at world-class standards; and
- maintain an effective corporate governance framework that aspires to deliver long-term value to shareholders.

### Directors' induction, training and information

Newly appointed directors participate in a structured induction programme and receive a comprehensive data pack providing detailed information on the Group.

An existing executive director acts as a mentor to each newly appointed non-executive director, giving guidance and advice as required. As part of their briefing, non-executive directors visit key sites and meet a cross-section of managers and employees to gain a better understanding of the Group and its operations. Ongoing training is available for all the directors, including presentations by the executive team on particular aspects of the business.

There is a procedure for directors to take independent professional advice at the Company's expense. This is in addition to the access every director has to the General Counsel and Company Secretary.

### Board effectiveness

The Chairman and the non-executive directors meet at least once a year without the executive directors present, in order to review the operation of the Board.

The Chairman has an annual meeting with each non-executive director to review his or her contribution to the Board. The Senior Independent Director chairs an annual meeting with the non-executive directors to review the performance of the Chairman, the outcome of which is reported back to him.

Each year, the Chairman reviews the performance of the Chief Executive as part of the annual salary review process overseen by the remuneration committee. The Chief Executive reviews the performance of the other executive directors in the same way.

In 2008, the annual process to enable the Board to evaluate the effectiveness of its performance involved the completion of a written questionnaire by the directors and a series of meetings between the Chairman and each individual director. The Board reviewed the results of this exercise in February 2009.

The review covered all aspects of corporate governance, including board and committee structure, board dynamics, the conduct and frequency of board meetings, the consideration of strategic issues by the Board and the information provided to directors. The Board considered that it was operating effectively. The review identified the need for improvements in some areas, including revising the format of the Board strategy sessions and improving the consistency of Board papers. The Board agreed to encourage greater interaction between the Board and management, for example, by arranging Board visits to Company facilities. The Board has also asked to receive more regular reports on succession planning for executives. These improvements will be implemented in 2009. The audit, remuneration and nominations committees have separately undertaken reviews of their terms of reference and effectiveness during 2008.

### Conflicts of interest

Directors have a duty to avoid a situation in which they have, or can have, a direct or indirect interest which conflicts, or possibly may conflict, with the interests of the Company unless that situational conflict has been authorised by the Board. The Board has reviewed and authorised all directors' situational conflicts and has agreed that while directors are required to keep confidential all Company information, they shall not be required to share with the Company confidential information received by them from a third party which is the subject of the situational conflict. The Board has also agreed that the authorisation of situational conflicts will be reviewed annually.

### Indemnity

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 170 of the Company's Articles of Association. The Company has also arranged appropriate insurance cover for any legal action taken against its directors and officers.

The Board is assisted by its committees. Details of their membership and principal terms of reference are set out below. Their full terms of reference are available on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).

## Attendance at meetings of the Board and its principal committees in 2008

	Board		Remuneration		Nominations		Audit		Ethics	
	Held	*Attended	Held	* Attended	Held	* Attended	Held	* Attended	Held	* Attended
Helen Alexander CBE	8	7	5	5	2	2			2	2
Peter Byrom	8	7	5	5	2	2			2	2
Iain Conn	8	7			2	1	5	4		
Prof Peter Gregson	8	6	5	4	2	1				
James Guyette	8	8								
Dr John McAdam	7	6	4	4	2	2				
John Neill CBE	2	1			1	0	0	0		
John Rishton	8	8			2	2	5	5	2	2
Simon Robertson	8	8			2	2				
Sir John Rose	8	7			2	2				
Andrew Shilston	8	8								
Colin Smith	8	7								
Ian Strachan	8	8			2	2	5	5	2	2
Carl Symon	3	3	2	2	0	0				
Mike Terrett	8	8								

\* The number of meetings held during the period a director was in office or a member of a committee.

### Remuneration committee

The committee has responsibility for making recommendations to the Board on the Group's policy regarding executive remuneration. The committee determines, on the Board's behalf, the specific remuneration packages of the Chairman, the executive directors and a number of senior executives. The committee met five times during the year. The committee's membership and principal terms of reference are set out in the Directors' remuneration report on page 70.

### Nominations committee

In 2008, the nominations committee was chaired by Simon Robertson. Its other members were Helen Alexander CBE, Peter Byrom, Iain Conn, Professor Peter Gregson, Dr John McAdam (from February 19, 2008), John Neill CBE (from November 13, 2008), John Rishton, Sir John Rose, Ian Strachan and Carl Symon (until May 7, 2008). The committee met twice during the year.

The committee makes recommendations to the Board on the appointment of executive and non-executive directors and on the membership of Board committees. It is assisted in the former task by external recruitment consultants. It reviews succession planning generally and also reviews specific appointments to the Board and to other senior positions within the Group. The committee also oversees the annual review of Board effectiveness.

In carrying out these tasks, the committee gives careful consideration to the balance of skills required on the Board, including the need to reflect diversity, international experience and strong managerial and business skills. Before recommending the appointment of a non-executive director to the Board, the committee satisfies itself that the candidate will have sufficient time available to discharge his or her responsibilities effectively.

### Audit committee

The audit committee consists exclusively of independent, non-executive directors. During 2008, the committee was chaired by John Rishton who has recent and relevant financial experience. In 2008, its other members were Iain Conn, Ian Strachan and John Neill CBE (from November 13, 2008). The committee met five times during the year. The Director of Risk, Head of Business Assurance and a representative of the external auditors normally attend the meetings. Additionally, the Head of Business Assurance has direct access to the committee. The Chairman of the Board, the Chief Executive, the Finance Director and any other Board member or senior executive may attend the meetings as necessary, at the invitation of the audit committee chairman.

The committee has responsibility for recommending to the Board the published accounts and for reviewing the Group's financial reporting and accounting policies, including major announcements made to a regulatory information service. It is also responsible for the relationship with the external auditors and for assessing the role and effectiveness of the internal audit function, which in Rolls-Royce is termed Business Assurance. In addition, the committee reviews the Group's procedures for detecting, monitoring and managing the risk of fraud.

The committee has responsibility for recommending to the Board the appointment of the external auditors and for reviewing the nature, scope and results of the annual external audit. It also approves the audit fee and, on an annual basis, assesses the effectiveness and independence of the external auditors. A resolution to reappoint the auditors, KPMG Audit Plc, and to authorise the directors to determine the auditors' remuneration, will be proposed at the 2009 AGM.

It keeps under review the Group's internal controls and systems for assessing and mitigating financial and non-financial risk. It also reviews and approves the Business Assurance work programmes and ensures that this function is adequately resourced and co-ordinated with the work of the external auditors. Twice a year the committee receives a written report on the reviews conducted throughout the Group by Business Assurance, and a report from senior executives on the key business risks and risk systems in selected sectors.

In order to safeguard auditor independence and objectivity, the following policy is applied in relation to services provided by the auditors:

*Audit related services* – these services are undertaken by the auditors as it is work that they must, or are best suited to, perform. It includes formalities relating to borrowings, shareholder and other circulars, risk management services, various regulatory reports and work in respect of acquisitions and disposals;

*Tax, accounting and mergers and acquisitions* – the auditors are used for this work where they are best suited to undertake it. All other significant consulting work in these areas is put out to tender; and

*All other advisory services/consulting* – the auditors are generally prohibited from providing these services.

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

### Ethics committee

In September 2008, the Board approved the formation of an ethics committee. The ethics committee consists exclusively of independent non-executive directors. Ian Strachan chairs the committee and its other members during 2008 were Helen Alexander CBE, Peter Byrom and John Rishton. The committee met twice during 2008. The Director of Risk, who has executive responsibility for ethics, attends the meetings. The Chairman of the Board, the Chief Executive and other executives of the Company may be invited to attend meetings of the committee.

The committee is responsible for reviewing compliance with the Group's Global Code of Business Ethics (the Global Code) and will make recommendations to the Board as appropriate for changes to the Global Code. The Global Code sets out the principles to be followed by employees when conducting business.

The committee will review recommendations on ethical matters made by external regulatory authorities or other bodies, such as the Woolf Committee, and will make recommendations to the Board about whether, and if so, to what extent, these should be applied to the Company. It also has responsibility for receiving reports on issues raised through the Group's confidential reporting lines and for reviewing the results of subsequent investigations.

The committee will ensure that ethical policies and practice are subject to an appropriate level of independent internal audit and, where necessary, will appoint auditors to conduct an external review.

### Risk committee

The Board has a risk committee, chaired by the Chief Executive, with specific accountability for the system of risk management and for reporting key risks and their associated mitigating actions to the Board. In 2008, its other members were James Guyette, Andrew Shilston, Colin Smith and Mike Terrett.

## Introduction

This report to shareholders covers:

- the policy under which the executive directors, the Chairman and the non-executive directors are remunerated; and
- details of the remuneration, fees and share interests of the directors.

It provides the information required by the Directors' Remuneration Report Regulations 2002 (the Regulations) and describes how the Company applies the principles of the Combined Code in relation to executive directors' remuneration. The Company confirms that it complies with the requirements of the Combined Code.

The report was approved by the remuneration committee (the committee) on February 10, 2009 and was signed on the Board's behalf by Helen Alexander CBE as the chairman of the committee. A resolution will be put to shareholders at the Annual General Meeting on April 30, 2009 inviting them to approve this report.

## The remuneration committee

The committee has responsibility for making recommendations to the Board on the Group's policy regarding executive remuneration. The committee determines, on the Board's behalf, the specific remuneration packages of the Chairman, the executive directors and a number of senior executives. A copy of the committee's terms of reference is available on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).

The committee consists exclusively of independent, non-executive directors. During 2008, it was chaired by Carl Symon (until May 7, 2008) and by Helen Alexander CBE (from May 7, 2008). Its other members were Peter Byrom, Professor Peter Gregson and Dr John McAdam (from March 31, 2008).

In 2008, Simon Robertson, Chairman, Sir John Rose, Chief Executive, the Director – Human Resources and the General Counsel and Company Secretary, attended meetings by invitation of the committee but were not present during any discussion of their own emoluments.

The committee met on five occasions in 2008 and details of members' attendance are set out in the table on page 69.

### Advice to the remuneration committee

The committee may call for information and advice from advisers inside and outside the Group. In 2008, Simon Robertson and Sir John Rose made recommendations to the committee relating to the performance of their direct reports. Internal support to the committee was provided primarily by the Director – Human Resources, advised by Deloitte LLP. Additional advice was provided by senior employees from the human resources and finance functions.

The committee received advice on remuneration matters from Deloitte LLP, and the Company's lawyers, Freshfields Bruckhaus Deringer LLP. During 2008, Deloitte LLP also advised the Group on tax, assurance, pensions and corporate finance and Deloitte MCS Limited provided consulting services.

## Remuneration policy

### The policy framework

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

Accordingly the Board has adopted, on the recommendation of the committee, a remuneration policy reflecting the following broad principles which it will continue to apply in 2009:

- the remuneration of executive directors and other senior executives should reflect their responsibilities and contain incentives to deliver the Group's performance objectives; it must also be capable of attracting and retaining the individuals necessary for business success;
- a significant proportion of total remuneration should be based on Group and individual performance, both in the short and long term; and
- the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the senior executives to acquire shares in the Company.

When determining remuneration, the committee takes into account pay and employment conditions elsewhere in the Group.

The committee regularly reviews both the competitiveness of the Group's remuneration structure and its effectiveness in incentivising executives to enhance value for shareholders over the longer term. It considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the Group's business environment and in remuneration practice.

For 2009, to ensure that executives are appropriately incentivised towards the achievement of stretching performance, a number of changes are being made to the Group's annual and long-term incentives (as described in the relevant sections on pages 71 and 72). Following these changes, executive directors' total incentive package opportunity will be positioned between the lower quartile and the median of FTSE 100 practice.

## The main components of remuneration

The main components of remuneration comprise base salary, annual incentive arrangements, long-term share-based incentives and pension and life assurance benefits. Executive directors and senior executives are also entitled to a company car or car allowance, private medical insurance and financial counselling. James Guyette is entitled to a housing allowance and the costs of additional housing are met by the Company for Mike Terrett.

The committee considers that there should be a continuing emphasis on those elements of remuneration, such as annual and long-term incentives, which directly influence the performance of senior executives.

### Base salaries

In determining the relative importance of these elements of remuneration, the committee believes that base salaries should be set at levels required to recruit and retain high quality senior executives and with reference to the levels in the relevant marketplace for companies of similar size, internationality and complexity. The committee has commissioned salary benchmarks from Deloitte LLP. The benchmarks have been prepared using their company size and complexity methodology which is based on these factors.

All salary increases must be justified on the basis of performance and are not automatic. Following the March 1 review, there will be no increases in the base salaries of executive directors for 2009. Other benefits are generally at the median of market practice.

### Annual incentives

Executive directors and selected senior executives participate in the Annual Performance Related Award plan (APRA). For UK participants, APRA awards do not form part of pensionable earnings.

*Target and maximum APRA bonus opportunity*

Under APRA as operated in 2008, executive directors were eligible for awards in accordance with the table below:

	Target bonus (as a % of salary) <sup>1</sup>	Maximum bonus (as a % of salary) <sup>1</sup>
James Guyette	48	80
Sir John Rose	60	100
Andrew Shilston	48	80
Colin Smith	48	80
Mike Terrett	48	80

<sup>1</sup> It was possible for a bonus award to be increased by a further 20 per cent to reflect exceptional personal performance, and for 2008, an additional 25 per cent if the Group achieved a target reduction in operating costs.

*APRA performance measures*

The APRA performance measures set by the committee are based on the Group's annual operating plans. For 2008, the measures for executive directors included underlying profit, average cash balance, cash flow, operating costs and individual contribution assessed with reference to the achievement of personal objectives and overall personal performance. The committee is mindful of corporate, environmental, social and governance risks when setting personal objectives. Forty per cent of any APRA bonus depends on personal performance.

A high proportion of the annual remuneration for executive directors is based on performance. For the Chief Executive, his 150 per cent maximum bonus opportunity means that 60 per cent of his combined basic pay and bonus opportunity is directly related to annual financial and personal performance. In 2008, the level of achievement against the financial measures was sufficient to generate up to 56.25 per cent of the maximum bonus for individual participants subject to the achievement of their personal objectives.

*Deferred APRA*

One third of the value of APRA is currently delivered in the form of a deferred award of shares in the Company. A participant who is granted a deferred share award under APRA must normally continue to remain an employee of the Group for two years from the date of the award in order to retain the shares, although shares will be released early in certain circumstances including retirement or redundancy.

The value of any deferred share awards is derived from the annual bonus criteria and is therefore dependent on personal and business financial performance; the release of deferred share awards is not dependent on the achievement of any further performance conditions. This arrangement provides a strong link between performance and remuneration, promotes a culture of share ownership amongst the Group's senior management and encourages decisions in the long-term interest of shareholders. The deferred share element operated for 2008 will result in share awards as described in the directors' emoluments table on page 74. Details of deferred shares held under the plan are shown in the table on page 78.

*Changes to APRA for 2009*

For 2009, APRA will change as follows:

- The opportunity to increase the bonus payable by 25 per cent for exceptional operating cost performance will be removed.
- Annual bonus opportunity levels will increase from 100 per cent to 135 per cent of salary for the Chief Executive and from 80 per cent to 125 per cent of salary for other executive directors.
- The percentage of APRA delivered in the form of a deferred award in the Company's shares will increase from 33 per cent to 40 per cent. This further aligns the interests of executives with those of shareholders.
- In order to simplify APRA, the average cash balance measure will be removed. The cash flow measure in APRA and the Cash Flow Per Share measure in the Rolls-Royce Group plc Performance Share Plan will both remain.

*Other annual incentives*

The same targets as set for APRA are used for the All-Employee Bonus Scheme, which typically enables all employees worldwide to receive a bonus of up to two weeks' pay, based on corporate and business performance. Those executives participating in APRA are excluded from the All-Employee Bonus Scheme.

*Rolls-Royce Group plc Performance Share Plan*

The Rolls-Royce Group plc Performance Share Plan (PSP) is designed to reward and incentivise selected senior executives who can influence the long-term performance of the Group.

Under the rules of the PSP, selected executives are granted conditional share awards entitling them to a number of shares determined by reference to corporate performance over a three-year performance period. The measures of corporate performance are Cash Flow Per Share (CPS), Earnings Per Ordinary Share (EPS) and Total Shareholder Return (TSR). These measures are considered particularly important in generating shareholder value and are explained in more detail below. There is no retesting of the performance criteria and no automatic vesting in the event of a takeover. In the three-year period to December 31, 2008, the Company's financial and TSR performance generated 80 per cent of the maximum number of shares under the rules of the plan.

*Performance measures*

No shares will be released from the PSP unless the growth in the Company's EPS exceeds the UK retail price index by three per cent per year over the performance period.

The number of shares released (if any) will be determined in accordance with CPS targets, which will not be adjusted for inflation. CPS is calculated as cash flow after interest, taxation and capital expenditure, but before cost of business acquisitions or proceeds of disposals and payments to shareholders, divided by the weighted average number of shares in issue. Intermediate levels of performance attract pro rata releases. The Company'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. This comparison will be carried out by an independent agency. If the Company's TSR exceeds the median of that group of companies, the number of shares due to be released to an executive following achievement of the EPS and CPS targets will be increased by 25 per cent.

Shareholders have authorised the committee to set CPS performance targets for future grants provided that, in the committee's reasonable judgement, the targets are no less challenging in the light of the Group's business circumstances and its internal forecasts than the targets for the initial grant in 2004 as approved by shareholders.

The following CPS targets apply to the grants to be made in 2009:

Aggregate CPS over three-year performance period	Percentage of maximum award released
40p	30
62p	100

The committee believes that these CPS targets are challenging and that the performance necessary to achieve awards towards the upper end of the range is stretching. They should not, therefore, be interpreted as providing guidance on the Group's performance over the relevant period.

*PSP award levels*

The size of awards under the PSP are set taking into account competitive levels within the marketplace for UK companies of a similar size and complexity to the Group. In 2008, Sir John Rose received a conditional award of shares with a market value at the time of grant of 110 per cent of his annual salary. For other executive directors and business heads the grant was 80 per cent, and 65 per cent for other members of the Group Executive. As described above, the number of shares released is increased by 25 per cent if the Company's TSR exceeds the median of the FTSE 100 Index.

For 2009, the number of conditional shares awarded under the PSP will increase from 110 per cent to 120 per cent of salary for the Chief Executive and from 80 per cent to 100 per cent of salary for other executive directors. A further stretch will be incorporated such that if TSR performance exceeds the upper quartile of the FTSE 100 index, awards are increased by 50 per cent, with straight line vesting between median and upper quartile performance.

These increases are within the existing limits for the PSP (200 per cent of salary), approved by shareholders in 2004.

*Share retention policy*

The committee believes it is important that the interests of the executive directors should be closely aligned with those of shareholders. The deferred APRA award and the PSP provide considerable alignment. However, participants in the PSP are also required to retain at least one half of the number of after-tax shares released from the PSP, until their shareholding reaches the level of 1.5 multiplied by the value of the shares conditionally granted to them in their most recent PSP grant. When this level is reached, it must be retained until retirement or departure from the Company.

*Executive share option plan*

No options have been granted under the executive share option plan since the introduction of the PSP and the Company does not currently intend to make any further grants. The plan terminates in 2009.

*All-employee share plans*

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

- i) the ShareSave Plan – a savings-related share option plan available to all employees. In the UK, this plan operates within UK tax legislation (including a requirement to finance the exercise of the option using the proceeds of a monthly savings contract) but the key principles are applied globally. The exercise of the option is not subject to the achievement of a performance target;
- ii) the 'Free Share' element of the Share Incentive Plan (SIP), under which UK employees receive shares of up to the equivalent of one and a half weeks' pay as part of the Company component of any bonus paid for 2008. The SIP attracts tax benefits for UK employees; and
- iii) the 'Partnership Share' element of the SIP under which UK employees may make regular purchases of shares from pre-tax income.

**Service contracts**

The committee's policy is that executive directors appointed to the Board are offered notice periods of 12 months. The committee recognises that in the case of appointments to the Board from outside the Group, it may be necessary to offer a longer initial notice period, which would subsequently reduce to 12 months after that initial period.

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

The following table summarises the terms of the executive directors' service contracts:

	Date of contract	Unexpired term	Notice period Company	Notice period individual
James Guyette	29 September 1997	Indefinite	30 days <sup>1</sup>	30 days
Sir John Rose	4 December 1992	12 months	12 months <sup>2</sup>	6 months
Andrew Shilston	5 November 2002	12 months	12 months	6 months
Colin Smith	1 July 2005	12 months	12 months	6 months
Mike Terrett	1 September 2007	12 months	12 months	6 months

<sup>1</sup> James Guyette has a contract with Rolls-Royce North America Inc, drawn up under the laws of the State of Virginia, US. It provides that, on termination without cause, he is entitled to 12 months' severance pay without mitigation and, in addition, appropriate relocation costs.

<sup>2</sup> In the event of the service contract being terminated by the Company, other than in accordance with the contract's terms, Sir John Rose is entitled to receive a liquidated sum of 12 months' salary and benefits. Performance related payments are not covered under this arrangement, although an annual bonus may be paid if he is in post at the end of the performance year.

**External directorships of executive directors**

James Guyette was a director of The PrivateBank and Trust Company of Chicago, Illinois and of priceline.com Inc. and Andrew Shilston was a non-executive director of Cairn Energy PLC until his resignation on May 23, 2008.

In each case, the director retained the relevant fees from serving on the boards of these companies, as shown in the table below:

*External directorship fees*

	Payment received £000
James Guyette <sup>1,2</sup>	68
Andrew Shilston	25

<sup>1</sup> James Guyette was paid in US dollars translated at \$1.854 = £1.

<sup>2</sup> In addition to an annual fee, James Guyette received 1,418 Restricted Share Units in PrivateBank. During 2008, 1,000 of his stock options in PrivateBank vested at an exercise price of US\$46.51 per share and 1,000 stock options vested at an exercise price of US\$33.73 per share. Also during 2008, 500 shares of restricted stock vested at US\$107.90 per share, 500 shares of restricted stock vested at US\$115.33 per share and 500 shares of restricted vested at US\$134.53 in priceline.com. He was also granted 863 shares of restricted stock at US\$115.33 per share.

**Non-executive directors**

The Chairman and the non-executive directors have letters of appointment rather than service contracts. No compensation is payable to the Chairman or to any non-executive director if the appointment is terminated early.

*Non-executive directors' fees*

The Board takes account of independent market surveys in determining the fees payable to the Chairman and the non-executive directors. The fees paid to the Chairman and non-executive directors are shown in the emoluments table.

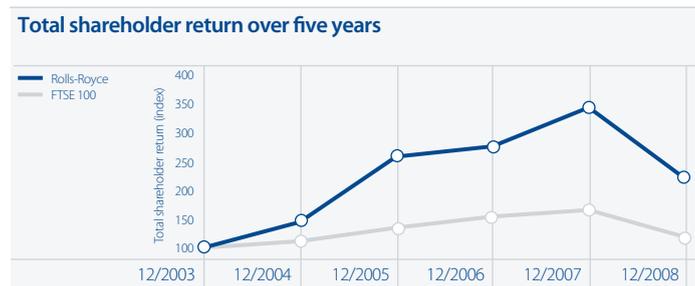
The current annual fees payable to the non-executive directors are as follows:

	Fees payable
Chairman	£370,000
Other non-executive directors	£55,000
Chairman of audit committee	£15,000
Chairman of remuneration committee	£12,000
Chairman of ethics committee	£12,000
Senior Independent Director	£10,000

The Chairman and the non-executive directors are not eligible to participate in any of the Group's share schemes, incentive arrangements or pension schemes. A facility is in place which enables non-executive directors to use some or all of their fees, after the appropriate statutory deductions, to make market purchases of shares in the Company on a monthly basis.

**Performance graph**

The Company's TSR performance over the previous five years compared to a broad equity market index is shown in the graph below. The FTSE 100 has been chosen as the comparator index because it contains a broad range of other leading UK listed companies.



### Aggregate directors' remuneration

The total amounts for directors' remuneration were as follows:

	2008 £000	2007 £000
Emoluments	5,022	4,988
Gains on exercise of share options	9	10,364
Value of shares vested under long-term incentive awards	3,458	4,850
Money purchase pension contributions	558	433
	<b>9,047</b>	<b>20,635</b>

### Directors' emoluments

The directors' emoluments are analysed as follows:

	Annual Performance Related Award plan (APRA)							2008	2007
	Basic salaries £000	Board and committee fees £000	Cash bonus £000	Deferred shares <sup>1</sup> £000	Total APRA £000	Pension payments <sup>2</sup> £000	Taxable benefits <sup>3</sup> £000	Aggregate emoluments excluding pensions contributions <sup>4</sup> £000	Aggregate emoluments excluding pensions contributions <sup>4</sup> £000
James Guyette <sup>5</sup>	413	—	116	58	174	—	36	623	572
Sir John Rose	842	—	255	128	383	—	28	1,253	1,262
Andrew Shilston	543	—	140	70	210	—	15	768	784
Colin Smith	384	—	100	50	150	96	11	641	622
Mike Terrett	493	—	130	65	195	123	113	924	395
Helen Alexander CBE	—	63	—	—	—	—	—	63	18
Peter Byrom	—	55	—	—	—	—	—	55	71
Iain Conn	—	65	—	—	—	—	—	65	57
Professor Peter Gregson	—	55	—	—	—	—	—	55	46
Dr John McAdam <sup>6</sup>	—	48	—	—	—	—	—	48	—
John Neill CBE <sup>7</sup>	—	7	—	—	—	—	—	7	—
John Rishton	—	70	—	—	—	—	—	70	50
Simon Robertson	—	367	—	—	—	—	—	367	330
Ian Strachan	—	59	—	—	—	—	—	59	54
Carl Symon <sup>8</sup>	—	24	—	—	—	—	—	24	66
Former directors who did not serve during the 2008 financial year	—	—	—	—	—	—	—	—	661
	<b>2,675</b>	<b>813</b>	<b>741</b>	<b>371</b>	<b>1,112</b>	<b>219</b>	<b>203</b>	<b>5,022</b>	<b>4,988</b>

<sup>1</sup> Shares forming part of the bonus under APRA have been valued at the date of award. An investment is expected to be made by March 31, 2009 when the trustee will acquire the required number of shares at the prevailing market price.

<sup>2</sup> Colin Smith and Mike Terrett received cash allowances in lieu of future pension accrual.

<sup>3</sup> Taxable benefits include the following: company car or car allowance, private medical insurance and financial counselling, and in the case of James Guyette, a housing allowance and appropriate club membership fees. In the case of Mike Terrett, the figure in the above table includes housing costs paid on his behalf and the tax charge on that benefit paid by the Company.

<sup>4</sup> Details of the directors' pensions are set out on page 75.

<sup>5</sup> James Guyette was paid in US dollars translated at \$1.854 = £1.

<sup>6</sup> Dr John McAdam was appointed as a non-executive director with effect from February 19, 2008.

<sup>7</sup> John Neill CBE was appointed as a non-executive director with effect from November 13, 2008.

<sup>8</sup> Carl Symon retired as a non-executive director with effect from May 7, 2008.

### Payments made to former directors of the Company

John Cheffins retired from the Board on September 30, 2007. Following his retirement, he has continued to be retained by the Company for one day per week to give support and advice on the strategy and implementation of Rolls-Royce Fuel Cell Systems Limited, supply chain management, and the assembly and test facilities. He was paid £103,200 and received benefits totalling £33,097.

Dr Mike Howse retired from the Board on June 30, 2005. Following his retirement, he has continued to be retained by the Company for his expertise in engineering. He was paid £39,060.

Sir Robin Nicholson retired as a non-executive director on May 4, 2005. He was retained by Rolls-Royce Fuel Cell Systems Limited for his management and technical expertise, and to provide advice on business related matters. Sir Robin was paid total fees of £30,000.

Phil Ruffles retired from the Board on October 18, 2001. He was retained by Rolls-Royce Fuel Cell Systems Limited until December 31, 2008 to give general advice on the best contacts and direction for the business. Phil Ruffles received total fees of £5,080.

## Pensions

The Group's UK pensions schemes are funded, registered schemes and were approved under the regime applying until April 6, 2006. They are defined benefit pension schemes providing, at retirement, a pension of up to two thirds of final remuneration, subject to HM Revenue & Customs limits. Andrew Shilston is a current member of the Group's UK pension scheme. Colin Smith and Mike Terrett have opted out of future pension accrual with effect from April 1, 2006. Sir John Rose opted out of future pension accrual with effect from February 1, 2008, see note 6 below.

Details of the pension benefits, which accrued over the year in the Group's registered UK defined benefit pension schemes<sup>1</sup>, are given below:

	Increase in accrued pension during the year ended Dec 31, 2008 £000pa		Total accrued pension entitlement at the year ended Dec 31, 2008 £000pa	Transfer value of accrued pension as at Dec 31, 2008 £000	Transfer value as at Dec 31, 2007 of accrued pension at that date £000	Increase in transfer value over 2008 net of the member's own contributions £000	
Sir John Rose <sup>6</sup>	10	(8)	449	10,632	11,225	-598	(191)
Andrew Shilston <sup>7</sup>	2	(2)	12	307	259	203	(49)
Colin Smith <sup>8</sup>	43	(36)	241	3,847	4,160	-313	(259)
Mike Terrett <sup>8</sup>	22	(13)	250	5,230	4,885	345	(269)

James Guyette participates in pension plans sponsored by Rolls-Royce North America Inc.

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

	Increase in accrued retirement lump sum during the year ended Dec 31, 2008 £000pa		Total accrued retirement lump sum entitlement at the year ended Dec 31, 2008 £000pa	Transfer value of accrued retirement lump sum as at Dec 31, 2008 £000	Transfer value as at Dec 31, 2007 of accrued retirement lump sum at that date £000	Increase in transfer value over 2008 net of the member's own contributions £000	
James Guyette <sup>11,12</sup>	91	(66)	711	711	620	487	(462)

<sup>1</sup> Members of the schemes have the option to pay Additional Voluntary Contributions. Neither the contributions nor the resulting benefits are included in the above table.

<sup>2</sup> The figure in brackets is the increase in pension/retirement lump sum during the year ended December 31, 2008 but, in this case, excluding the effect of inflation.

<sup>3</sup> The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year, or to April 1, 2006 for members with enhanced protection from 'A' day.

<sup>4</sup> The transfer values stated represent liabilities of the Rolls-Royce sponsored pension schemes and are not sums paid to the individuals. The transfer values of the accrued pensions as at December 31, 2007 have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11 (GN11). GN11 covers individual transfer calculations and the above figures have been calculated using assumptions certified by the Actuaries as being consistent with GN11. The transfer values of the accrued pensions as at December 31, 2008 have been calculated on a basis adopted by the trustees on October 6, 2008 following receipt of actuarial advice for transfer values.

<sup>5</sup> The figure in brackets is the transfer value of the increase in pension/retirement lump sum during the year ended December 31, 2008 excluding the effect of inflation and net of the member's own contributions.

<sup>6</sup> Sir John Rose started to receive his pension from February 1, 2008. Sir John Rose is not accruing any further benefit or allowance in lieu of pension benefit from his ongoing employment with the Group. The total accrued pension entitlement at December 31, 2008 is after allowance for reduction for early payment of pension and taking a part of his pension as lump sum. The transfer value is the value of benefits in payment as at December 31, 2008 increased by cash taken on retirement.

<sup>7</sup> The Group operates the Rolls-Royce Supplementary Retirement Scheme. The purpose of the Scheme is to fund pension provision above the pensionable earnings cap which was imposed on approved pension schemes by the 1989 Finance Act. Membership of the Scheme is restricted to executive directors and to a limited number of senior executives. Andrew Shilston is a member of this Scheme. He joined the Group after the introduction of the earnings cap and his terms and conditions on joining included a commitment to provide pension and life cover based on total salary. Employer contributions to the Scheme during 2008 have been added to the increase in transfer value over 2008 for the registered defined benefit plans, and are therefore included in the figures shown in the right hand column of the first table.

<sup>8</sup> Colin Smith and Mike Terrett receive a cash allowance in lieu of future pension accrual. Had they elected to continue to accrue pension the estimated cost of that accrual would be higher than the cash allowance to be paid in lieu.

<sup>9</sup> The lump sum entitlement shown is that which would be paid on immediate retirement based on service to the end of the year.

<sup>10</sup> The transfer values have been calculated on the basis of actuarial advice.

<sup>11</sup> Benefits are translated at US\$ = £1.438.

<sup>12</sup> James Guyette is a member of two defined benefit plans in the US, one qualified and one non-qualified. He accrues a retirement lump sum benefit in both of these plans. The aggregate value of the retirement lump sums accrued in these two plans, and the transfer values of these benefits, are shown in the second table. In addition, James Guyette is a member of two 401(K) Savings Plans in the US, one qualified and one non-qualified, to which both he and his employer, Rolls-Royce North America Inc., contribute. James Guyette is also a member of an unfunded non-qualified deferred compensation plan in the US, to which his employer makes notional contributions. Employer contributions to these three plans during 2008 have been added to the increase in transfer value over 2008 for the defined benefit plans, and are therefore included in the figures shown in the right hand column of the second table.

### Directors' share interests

The directors who held office at December 31, 2008 and their connected persons had the following interests in the ordinary shares and B Shares<sup>1</sup> of the Company in respect of which transactions are notifiable to the Company under DTR 3.1.2R of the Disclosure Rules and Transparency Rules as shown in the following table:

	Ordinary shares			B Shares		
	January 1, 2008 *	Changes in 2008	December 31, 2008 \$	January 1, 2008 *	Changes in 2008	December 31, 2008 \$
James Guyette	255,152	95,729	350,881	—	—	—
Sir John Rose <sup>2</sup>	864,276	222,042	1,086,318	—	—	—
Andrew Shilston	260,626	103,111	363,737	—	—	—
Colin Smith	71,901	31,864	103,765	—	—	—
Mike Terrett	293,786	79,031	372,817	—	—	—
Helen Alexander CBE	1,000	21	1,021	—	—	—
Peter Byrom	159,383	44,576	203,959	—	—	—
Iain Conn	8,386	3,355	11,741	28,504	(28,504)	—
Professor Peter Gregson	—	1,219	1,219	—	—	—
Dr John McAdam <sup>3</sup>	—	—	—	—	—	—
John Neill CBE <sup>4</sup>	—	—	—	—	—	—
John Rishton	519	2,878	3,397	—	—	—
Simon Robertson	27,233	10,992	38,225	—	—	—
Ian Strachan	11,500	—	11,500	—	—	—
Carl Symon <sup>5</sup>	7,049	52	7,101	—	—	—

\* or date of appointment if later.  
\$ or date of retirement if earlier.

- <sup>1</sup> Non-cumulative redeemable convertible preference shares of 0.1p each.
- <sup>2</sup> Sir John Rose had a non-beneficial interest in 45,191 (2007: 43,932) ordinary shares.
- <sup>3</sup> Dr John McAdam was appointed as a non-executive director with effect from February 19, 2008.
- <sup>4</sup> John Neill CBE was appointed as a non-executive director with effect from November 13, 2008.
- <sup>5</sup> Carl Symon retired as a non-executive director with effect from May 7, 2008.

Directors' interests in the Company's share plans are shown separately on pages: 77 (Share Incentive Plan); 78 (share options); 78 (Annual Performance Related Award plan); and page 79 (Performance Share Plan). No director had any other interests, beneficial or otherwise, in the share capital of the Company or any of its subsidiaries as at December 31, 2008.

Changes in the interests of the directors between December 31, 2008 and February 11, 2009 are listed below:

- On January 2, 2009, Simon Robertson was allotted 2,186,470 non-cumulative redeemable preference shares of 0.1p each (C Shares).
- On January 6, 2009, the following directors purchased ordinary shares under the C Share Reinvestment Plan: James Guyette 5,502; Andrew Shilston 5,703; Colin Smith 1,526; Mike Terrett 5,845; Peter Byrom 3,194; Iain Conn 173; Professor Peter Gregson 15 and John Rishton 43.
- The following directors purchased ordinary shares under arrangements made for non-executive directors to purchase shares on a monthly basis using a percentage of their after tax fees:  
On January 7, 2009, Iain Conn 276; Professor Peter Gregson 108; John Neill CBE 276; and John Rishton 276 and on February 9, 2009, Iain Conn 297; Professor Peter Gregson 116; John Neill CBE 297; and John Rishton 297.
- On February 2, 2009, Colin Smith exercised a ShareSave option under the Rolls-Royce International ShareSave Plan and was allotted 2,396 ordinary shares.
- On February 2, 2009, James Guyette exercised a ShareSave option under the Rolls-Royce International ShareSave Plan and was allotted 65 ordinary shares.

**Directors' share interests** continued*'Partnership Shares' held in trust under the Share Incentive Plan*<sup>1</sup>

	Ordinary shares		
	January 1, 2008	Changes in 2008	December 31, 2008
Sir John Rose <sup>2,3</sup>	3,214	(875)	2,339
Andrew Shilston <sup>2,3</sup>	2,944	(603)	2,341
Colin Smith <sup>2,3</sup>	3,214	(875)	2,339
Mike Terrett <sup>2,3</sup>	3,213	(871)	2,342

*'Free Shares' held in trust under the Share Incentive Plan*<sup>1</sup>

	Ordinary shares		
	January 1, 2008	Changes in 2008	December 31, 2008
Sir John Rose <sup>4</sup>	6,593	(3,906)	2,687
Andrew Shilston <sup>4</sup>	4,989	(319)	4,670
Colin Smith <sup>4</sup>	2,352	751	3,103
Mike Terrett <sup>4</sup>	1,395	41	1,436

*'Unrestricted Shares' held in trust under the Share Incentive Plan*<sup>1</sup>

	Ordinary shares		
	January 1, 2008	Changes in 2008	December 31, 2008
Sir John Rose <sup>3,5</sup>	208	5,470	5,678
Andrew Shilston <sup>3,5</sup>	—	2,235	2,235
Colin Smith <sup>3,5</sup>	208	1,375	1,583
Mike Terrett <sup>3,5</sup>	106	1,367	1,473

<sup>1</sup> Under the Share Incentive Plan (SIP), 'Free Shares' and 'Partnership Shares' held in trust for more than five years are classified as 'Unrestricted' and are no longer subject to income tax or national insurance contributions on withdrawal. 'Unrestricted Shares' can be held in Trust under the SIP for as long as the participant remains an employee of the Company.

<sup>2</sup> On January 2, 2009, C Shares were awarded under the 'Partnership Shares' element of the SIP to Sir John Rose 138,080; Andrew Shilston 138,195; Colin Smith 138,080 and Mike Terrett 138,080.

<sup>3</sup> Sir John Rose, Andrew Shilston, Colin Smith and Mike Terrett purchased 36 ordinary shares each on January 7, 2009 and 38 ordinary shares each on February 9, 2009 under the HM Revenue & Customs approved Share Incentive Plan. On January 7, 2009 and February 9, 2009 the ordinary shares held as Partnership Shares by Sir John Rose 81 and 78; Andrew Shilston 82 and 78; Colin Smith 81 and 78 and Mike Terrett 83 and 79 were classified as Unrestricted Shares.

<sup>4</sup> On January 2, 2009, C Shares were awarded under the 'Free Shares' element of the SIP to Sir John Rose 153,697; Andrew Shilston 267,124; Colin Smith 177,492 and Mike Terrett 82,140.

<sup>5</sup> On January 2, 2009, C Shares were awarded under the 'Unrestricted Shares' element of the SIP to Sir John Rose 315,744; Andrew Shilston 118,804; Colin Smith 81,510 and Mike Terrett 75,389.

### Share options

The directors held the following options under the Rolls-Royce 1999 Executive Share Option Plan, all of which have vested and are capable of exercise unless otherwise indicated, and the Rolls-Royce International ShareSave Plan.

All employees were eligible for options under the International ShareSave Plan and the 2003 (five year) plan matured on December 1, 2008.

	January 1, 2008	Granted in 2008	Lapsed in 2008	Exercised in 2008	December 31, 2008	Exercise price	Market price at date exercised	Aggregate gains 2008 £000	Aggregate gains 2007 £000	Exercisable dates
James Guyette <sup>1</sup>	1,397				1,397	298p <sup>2</sup>				2009
	683				683	416p <sup>2</sup>				2011
	2,080				2,080	337p <sup>3</sup>		2,082		
Colin Smith <sup>4</sup>	15,444				15,444	194p <sup>5</sup>				2009-2010
	6,362			6,362		142p <sup>2</sup>	286p	9		2009
	2,396				2,396	108p <sup>2</sup>				2009
	1,233				1,233	298p <sup>2</sup>				2011
	25,435			6,362	19,073	190p <sup>3</sup>		9	235	
Mike Terrett	180,556				180,556	216p <sup>6</sup>				2009-2011
	6,900				6,900	142p <sup>2</sup>				2009
	187,456				187,456	213p <sup>3</sup>				

<sup>1</sup> On February 2, 2009, James Guyette exercised a ShareSave option under the Rolls-Royce International ShareSave Plan and was allotted 65 ordinary shares.

<sup>2</sup> ShareSave plans.

<sup>3</sup> Weighted average exercise price of December 31, 2008 balance.

<sup>4</sup> On February 2, 2009, Colin Smith exercised a ShareSave option under the Rolls-Royce International ShareSave Plan and was allotted 2,396 ordinary shares.

<sup>5</sup> Granted under the Rolls-Royce 1999 Executive Share Option Plan. The only performance criteria is that the growth in EPS must exceed UK RPI over a rolling three-year period.

<sup>6</sup> Granted in 2001 under the Rolls-Royce 1999 Executive Share Option Plan with additional performance and personal shareholding requirements. Vesting of these Supplementary options is subject to attainment of significant personal shareholding targets and the requirement that the growth in EPS exceeds an average of six per cent year on year as well as exceeding the UK RPI by three per cent per year over a rolling three-year period. The increases are measured from the year 2000 or the base year of the rolling three-year period, whichever is the more stringent. All options were granted at the market value on the date of issue and no discount was applied. No options were varied during the year and no consideration was paid for the grant of options. The market price of the Company's ordinary shares ranged between 249p and 547p during 2008. The closing price on December 31, 2008 was 335.50p.

### Long-term incentive awards

The directors as at December 31, 2008 had the following deferred share awards arising out of the operation of the Annual Performance Related Award<sup>1</sup> plan:

	January 1, 2008	Vested during 2008	Granted during 2008	December 31, 2008
James Guyette	41,123	22,271	12,805	31,657
Sir John Rose	84,868	42,777	34,771	76,862
Andrew Shilston	46,871	23,634	20,313	43,550
Colin Smith	27,428	11,041	12,045	28,432
Mike Terrett	30,360	14,777	14,888	30,471

<sup>1</sup> Under the Annual Performance Related Award plan (APRA), shares vest after two years. Shares went into trust in 2006, 2007 and 2008 at prices of 447.60p, 501.62p and 440.03p respectively. At December 31, 2008, the amounts stated in the emoluments table representing the 2008 APRA deferred shares had not yet been applied by the Trustee to purchase shares. An investment is expected to be made by March 31, 2009 when the trustee will acquire the required number of shares at the prevailing market price. The market value per share, which vested under APRA during 2008, was 432.14p.

**Long-term incentive awards** continued

Conditional awards, granted under the Rolls-Royce Group plc Performance Share Plan (PSP) to executive directors are set out below. The number of shares released will be dependent upon the achievement of the EPS and CPS targets over the three-year performance period and will be increased by 25 per cent if the TSR exceeds the median for the FTSE 100 companies over the three-year performance period.

	<b>PSP</b>							
	January 1, 2008	Granted during 2008	TSR uplift at vesting <sup>1</sup>	Total vested during 2008	December 31, 2008	Performance period	Date of grant	Market price at date of grant
James Guyette	93,871	—	23,468	117,339	—	Jan 1, 2005 to Dec 31, 2007	March 8, 2005	261.58p
	72,670	—	—	—	72,670	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	60,669	—	—	—	60,669	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	—	70,672	—	—	70,672	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	227,210	70,672	23,468	117,339	204,011			
Sir John Rose	263,782	—	65,946	329,728	—	Jan 1, 2005 to Dec 31, 2007	March 8, 2005	261.58p
	177,240	—	—	—	177,240	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	175,649	—	—	—	175,649	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	—	212,888	—	—	212,888	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	616,671	212,888	65,946	329,728	565,777			
Andrew Shilston	109,596	—	27,399	136,995	—	Jan 1, 2005 to Dec 31, 2007	March 8, 2005	261.58p
	82,930	—	—	—	82,930	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	81,438	—	—	—	81,438	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	—	100,183	—	—	100,183	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	273,964	100,183	27,399	136,995	264,551			
Colin Smith	22,403	—	5,601	28,004	—	Jan 1, 2005 to Dec 31, 2007	March 8, 2005	261.58p
	54,085	—	—	—	54,085	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	59,881	—	—	—	59,881	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	—	70,356	—	—	70,356	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	136,369	70,356	5,601	28,004	184,322			
Mike Terrett	83,179	—	20,795	103,974	—	Jan 1, 2005 to Dec 31, 2007	March 8, 2005	261.58p
	60,638	—	—	—	60,638	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	61,693	—	—	—	61,693	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	—	91,075	—	—	91,075	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	205,510	91,075	20,795	103,974	213,406			

<sup>1</sup> Under the rules of the PSP, the number of shares vesting in 2008 was increased by 25 per cent as the TSR exceeded the median of the FTSE 100 companies during the three-year performance period to December 31, 2007. The market value per share, which vested under the PSP during 2008, was 413.73p.

**Approval of the Directors' remuneration report**

The Directors' remuneration report above was approved by the Board of directors on February 11, 2009 and signed on its behalf by

**Helen Alexander CBE**

Chairman of the remuneration committee

## Directors' responsibility for internal control

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

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

There is an ongoing process to identify, assess and manage risk, including those risks affecting the Group's reputation. This process is subject to continuous improvement and has been in place throughout the financial year to which these statements apply and up to the date of their approval. In 2008, the effectiveness and consistency of risk management at all levels of the organisation has been measured, improved and reported via the sector and function assurance framework.

The Board has reviewed the risk management process and confirms that ongoing processes and systems ensure that the Group continues to be compliant with the Turnbull guidance as contained in 'Internal Control: Guidance for Directors on the Combined Code'.

## Organisation structure

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

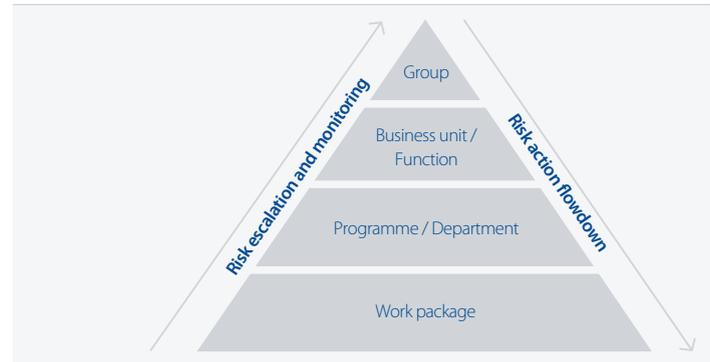
## The risk management system

The risk management system is an integral part of management's approach to delivering business objectives and is a systematic process designed to identify, assess, treat, manage and communicate risks.



The risk management process

Risks are recorded in regularly updated risk registers operating at all levels of the organisation and are continuously reviewed and monitored. The risk management process places significant emphasis on learning from and sharing prior experience. The system provides methods for escalation and delegation to the appropriate levels within the organisation and ensures that actions are owned, defined, resourced and effective.



The risk escalation process

Risks may arise from a variety of internal and external sources. They may be associated with regulations, customer requirements and competitor actions, or could result from the capability of the processes used to execute the business, or from external and largely unpredictable events, such as terrorist activity or war. The principal risks and uncertainties for the Group are shown on pages 21 to 24.

Risks, irrespective of source, are managed through processes operated by business unit and functional teams. The corporate risk register is updated and reviewed by the risk committee twice a year so that the Board may then consider and review these risks in terms of their potential impact.

Management has continued to perform comprehensive risk reviews for all key projects, programmes and business change plans.

All the processes operated by the Group are subject to continuous improvement, including the risk management process itself. Development and deployment of the process is the responsibility of a dedicated Enterprise Risk Management team. The team has created a comprehensive framework for the assessment of risk management maturity at all levels throughout the organisation that enables focused improvement actions and drives consistent application of the risk management process throughout the Group.

The risk process is underpinned by an integrated range of tools and training and education programmes. Deployment of an enterprise-wide risk management software application enables the analysis, management and communication of risks across the business. A network of risk champions, mentors and facilitators helps to develop, embed and share best practice throughout the organisation.

## Systems of internal control

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

The Group has a comprehensive budgeting system with an annual budget approved by the Board. Revised forecasts for the year are reported at least quarterly. Actual results are reported monthly against budget and variances reviewed.

The activities of the Group are subject to review by the Department of Risk, including business assurance and product introduction and life cycle management, and the assurance functions of Health, Safety and Environment, Quality and Engineering. These functions operate to work programmes agreed by the appropriate Board member.

The business assurance function, which works closely with the external auditors, undertakes a programme of financial and operational audits and reviews agreed by the audit committee and covering all Group activities. The programme includes independent reviews of the systems of internal control and risk management. The findings and the status of corrective actions taken to address these are reported in writing to both the audit and risk committees twice a year.

### Share capital and voting rights

At December 31, 2008, the Company's authorised share capital was £3,500,050,000.60 and comprised: 2,499,999,998 ordinary shares of 20p; 2,000,000,000,000 C Shares of 0.1p; 1,000,000,000,000 B Shares of 0.1p; one Special Share of £1; and 50,000 preference shares of £1.

On December 31, 2008, there were 1,843,740,136 ordinary shares and one Special Share in issue. The ordinary shares are listed on the London Stock Exchange. The first issue of C Shares took place on January 2, 2009. The C Shares are not listed.

### Payments to shareholders

At the AGM on April 30, 2009, the directors will recommend an issue of 85.8 C Shares with a total nominal value of 8.58p for each ordinary share. Together with the interim issue on January 2, 2009 of 57.2 C Shares for each ordinary share with a total nominal value of 5.72p, this is the equivalent of a total annual payment to ordinary shareholders of 14.30p for each ordinary share.

### Communication with shareholders

The Company attaches importance to the effectiveness of its communications with shareholders. It publishes an Annual review and summary financial statement as well as a full Annual report. There are also separate reports covering the environment and community relations.

The Company maintains a regular dialogue with institutional shareholders and the financial community. This includes presentations of the preliminary and interim results, regular meetings with major shareholders, participation in stockbrokers' seminars and site visits.

Each year the Group holds an investors' seminar, in order to improve the financial community's understanding of the Group and to introduce investors to a broader range of management. All shareholders can gain access to these and other presentations, as well as to the Annual report and other information about the Group, on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).

Holders of ordinary shares may attend the Company's AGM at which the Company highlights key business developments during the year and at which shareholders have an opportunity to ask questions. The chairmen of the audit, remuneration, ethics, and nominations committees are available to answer any questions from shareholders on the work of their committees.

The Company confirms that it sends the AGM notice and relevant documentation to all shareholders at least 20 working days before the date of the AGM. For those shareholders who have elected to receive communications electronically, notice is given by email of the availability of documents on the Group's website. Responsibility for maintaining regular communications with shareholders rests with the executive management team led by the Chief Executive. However, the Board is informed on a regular basis of key shareholder issues, including share price performance, the composition of the shareholder register and City expectations. Independent research is commissioned annually into institutional shareholder perceptions of the Group. The Chairman, the Senior Independent Director and the non-executive directors make themselves available to meet with shareholders as required.

### Share class rights

The rights and obligations attaching to ordinary shares are set out in the Company's Articles of Association.

1 *Ordinary shares* – Holders of ordinary shares are entitled to receive the Company's Annual report. They are also entitled to attend and speak at general meetings of the Company, to appoint one or more proxies or, if they are corporations, corporate representatives, and to exercise voting rights. Holders of ordinary shares may receive a bonus issue of C Shares or a dividend and on liquidation may share in the assets of the Company.

Holders of not less than ten per cent of the issued ordinary share capital of the Company may requisition a general meeting of the Company. Holders of not less than five per cent of the issued share capital of the Company or 100 holders holding shares with an average of not less than £100 per member paid up on such shares (which reflects the nominal value not the market value of the relevant shares) may requisition the Company to give shareholders notice of any resolution which may properly be moved at an AGM or may require the Company to circulate a statement of not more than 1,000 words with respect to a matter referred to in a proposed resolution or other business to be dealt with at a general meeting.

- 2 *C Shares* – Since January 2009 the Company has issued non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. Shareholders can choose to:
- redeem all C Shares for cash;
  - redeem all C Shares for cash and reinvest the proceeds in additional ordinary shares using the C Share Reinvestment Plan (CRIP) operated by Computershare Investor Services PLC (the Registrar); or
  - keep the C Shares.

Any C Shares retained attract a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. In certain circumstances the Company has the option to compulsorily redeem the C Shares, at any time, if the aggregate number of C Shares in issue is less than ten per cent of the aggregate number of all C Shares issued, or on the acquisition or capital restructuring of the Company.

On a return of capital on a winding-up, the holders of C Shares shall be entitled, in priority to any payment to the holders of ordinary shares, to the repayment of the nominal capital paid-up or credited as paid-up on the C Shares held by them, together with a sum equal to the outstanding preferential dividend which will have been accrued but not been paid until the date of return of capital.

The holders of C Shares are entitled to attend, speak and vote at a general meeting only if a resolution to wind up the Company is to be considered, in which case they may vote only on such resolution.

- 3 *B Shares* – Up to July 2008, the Company had issued B Shares as an alternative to paying a cash dividend. Following a strategic financial review, the directors concluded that the dilution caused by the conversion of B Shares to ordinary shares was inconsistent with the Group's strategy. The only material difference between B Shares and C Shares is that C Shares do not carry the option to convert directly into ordinary shares. C Shares can only be redeemed for cash. All remaining B Shares were redeemed on September 22, 2008 and the Company has no intention of issuing further B Shares.

- 4 *Special Share* – Certain rights attach to the special rights non-voting share (Special Share) issued to HM Government (Special Shareholder). Subject to the provisions of the Companies Act 1985, the Special Share may be redeemed by the Treasury Solicitor at par at any time. The Special Share confers no rights to dividends but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

Certain Articles (in particular those relating to the foreign shareholding limit, disposals and the nationality of directors) that relate to the rights attached to the Special Share may only be altered with the consent of the Special Shareholder.

The Special Shareholder is not entitled to vote at any general meeting or any other meeting of any class of shareholders.

- 5 *Preference shares* – The 50,000 preference shares were issued pursuant to the Company's incorporation and were subsequently redeemed. They cannot be reissued.

### Restrictions on transfer of shares and limitations on holdings

There are no restrictions on transfer or limitations on the holding of the ordinary shares or C Shares other than under the Articles of Association (as described below), under restrictions imposed by law or regulation (for example, insider trading laws) or pursuant to the Company's share dealing code.

The Articles of Association provide that the Company should be and remain under United Kingdom control. As such, an individual foreign shareholding limit is set at 15 per cent of the aggregate votes attaching to the share capital of all classes (taken as a whole) and capable of being cast on a poll and to all other shares that the directors determine are to be included in the calculation of such holding.

### Shareholder agreements and consent requirements

There are no known arrangements under which financial rights carried by any of the shares in the Company are held by a person other than the holder of the shares and no known agreements between the holders of shares with restrictions on the transfer of shares or exercise of voting rights.

No disposal may be made to a non-Group member which, alone or when aggregated with, the same or a connected transaction, constitutes a disposal of the whole or a material part of either the nuclear business or the assets of the Group as a whole, without consent of the Special Shareholder.

### Authority to issue shares

At the AGM in 2008, authority was given to the directors to allot new ordinary shares up to a nominal value of £128,748,950, equivalent to one third of the issued share capital of the Company at February 6, 2008. Such authority is valid until the AGM in 2009 or 18 months from May 7, 2008, whichever is the earlier. A further special resolution was passed to effect a disapplication of pre-emption rights for a maximum of five per cent of the issued share capital of the Company at February 6, 2008. The directors propose to renew these authorities at the AGM in 2009.

At the AGM in 2008, authority was given to the directors to allot new B Shares up to a nominal value of £350 million as an alternative to a cash dividend. Such authority is valid until the AGM in 2009 or 18 months from May 7, 2008, whichever is the earlier. The directors do not propose to renew this authority at the AGM in 2009.

At the AGM in 2008, authority was given to the directors to allot new C Shares up to a nominal value of £350 million as an alternative to a cash dividend. Such authority is valid until the AGM in 2009 or 18 months from May 7, 2008, whichever is the earlier. The directors propose to renew this authority at the AGM in 2009.

### Authority to purchase own shares

At the AGM in 2008, the Company was authorised by shareholders to purchase up to 182,161,998 of its own ordinary shares representing ten per cent of its issued ordinary share capital as at February 6, 2008. The Company did not make use of this authority during 2008.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2009 and a resolution to renew it will be proposed at that meeting.

### Voting rights

#### Deadlines for exercising voting rights

Electronic and paper proxy appointment and voting instructions must be received by the Company's Registrars not less than 48 hours before a general meeting.

#### Voting rights for employee share plan shares

Shares are held in various employee benefit trusts for the purpose of satisfying awards made under the various employee share plans. For shares held in a nominee capacity or if plan/trust rules provide the participant with the right to vote in respect of specifically allocated shares, the trustee votes in line with the participants' instructions. For shares that are not held absolutely on behalf of specific individuals, the general policy of the trustees, in accordance with investor protection guidelines, is to abstain from voting in respect of those shares.

### Major shareholdings

At February 11, 2009, the following companies had notified an interest in the issued ordinary share capital of the Company in accordance with the Financial Services Authority's Disclosure and Transparency Rules:

Company	Date notified	% of issued ordinary share capital
Invesco Limited	February 4, 2008	6.91
Legal and General Group Plc	December 4, 2008	4.99

### Political donations

In line with its established policy, the Group made no political donations pursuant to the authority granted at the 2008 AGM.

Although the Company does not make, and does not intend to make, donations to political parties, within the normal meaning of that expression, the definition of political donations is very broad and includes expenses legitimately incurred as part of the process of talking to members of parliament and opinion-formers to ensure that the issues and concerns of the Group are considered and addressed. These activities are not intended to support any political party and the Group's policy is not to make any donations for political purposes in the normally accepted sense.

A resolution will therefore be proposed at the 2009 AGM seeking shareholder approval for the directors to be given authority to make donations and incur expenditure which might otherwise be caught by the terms of the Companies Act 2006. The authority sought will be limited to a maximum amount of £25,000 per Group company but so as not to exceed £50,000 for the entire Group in aggregate.

During the year, one of our US subsidiaries made a contribution towards the running expenses of a political action committee (PAC) organised by its employees in an amount of US\$23,700 (2007: US\$22,440). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act. The Rolls-Royce PAC is independent of the Company and independent of any political party. Its funds are contributed voluntarily by employees and the Company cannot affect how they are applied. Such contributions do not require authorisation by shareholders under the Companies Act 2006 and therefore do not count towards the £25,000 and £50,000 limits for political donations and expenditure for which shareholder approval will be sought at the AGM.

### Change of control

#### *Contracts and joint venture agreements*

There are a number of contracts and joint venture agreements which would allow the counterparties to terminate or alter those arrangements in the event of a change of control of the Company. These arrangements are commercially confidential and their disclosure could be seriously prejudicial to the Company.

#### *Borrowings and other financial instruments*

The Group has a number of borrowing facilities provided by various lenders. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At December 31, 2008 these facilities were substantially undrawn.

The Group has entered into a series of financial instruments to hedge its currency, interest rate and commodity exposures. These contracts provide for termination or alteration in the event that a change of control of the Company materially weakens the creditworthiness of the Group.

#### *Employee share plans*

In the event of a change of control of the Company, the effect on the employee share plans would be as follows:

- *Executive Share Option Plan* – All options granted have vested and are exercisable. Consequently, no early vesting is currently possible. It is not proposed to make any further grants under this plan, which terminates in 2009.
- *Performance Share Plan* – Awards would vest pro-rata to service in the performance period, subject to remuneration committee judgement of company performance.
- *Annual Performance Related Award deferred shares* – The shares would be released from trust immediately.

- *ShareSave* – Options would become exercisable immediately. The new company might offer an equivalent option in exchange for cancellation of the existing option.
- *Share Incentive Plan* – Consideration received as shares would be held within the Plan, if possible, otherwise the consideration would be treated as a disposal from the Plan.

### Essential commercial relationships

#### *Supply chain*

Certain suppliers to the Group contribute key components or services the loss of which could cause disruption to the Group's deliveries. However, none are so vital that their loss would affect the viability of the business as a whole. When dealing with suppliers, the Group is guided by the Supply Chain Relationships in Aerospace (SCRIA) initiative. It seeks the best possible terms from suppliers and, when entering into binding purchasing contracts, gives consideration to quality, delivery, price and the terms of payment. In the event of disputes, efforts are made to resolve them quickly. As the Company is a holding company and does not itself trade, it owed no amounts to trade creditors at December 31, 2008 and therefore the number of creditor days required to be shown in this report to comply with the provisions of the Companies Act 1985, is nil.

#### *Export licences*

The Group holds export licences with UK, US and a number of other national licensing authorities where the Group operates. Maintaining and securing such licences is critical to success as a global business. The Group therefore attaches the highest priority to complying fully with export controls in all the jurisdictions in which it operates. Detailed processes have been put in place to ensure that the Group follows all applicable legal and regulatory requirements. The Board has established an Exports Committee, chaired by the Chief Operating Officer, which has responsibility for policy and compliance with regard to the Group's export activity.

In the UK, the Group fully complies with the provisions of the UK Export Control Act (2002) and all relevant EU Export Control Regulations applicable in the UK. Globally, the Group complies with all relevant laws and regulations regarding the export of military, dual use goods and technology. Most notably, in the US the Group vigorously enforces a policy of compliance with the relevant legislation and its underlying regulatory intent.

#### *Customers*

The increasingly global nature of the business, balanced across the civil aerospace, defence aerospace, marine and energy businesses, ensures that the Group is not overly dependent on any individual customer.

**Statement of directors' responsibilities**

The directors are responsible for preparing the Annual report 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 as adopted by the EU (IFRS) 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 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;
- 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.

Under applicable law and regulations, the directors are also responsible for preparing a Directors' report, Directors' remuneration report and Corporate governance statement that comply with that law and those regulations. The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

**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. The financial risk management objectives and policies of the Company and the exposure of the Company to price risk, credit risk, liquidity risk and cash flow risk is discussed on pages 60 to 63 of the business review.

**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 or she ought to have taken as a director in order to make himself or 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.

**Responsibility statement**

Each of the persons who is a director at the date of approval of this report confirms that to the best of his or her knowledge:

- i) each of the Group and parent company financial statements, prepared in accordance with IFRS and UK Accounting Standards respectively, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole; and
- ii) the Directors' report on pages 1 to 84 includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

**Tim Rayner**

General Counsel and Company Secretary  
February 11, 2009

<b>Consolidated financial statements</b>	
86	Consolidated income statement
87	Consolidated balance sheet
88	Consolidated cash flow statement
90	Consolidated statement of recognised income and expense
91	<b>Notes to the consolidated financial statements</b>
91	1 Significant accounting policies
96	2 Segmental analysis
100	3 Net financing
101	4 Taxation
103	5 Earnings per ordinary share
103	6 Employee information
104	7 Auditors' remuneration
105	8 Intangible assets
107	9 Property, plant and equipment
109	10 Investments
110	11 Inventory
110	12 Trade and other receivables
111	13 Cash and cash equivalents
111	14 Borrowings
112	15 Trade and other payables
113	16 Financial instruments
125	17 Provisions
126	18 Post-retirement benefits
129	19 Share capital
130	20 Movements in capital and reserves
131	21 Share-based payments
134	22 Operating and finance leases
135	23 Contingent liabilities
136	24 Related party transactions
137	25 Acquisitions and disposals

<b>Company financial statements</b>	
138	Company balance sheet
138	Reconciliation of movements in shareholders' funds
139	<b>Notes to the Company financial statements</b>
139	1 Accounting policies
139	2 Investments – subsidiary undertakings
140	3 Financial liabilities
140	4 Share capital
141	5 Movements in capital and reserves
141	6 Contingent liabilities
141	7 Other information

<b>Other matters</b>	
142	Principal subsidiary undertakings
143	Principal joint ventures
145	Independent auditors' report

# Consolidated income statement

For the year ended December 31, 2008

86

	Notes	2008 £m	2007 £m
<b>Revenue</b>	2	<b>9,082</b>	7,435
Cost of sales		<b>(7,311)</b>	(6,003)
<b>Gross profit</b>		<b>1,771</b>	1,432
Other operating income		<b>79</b>	50
Commercial and administrative costs		<b>(666)</b>	(653)
Research and development costs		<b>(403)</b>	(381)
Share of profit of joint ventures	10	<b>74</b>	66
<b>Operating profit</b>		<b>855</b>	514
Profit/(loss) on sale or termination of businesses	25	<b>7</b>	(2)
<b>Profit before financing</b>	2	<b>862</b>	512
Financing income	3	<b>432</b>	718
Financing costs	3	<b>(3,186)</b>	(497)
Net financing		<b>(2,754)</b>	221
<b>(Loss)/profit before taxation<sup>1</sup></b>		<b>(1,892)</b>	733
Taxation	4	<b>547</b>	(133)
<b>(Loss)/profit for the year</b>		<b>(1,345)</b>	600
<b>Attributable to:</b>			
Equity holders of the parent		<b>(1,340)</b>	606
Minority interests	20	<b>(5)</b>	(6)
<b>(Loss)/profit for the year</b>		<b>(1,345)</b>	600
<b>Earnings per ordinary share:</b>			
Basic	5	<b>(73.63)p</b>	33.67p
Diluted	5	<b>(73.63)p</b>	32.97p
Payments to shareholders in respect of the year	16	<b>(263)</b>	(237)
<sup>1</sup> Underlying profit before taxation	2	<b>880</b>	800

# Consolidated balance sheet

At December 31, 2008

87

	Notes	2008 £m	2007 £m
<b>ASSETS</b>			
<b>Non-current assets</b>			
Intangible assets	8	2,286	1,761
Property, plant and equipment	9	1,995	1,813
Investments – joint ventures	10	345	284
Other investments	10	53	57
Deferred tax assets	4	685	81
Post-retirement scheme surpluses	18	453	210
		<b>5,817</b>	<b>4,206</b>
<b>Current assets</b>			
Inventory	11	2,600	2,203
Trade and other receivables	12	3,929	2,585
Taxation recoverable		9	7
Other financial assets	16	390	514
Short-term investments		1	40
Cash and cash equivalents	13	2,471	1,897
Assets held for sale		12	7
		<b>9,412</b>	<b>7,253</b>
<b>Total assets</b>		<b>15,229</b>	<b>11,459</b>
<b>LIABILITIES</b>			
<b>Current liabilities</b>			
Borrowings	14	(23)	(34)
Other financial liabilities	16	(2,450)	(85)
Trade and other payables	15	(5,735)	(4,326)
Current tax liabilities		(184)	(188)
Provisions	17	(181)	(121)
		<b>(8,573)</b>	<b>(4,754)</b>
<b>Non-current liabilities</b>			
Borrowings	14	(1,325)	(1,030)
Other financial liabilities	16	(391)	(303)
Trade and other payables	15	(1,318)	(965)
Non-current tax liabilities		(1)	—
Deferred tax liabilities	4	(307)	(345)
Provisions	17	(188)	(180)
Post-retirement scheme deficits	18	(595)	(333)
		<b>(4,125)</b>	<b>(3,156)</b>
<b>Total liabilities</b>		<b>(12,698)</b>	<b>(7,910)</b>
<b>Net assets</b>		<b>2,531</b>	<b>3,549</b>
<b>EQUITY</b>			
<b>Capital and reserves</b>			
Called-up share capital	19	369	364
Share premium account	20	82	67
Capital redemption reserves	20	204	191
Hedging reserves	20	(22)	77
Other reserves	20	663	62
Retained earnings	20	1,226	2,776
<b>Equity attributable to equity holders of the parent</b>		<b>2,522</b>	<b>3,537</b>
<b>Minority interests</b>	20	<b>9</b>	<b>12</b>
<b>Total equity</b>		<b>2,531</b>	<b>3,549</b>

The financial statements on pages 86 to 137 were approved by the Board on February 11, 2009 and signed on its behalf by:

**Simon Robertson**  
Chairman

**Andrew Shilston**  
Finance Director

# Consolidated cash flow statement

For the year ended December 31, 2008

88

	Notes	2008 £m	2007 £m
<b>Reconciliation of cash flows from operating activities</b>			
(Loss)/profit before taxation		(1,892)	733
Share of profit of joint ventures	10	(74)	(66)
(Profit)/loss on sale or termination of businesses	25	(7)	2
(Profit)/loss on sale of property, plant and equipment		(11)	1
Net interest payable	3	10	6
Net post-retirement scheme financing	3	22	(30)
Net other financing	3	2,722	(197)
Taxation paid		(117)	(71)
Amortisation of intangible assets	8	107	63
Depreciation of property, plant and equipment	9	208	170
Increase/(decrease) in provisions		39	(42)
Increase in inventories		(208)	(359)
Increase in trade and other receivables		(1,072)	(128)
Increase in trade and other payables		1,242	778
Decrease in other financial assets and liabilities		144	357
Additional cash funding of post-retirement schemes		(117)	(441)
Share-based payments charge	21	40	36
Transfers of hedge reserves to income statement	16	(80)	(149)
Dividends received from joint ventures	10	59	42
<b>Net cash inflow from operating activities</b>		<b>1,015</b>	<b>705</b>
<b>Cash flows from investing activities</b>			
Additions of unlisted investments		(1)	(5)
Disposals of unlisted investments		6	—
Additions to intangible assets		(389)	(294)
Purchases of property, plant and equipment		(286)	(304)
Disposals of property, plant and equipment		68	47
Acquisitions of businesses	25	(50)	(6)
Disposals of businesses	25	6	3
Investments in joint ventures		(32)	(13)
Disposals of joint ventures		30	—
<b>Net cash outflow from investing activities</b>		<b>(648)</b>	<b>(572)</b>
<b>Cash flows from financing activities</b>			
Borrowings due within one year – repayment of loans		(1)	(350)
Borrowings due after one year – repayment of loans		(22)	—
Capital element of finance lease payments		(4)	(5)
Net cash outflow from decrease in borrowings		(27)	(355)
Interest received		52	95
Interest paid		(53)	(93)
Interest element of finance lease payments		(1)	(3)
Decrease/(increase) in government securities and corporate bonds		39	(6)
Issue of ordinary shares		17	29
Purchase of ordinary shares		(44)	(77)
Other transactions in ordinary shares		(4)	34
Redemption of B Shares		(200)	(97)
<b>Net cash outflow from financing activities</b>		<b>(221)</b>	<b>(473)</b>
<b>Increase/(decrease) in cash and cash equivalents</b>		<b>146</b>	<b>(340)</b>
<b>Cash and cash equivalents at January 1</b>		<b>1,872</b>	<b>2,171</b>
Foreign exchange		441	41
Net cash of businesses acquired/disposed		3	—
<b>Cash and cash equivalents at December 31</b>		<b>2,462</b>	<b>1,872</b>

	2008 £m	2007 £m
<b>Reconciliation of movements in cash and cash equivalents to movements in net funds</b>		
Increase/(decrease) in cash and cash equivalents	146	(340)
Net cash outflow from decrease in borrowings	27	355
Cash (inflow)/outflow from (decrease)/increase in government securities and corporate bonds	(39)	6
Change in net funds resulting from cash flows	134	21
Net funds of businesses acquired	(3)	—
Exchange adjustments	439	41
Fair value adjustments	(319)	(18)
<b>Movement in net funds</b>	<b>251</b>	<b>44</b>
Net funds at January 1 excluding the fair value of swaps	873	829
Net funds at December 31 excluding the fair value of swaps	1,124	873
<b>Fair value of swaps hedging fixed rate borrowings</b>	<b>334</b>	<b>15</b>
<b>Net funds at December 31</b>	<b>1,458</b>	<b>888</b>

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

	At January 1, 2008 £m	Funds flow £m	Net funds of businesses acquired/ disposed £m	Exchange adjustments £m	Fair value adjustments £m	Reclassi- fications £m	At December 31, 2008 £m
Cash at bank and in hand	1,265	(550)	1	224	—	—	940
Overdrafts	(25)	18	—	(2)	—	—	(9)
Short-term deposits	632	678	2	219	—	—	1,531
Cash and cash equivalents	1,872	146	3	441	—	—	2,462
Investments	40	(39)	—	—	—	—	1
Other borrowings due within one year	(4)	1	(6)	—	—	(2)	(11)
Borrowings due after one year	(1,026)	22	—	(3)	(319)	2	(1,324)
Finance leases	(9)	4	—	1	—	—	(4)
	873	134	(3)	439	(319)	—	1,124
Fair value of swaps hedging fixed rate borrowings	15	—	—	—	319	—	334
	888	134	(3)	439	—	—	1,458

# Consolidated statement of recognised income and expense

For the year ended December 31, 2008

90

	Notes	2008 £m	2007 £m
Foreign exchange translation differences from foreign operations		603	117
Net actuarial gains	18	944	511
Movement in unrecognised post-retirement surplus	18	(928)	(112)
Transfers from transition hedging reserve	16	(80)	(149)
Transfers to cash flow hedging reserve	10	(41)	—
Related tax movements	4	15	(86)
Change in rates of corporation tax	4	—	(9)
Net income recognised directly in equity		513	272
(Loss)/profit for the year		(1,345)	600
<b>Total recognised income and expense for the year</b>		<b>(832)</b>	<b>872</b>
<b>Attributable to:</b>			
Equity holders of the parent		(829)	878
Minority interests		(3)	(6)
<b>Total recognised income and expense for the year</b>		<b>(832)</b>	<b>872</b>

## 1 Significant accounting policies

### The Company

Rolls-Royce Group plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended December 31, 2008 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 11, 2009.

### 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, 2008 (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 that 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.

### Basis of consolidation

The Group financial statements include the financial statements of the Company and all of its subsidiary undertakings made up to December 31, together with the Group's share of the results of 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 risks 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 2008. 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, 2008.

*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 products 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, 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.

*Government grants*

Government grants are recognised in the income statement so as to match them with the related expenses that they are intended to compensate. Where grants are received in advance of the related expenses, they are included in the balance sheet as deferred income. Non-monetary grants are recognised at fair value.

*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. The Group 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, financial RRSPs and B Shares 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 (except for changes in exchange rates which are included in the income statement) 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.

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, exercised, or no longer qualifies for hedge accounting. At that time, for cash flow hedges and if the forecast transaction remains probable, 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 previously 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 of the identifiable assets acquired and the liabilities assumed.

- 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 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 price 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.

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

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 24 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 17 years).

#### *Leases*

- i) As Lessee
 

Assets financed by leasing agreements that give rights approximating to ownership (finance leases) are 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 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 provides share-based payment arrangements to certain employees. These are principally 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.

Cash-settled share options (grants in the International ShareSave plan) are measured at fair value at the balance sheet date. The Group recognises a liability at the balance sheet date based on these fair values, and taking into account the estimated number of options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

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 21 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 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 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 set out below. The estimation of the relevant assets and liabilities involves the combination of a number of assumptions. Where appropriate and practicable, sensitivities are disclosed in the relevant notes.

*Current economic environment*

The current economic environment could impact a number of estimates necessary to prepare the financial statements, in particular, the recoverable amount of assets and contingent liabilities. The Group has taken these factors into account in assessing the estimates set out below. These matters are discussed in more detail in the Finance Director's review.

#### 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. (Carrying values at December 31, 2008 £1,008m, December 31, 2007 £801m).
- 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. (Carrying values at December 31, 2008 £1,072m, December 31, 2007 £880m).
- The financial liabilities arising from financial risk and revenue sharing partnerships are valued at each reporting date using the amortised cost method. (Carrying values at December 31, 2008 £455m, December 31, 2007 £315m). 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, 2008 £685m, December 31, 2007 £81m) 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. The accounting valuation, which was based on assumptions determined with independent actuarial advice, resulted in a net deficit of £142m before deferred taxation being recognised on the balance sheet at December 31, 2008 (December 31, 2007 £123m). 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 18.

#### Provisions

As described in the accounting policy above, the Group measures provisions (carrying value at December 31, 2008 £369m, December 31, 2007 £301m) 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 23, the Group has significant long-term contingent obligations. The directors consider that, after allowing for provisions already made, 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 adopted in 2008

No standards or interpretations that became effective during 2008 had a significant impact on the Group's financial statements.

#### Revisions to IFRS not applicable in 2008

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 14 *IAS 19 The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* is applicable for 2009. This interpretation applies where regulatory funding requirements will result in an unrecognisable surplus arising in the future. Had it been applicable in 2008 an additional pension deficit of approximately £425m would have been recognised.

Amendment to IAS 23 *Borrowing Costs* is applicable for 2009. The amendment generally eliminates the option to expense borrowing costs attributable to the acquisition, construction or production of a qualifying asset as incurred, and instead requires the capitalisation of such borrowing costs as part of the cost of the specific asset. The Group does not consider that the adoption of this amendment will result in the capitalisation of a significant level of borrowing costs.

Amendments to IFRS 2 *Share-based Payments: Vesting Conditions and Cancellations* are applicable for 2009. These amendments concern certain aspects of the valuation of share-based payments and the impact of a cancellation by a grantee. The Group does not consider that these amendments will have a significant impact on the charges recognised to date for share-based payments.

Amendments to IAS 1 *Presentation of Financial Statements* are applicable for 2010. These amendments revise requirements for the presentation of the financial statements and will not affect the Group's overall reported results.

Revised IFRS 3 *Business Combinations* and amendments to IAS 27 *Consolidated and Separate Financial Statements* are applicable for 2010, if endorsed by the EU. If endorsed, these standards will affect the future accounting for acquisitions and transactions with non-controlling interests. There will be no retrospective impact.

IFRIC 12 *Service Concession Arrangements* is applicable for 2009, if endorsed by the EU. If endorsed, this will apply to the Group's investments in the joint ventures operating the Future Strategic Tanker Aircraft contract with the UK Ministry of Defence.

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.

## 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 and 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
<b>Analysis by business segments for the year ended December 31, 2008</b>							
Revenue from sale of original equipment	1,761	738	1,488	390	—	—	4,377
Revenue from aftermarket services	2,676	950	712	367	—	—	4,705
Total revenue	4,437	1,688	2,200	757	—	—	9,082
Other operating income – RRSP receipts	79						79
Operating profit excluding share of profit of joint ventures	438	220	178	(4)	(51)	—	781
Share of profit of joint ventures	55	12	(2)	9	—	—	74
Profit/(loss) on sale or termination of businesses	8	—	—	(1)	—	—	7
<b>Profit/(loss) before financing and taxation</b>	<b>501</b>	<b>232</b>	<b>176</b>	<b>4</b>	<b>(51)</b>	<b>—</b>	<b>862</b>
Financing income					432		432
Financing costs					(3,186)		(3,186)
Taxation					547		547
<b>Profit for the year</b>							<b>(1,345)</b>
<b>Other information</b>							
Segment assets	7,223	1,044	2,334	807	—	(477)	10,931
Investments in joint ventures	320	(7)	5	27	—	—	345
Cash and short-term investments					2,472		2,472
Fair value of swaps hedging fixed rate borrowings					334		334
Income tax assets					694		694
Post-retirement scheme surpluses					453		453
Total assets	7,543	1,037	2,339	834	3,953	(477)	15,229
Segment liabilities	(7,213)	(1,234)	(1,851)	(442)	—	477	(10,263)
Borrowings					(1,348)		(1,348)
Income tax liabilities					(492)		(492)
Post-retirement scheme deficits					(595)		(595)
Total liabilities	(7,213)	(1,234)	(1,851)	(442)	(2,435)	477	(12,698)
Net assets/(liabilities)	330	(197)	488	392	1,518	—	2,531
<b>Expenditure on intangible assets and property, plant and equipment</b>							
Expenditure on intangible assets and property, plant and equipment	495	79	67	35			676
Depreciation and amortisation	212	42	32	29			315

## 2 Segmental analysis continued

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Central items £m	Eliminations £m	Group £m
<b>Analysis by business segments for the year ended December 31, 2007</b>							
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
Other operating income – RRSP receipts	50	—	—	—	—	—	50
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)
<b>Profit/(loss) before financing and taxation</b>	<b>308</b>	<b>170</b>	<b>91</b>	<b>(8)</b>	<b>(49)</b>	<b>—</b>	<b>512</b>
Financing income					718		718
Financing costs					(497)		(497)
Taxation					(133)		(133)
<b>Profit for the year</b>							<b>600</b>
<b>Other information</b>							
Segment assets	6,032	992	1,693	642	—	(461)	8,898
Investments in joint ventures	214	34	5	31	—	—	284
Cash and short-term investments					1,937		1,937
Fair value of swaps hedging fixed rate borrowings					42		42
Income tax assets					88		88
Post-retirement scheme surpluses					210		210
Total assets	6,246	1,026	1,698	673	2,277	(461)	11,459
Segment liabilities	(3,778)	(1,198)	(1,135)	(303)	—	461	(5,953)
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	(3,778)	(1,198)	(1,135)	(303)	(1,957)	461	(7,910)
Net assets/(liabilities)	2,468	(172)	563	370	320	—	3,549
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

### Geographical segments

The Group's revenue by destination is shown below:

	2008 £m	2007 £m
United Kingdom	1,462	1,185
Rest of Europe	1,890	1,478
USA	2,214	2,232
Canada	299	274
Asia	2,439	1,785
Africa	143	108
Australasia	255	137
Other	380	236
	<b>9,082</b>	<b>7,435</b>

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:

	Assets		Additions to intangible assets and property, plant and equipment	
	2008 £m	2007 £m	2008 £m	2007 £m
United Kingdom	10,275	7,737	517	517
North America	1,764	1,465	78	39
Nordic countries	1,756	1,280	28	18
Germany	893	645	40	20
Other	662	394	13	6
Eliminations	(121)	(62)	—	—
	<b>15,229</b>	<b>11,459</b>	<b>676</b>	<b>600</b>

## 2 Segmental analysis continued

### Underlying performance

As discussed in the Finance Director's review on pages 55 and 56, the Group seeks to present a measure of underlying performance that excludes items considered to be non-underlying in nature. The principles adopted are:

*Underlying revenues* – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these exclude the release of the foreign exchange transition hedging reserve and reflect the achieved exchange rates arising on settled derivative contracts.

*Underlying profit before financing* – Where transactions are denominated in a currency other than the functional currency of the Group undertaking, this excludes the release of the foreign exchange transition hedging reserve and reflects the transactions at the achieved exchange rates on settled derivative contracts. In 2007, this also excluded £130m of past service post-retirement costs.

*Underlying profit before taxation* – In addition to those adjustments in underlying profit before financing:

- Includes amounts realised from settled derivative contracts and revaluation of relevant assets and liabilities to exchange rates forecast to be achieved from future settlement of derivative contracts.
- Excludes unrealised amounts arising from revaluations required by IAS 39 *Financial Instruments: Recognition and Measurement*, changes in value of financial RRSP contracts arising from changes in forecast payments and the net impact of financing costs related to post-retirement scheme benefits.

Underlying profit adjustments:

	2008		2007	
	Profit before financing £m	(Loss)/profit before tax £m	Profit before financing £m	Profit before tax £m
<b>Profit/(loss) per consolidated income statement</b>	<b>862</b>	<b>(1,892)</b>	512	733
Release of transition hedging reserve	(80)	(80)	(149)	(149)
Realised gains on settled derivative contracts <sup>1</sup>	185	292	415	420
Net unrealised fair value changes to derivative contracts <sup>2</sup>	(4)	2,475	—	(251)
Effect of currency on contract accounting	(44)	(44)	(76)	(76)
Revaluation of trading assets and liabilities	—	(14)	—	10
Financial RRSPs – foreign exchange differences and changes in forecast payments	—	121	—	13
Net post-retirement scheme financing	—	22	—	(30)
Post-retirement schemes – past service costs <sup>3</sup>	—	—	130	130
Total underlying adjustments	57	2,772	320	67
<b>Underlying profit</b>	<b>919</b>	<b>880</b>	832	800

<sup>1</sup> Loss before tax excludes £24m of realised losses (2007 nil) on derivative contracts settled in respect of trading cash flows that will occur after the year-end.

<sup>2</sup> Includes £4m of unrealised gains (2007 £nil) in respect of derivative contracts held by joint venture companies (included in profit before financing).

<sup>3</sup> During 2007, 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 also increased the amount of the lump sum payment for the pension commuted. Updating the commutation arrangements to reflect these factors increased the post-retirement liability by £100m. The Group also agreed a 2 per cent discretionary increase applicable to pensions that do not benefit from any guaranteed increase, which increased the liability by £30m.

The reconciliation of underlying earnings per ordinary share is provided in note 5.

Underlying profit reconciliation:

	2008			2007		
	Results per consolidated income statement £m	Underlying adjustments £m	Underlying results £m	Results per consolidated income statement £m	Underlying adjustments £m	Underlying results £m
<b>Profit before financing</b>						
Civil aerospace	501	65	566	308	256	564
Defence aerospace	232	(9)	223	170	29	199
Marine	176	7	183	91	22	113
Energy	4	(6)	(2)	(8)	13	5
Central items	(51)	—	(51)	(49)	—	(49)
	862	57	919	512	320	832
Net financing	(2,754)	2,715	(39)	221	(253)	(32)
<b>(Loss)/profit before taxation</b>	<b>(1,892)</b>	<b>2,772</b>	<b>880</b>	733	67	800
Taxation	547	(764)	(217)	(133)	(60)	(193)
<b>(Loss)/profit for the year</b>	<b>(1,345)</b>	<b>2,008</b>	<b>663</b>	600	7	607

### 3 Net financing

	2008		2007	
	Per consolidated income statement £m	Underlying financing <sup>1</sup> £m	Per consolidated income statement £m	Underlying financing <sup>1</sup> £m
<b>Financing income</b>				
Interest receivable	59	59	83	83
Fair value gains on foreign currency contracts (note 16) <sup>2</sup>	—	—	215	—
Fair value gains on commodity derivatives (note 16) <sup>2</sup>	—	—	36	—
Expected return on post-retirement scheme assets (note 18)	373	—	384	—
	<b>432</b>	<b>59</b>	718	83
<b>Financing costs</b>				
Interest payable	(69)	(69)	(89)	(89)
Fair value losses on foreign currency contracts (note 16) <sup>2</sup>	(2,383)	—	—	—
Financial RRSPs – foreign exchange differences and changes in forecast payments (note 16)	(121)	—	(13)	—
Financial charge relating to financial RRSPs (note 16)	(26)	(26)	(26)	(26)
Fair value losses on commodity derivatives (note 16) <sup>2</sup>	(96)	—	—	—
Interest on post-retirement scheme liabilities (note 18)	(395)	—	(354)	—
Net foreign exchange losses	(91)	—	(15)	—
Other financing charges	(5)	(3)	—	—
	<b>(3,186)</b>	<b>(98)</b>	(497)	(115)
<b>Net financing</b>	<b>(2,754)</b>	<b>(39)</b>	221	(32)
<b>Analysed as:</b>				
Net interest payable	(10)	(10)	(6)	(6)
Net post-retirement scheme financing	(22)	—	30	—
Net other financing	(2,722)	(29)	197	(26)
<b>Net financing</b>	<b>(2,754)</b>	<b>(39)</b>	221	(32)
<sup>1</sup> See note 2				
<sup>2</sup> Net (loss)/gain on items held for trading	(2,479)	—	251	—

## 4 Taxation

	UK		Overseas		Total	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
<b>Current tax</b>						
Current tax charge for the year	7	47	88	72	95	119
Less double tax relief	(7)	(7)	—	—	(7)	(7)
	—	40	88	72	88	112
Adjustments in respect of prior years	(9)	(27)	14	21	5	(6)
	(9)	13	102	93	93	106
<b>Deferred tax</b>						
Deferred tax (credit)/charge for the year	(574)	65	(50)	13	(624)	78
Adjustments in respect of prior years	2	(8)	(18)	(8)	(16)	(16)
Deferred tax credit resulting from reduction in tax rates <sup>1</sup>	—	(23)	—	(12)	—	(35)
	(572)	34	(68)	(7)	(640)	27
Recognised in the income statement	(581)	47	34	86	(547)	133

### Other tax charges/(credits)

	2008 £m	2007 £m
Recognised in the statement of recognised income and expense – deferred tax <sup>1</sup>	(15)	95
Recognised directly in equity – current tax	—	(43)
– deferred tax <sup>1</sup>	11	23
	(4)	75

<sup>1</sup> In 2007, the deferred tax assets and liabilities reflected the reductions in corporate tax rates in the UK and Germany which were enacted during that year. The resulting charges or credits were recognised in the income statement except to the extent that they related to items previously charged or credited to the statement of recognised income and expense or equity. Accordingly in 2007, £35m was credited to the income statement, £9m was charged to the statement of recognised income and expense, and £5m was charged directly to equity.

### Tax reconciliation

	2008 £m	2007 £m
(Loss)/profit before taxation	(1,892)	733
Less share of profits of joint ventures (note 10)	(74)	(66)
(Loss)/profit before taxation excluding joint ventures	(1,966)	667
Nominal tax charge at UK corporation tax rate <b>28.5%</b> (2007 30%)	(560)	200
UK R&D credit	(25)	(22)
Rate differences	16	12
Other permanent differences	15	(3)
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	(3)	(6)
Tax losses in year not recognised in deferred tax	21	9
Adjustments in respect of prior years	(11)	(22)
Reduction in opening deferred taxes resulting from reduction in tax rate	—	(35)
	(547)	133
Analysis of taxation charge:		
Underlying items (note 2)	217	193
Non-underlying items	(764)	(60)
	(547)	133

## 4 Taxation continued

### Deferred taxation assets and liabilities

	2008 £m	2007 £m
At January 1	(264)	(111)
Amount credited/(charged) to income statement	640	(27)
Amount credited/(charged) to statement of recognised income and expense (SORIE)	15	(95)
Amount charged to equity	(11)	(23)
On acquisition of business	(5)	—
Exchange movements	3	(8)
At December 31	378	(264)
Analysed as:		
Deferred tax assets	685	81
Deferred tax liabilities	(307)	(345)
	378	(264)

The analysis of the deferred tax position is as follows:

	At January 1, 2008 £m	Recognised in income statement £m	Recognised in SORIE £m	Recognised in equity £m	On acquisition £m	Exchange movements £m	At December 31, 2008 £m
Intangible assets	(140)	(50)	—	—	(4)	(6)	(200)
Property, plant and equipment	(143)	3	—	—	—	(6)	(146)
Other temporary differences	62	(40)	—	(20)	—	(33)	(31)
Amounts recoverable on contracts	(145)	(50)	—	—	—	—	(195)
Pensions and other post-retirement scheme benefits	35	(26)	(7)	—	(1)	48	49
Foreign exchange and commodity financial assets and liabilities	(121)	754	22	—	—	—	655
Losses	124	49	—	9	—	—	182
Advance corporation tax	64	—	—	—	—	—	64
	(264)	640	15	(11)	(5)	3	378

	2008 £m	2007 £m
Advance corporation tax	118	118
Losses and other unrecognised deferred tax assets	67	42
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	185	160

In addition, there are temporary differences of **£946m** (2007 £943m) 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.

## 5 Earnings per ordinary share

Basic earnings per ordinary share (EPS) are calculated by dividing the profit attributable to ordinary shareholders by weighted average number of ordinary shares in issue during the year, excluding ordinary shares held under trust, which have been treated as if they had been cancelled.

Diluted EPS are calculated by dividing the profit attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the year as above, adjusted by the bonus element of share options.

	2008			2007		
	Basic	Potentially dilutive share options	Diluted	Basic	Potentially dilutive share options	Diluted
(Loss)/profit (£m)	(1,340)	—	(1,340)	606	—	606
Weighted average number of shares (millions)	1,820	— <sup>1</sup>	1,820	1,800	38	1,838
EPS (pence)	(73.63)	—	(73.63)	33.67	(0.70)	32.97

<sup>1</sup> As the basic EPS is negative, in accordance with IAS 33 *Earnings per Share*, share options are not considered dilutive.

Underlying<sup>2</sup> EPS has been calculated as follows:

	2008		2007	
	Pence	£m	Pence	£m
EPS/(Loss)/profit attributable to equity holders of the parent	(73.63)	(1,340)	33.67	606
Release of transition hedging reserve	(4.40)	(80)	(8.28)	(149)
Realised gains on settled derivative contracts	16.05	292	23.33	420
Net unrealised fair value changes to derivative contracts	135.99	2,475	(13.94)	(251)
Effect of currency on contract accounting	(2.42)	(44)	(4.22)	(76)
Revaluation of trading assets and liabilities	(0.77)	(14)	0.56	10
Financial RRSPs – foreign exchange differences and changes in forecast payments	6.65	121	0.72	13
Net post-retirement scheme financing	1.21	22	(1.67)	(30)
Post-retirement schemes – past service costs (note 18)	—	—	7.22	130
Related tax effect	(41.98)	(764)	(1.39)	(25)
Change in rates of corporation tax (note 4)	—	—	(1.94)	(35)
Underlying EPS/Underlying profit attributable to equity holders of the parent	36.70	668	34.06	613

<sup>2</sup> See note 2.

## 6 Employee information

	2008 Number	2007 Number
<b>Average weekly number of Group employees during the year</b>		
United Kingdom	22,500	22,900
Overseas	16,500	15,700
	<b>39,000</b>	<b>38,600</b>
Civil aerospace	22,700	22,800
Defence aerospace	5,700	5,600
Marine	8,100	7,700
Energy	2,500	2,500
	<b>39,000</b>	<b>38,600</b>
	£m	£m
<b>Group employment costs<sup>1</sup></b>		
Wages and salaries	1,649	1,534
Social security costs	180	172
Share-based payments (note 21)	40	36
Pensions and other post-retirement scheme benefits (note 18)	218	248
	<b>2,087</b>	<b>1,990</b>

<sup>1</sup> Remuneration of key management personnel is shown in note 24.

## 7 Auditors' remuneration

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

	2008 £m	2007 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements <sup>1</sup>	0.1	0.1
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	3.6	3.7
Total fees payable for the audit services	3.7	3.8
Fees payable to the Company's auditors and its associates for other services:		
Other services pursuant to legislation	0.5	0.1
Other services relating to taxation	0.4	0.3
	<b>4.6</b>	<b>4.2</b>
Fees payable in respect of the Group's pension schemes		
Audit	0.2	0.2
Other services relating to taxation	—	0.1

<sup>1</sup> The level of fees payable to the Company's auditors for the audit of the Company's annual financial statements reflects the fact that limited incremental work is required in respect of the audit of these financial statements. Rolls-Royce plc, a subsidiary of the Company, is also required to prepare consolidated financial statements and the fees payable to the Company's auditors for the audit of those financial statements, including the audit of the sub-consolidation, is included in the audit of the Company's subsidiaries pursuant to legislation.

## 8 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
<b>Cost:</b>						
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 January 1, 2008	<b>801</b>	<b>504</b>	<b>514</b>	<b>366</b>	<b>109</b>	<b>2,294</b>
Exchange adjustments	<b>173</b>	<b>9</b>	<b>5</b>	<b>—</b>	<b>7</b>	<b>194</b>
Additions	—	<b>55</b>	<b>113</b>	<b>97</b>	<b>128</b>	<b>393</b>
On acquisitions of businesses	<b>41</b>	—	—	—	<b>11</b>	<b>52</b>
On disposals of businesses	<b>(2)</b>	—	—	—	—	<b>(2)</b>
Disposals	—	—	—	—	(1)	(1)
At December 31, 2008	<b>1,013</b>	<b>568</b>	<b>632</b>	<b>463</b>	<b>254</b>	<b>2,930</b>
<b>Accumulated amortisation and impairment:</b>						
At January 1, 2007	—	143	132	176	19	470
Provided during the year <sup>1</sup>	—	7	18	28	10	63
At January 1, 2008	—	<b>150</b>	<b>150</b>	<b>204</b>	<b>29</b>	<b>533</b>
Exchange adjustments	—	<b>3</b>	—	—	<b>2</b>	<b>5</b>
Provided during the year <sup>1</sup>	<b>5</b>	<b>12</b>	<b>26</b>	<b>46</b>	<b>18</b>	<b>107</b>
Disposals	—	—	—	—	(1)	(1)
At December 31, 2008	<b>5</b>	<b>165</b>	<b>176</b>	<b>250</b>	<b>48</b>	<b>644</b>
<b>Net book value at December 31, 2008</b>	<b>1,008</b>	<b>403</b>	<b>456</b>	<b>213</b>	<b>206</b>	<b>2,286</b>
Net book value at December 31, 2007	801	354	364	162	80	1,761
Net book value at January 1, 2007	735	231	290	153	51	1,460

<sup>1</sup> Charged to cost of sales except development costs, which are charged to research and development costs.

## 8 Intangible assets continued

### 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	2008 £m	2007 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	266	203
Commercial marine – arising from the acquisition of Vinters plc	Marine	599	514
Commercial marine – arising from the acquisition of Scandinavian Electric Holding AS	Marine	42	—
Energy – arising from the acquisition of Rolls-Royce Energy Systems Inc.	Energy	73	54
Other	Various	28	30
		<b>1,008</b>	<b>801</b>

Goodwill has been tested for impairment during 2008 on the following basis:

- The carrying value of goodwill has been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long-term and established nature of many of the Group's products (product lives are often measured in decades), 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.

The principal value in use assumptions for significant goodwill balances are:

- Rolls-Royce Deutschland Ltd & Co KG – volume of engine deliveries, flying hours of installed fleet and cost escalation, based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at 2.5 per cent. The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. A doubling of the discount rate would not lead to an impairment of this balance.
- Vinters plc – volume of equipment deliveries, capture of aftermarket and cost escalation, based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at 4 per cent. The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. It would require a doubling of the discount rate to cause an impairment of this balance.

## 9 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
<b>Cost:</b>					
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 disposals of businesses	—	(4)	—	—	(4)
Reclassifications	70	111	4	(185)	—
Transferred to assets held for sale	—	—	(12)	—	(12)
Disposals/write-offs	—	(120)	(65)	—	(185)
At January 1, 2008	<b>699</b>	<b>2,110</b>	<b>174</b>	<b>176</b>	<b>3,159</b>
Exchange adjustments	<b>70</b>	<b>180</b>	<b>6</b>	<b>22</b>	<b>278</b>
Additions	<b>18</b>	<b>104</b>	<b>28</b>	<b>133</b>	<b>283</b>
On acquisitions of businesses	<b>18</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>18</b>
On disposals of businesses	<b>—</b>	<b>(13)</b>	<b>—</b>	<b>—</b>	<b>(13)</b>
Reclassifications	<b>17</b>	<b>69</b>	<b>—</b>	<b>(86)</b>	<b>—</b>
Transferred to assets held for sale	<b>(32)</b>	<b>(3)</b>	<b>—</b>	<b>—</b>	<b>(35)</b>
Disposals/write-offs	<b>(3)</b>	<b>(97)</b>	<b>(37)</b>	<b>—</b>	<b>(137)</b>
At December 31, 2008	<b>787</b>	<b>2,350</b>	<b>171</b>	<b>245</b>	<b>3,553</b>
<b>Accumulated depreciation and impairment:</b>					
At January 1, 2007	150	1,096	43	—	1,289
Exchange adjustments	7	24	—	—	31
Provided during the year <sup>1</sup>	23	139	8	—	170
On disposals of businesses	—	(2)	—	—	(2)
Transferred to assets held for sale	—	—	(5)	—	(5)
Disposals/write-offs	—	(111)	(26)	—	(137)
At January 1, 2008	<b>180</b>	<b>1,146</b>	<b>20</b>	<b>—</b>	<b>1,346</b>
Exchange adjustments	<b>18</b>	<b>106</b>	<b>3</b>	<b>—</b>	<b>127</b>
Provided during the year <sup>1</sup>	<b>44</b>	<b>155</b>	<b>9</b>	<b>—</b>	<b>208</b>
On disposals of businesses	<b>—</b>	<b>(11)</b>	<b>—</b>	<b>—</b>	<b>(11)</b>
Transferred to assets held for sale	<b>(22)</b>	<b>(3)</b>	<b>—</b>	<b>—</b>	<b>(25)</b>
Disposals/write-offs	<b>(2)</b>	<b>(85)</b>	<b>—</b>	<b>—</b>	<b>(87)</b>
At December 31, 2008	<b>218</b>	<b>1,308</b>	<b>32</b>	<b>—</b>	<b>1,558</b>
<b>Net book value at December 31, 2008</b>	<b>569</b>	<b>1,042</b>	<b>139</b>	<b>245</b>	<b>1,995</b>
Net book value at December 31, 2007	519	964	154	176	1,813
Net book value at January 1, 2007	437	900	112	257	1,706

<sup>1</sup> Depreciation provided during the year is charged to the income statement or included in the cost of inventory as appropriate.

## 9 Property, plant and equipment continued

Property, plant and equipment includes:

	2008 £m	2007 £m
Net book value of finance leased assets:		
Land and buildings	9	9
Plant and equipment	9	14
Assets held for use in operating leases:		
Cost	141	141
Depreciation	(28)	(18)
Net book value	113	123
Non-depreciable land	113	94
Land and buildings at net book value comprise:		
Freehold	533	489
Long leasehold	12	13
Short leasehold	24	17
	569	519
Capital expenditure commitments – contracted but not provided for	122	82
Cost of fully depreciated assets	475	382

## 10 Investments

	Joint ventures			Other <sup>1</sup>	
	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m	Unlisted £m
At January 1, 2007	110	116	14	240	51
Exchange adjustments	1	5	—	6	—
Additions	13	—	—	13	6
Taxation paid by the Group	—	2	—	2	—
Share of retained profit	—	24	—	24	—
Disposals	—	(1)	—	(1)	—
At January 1, 2008	<b>124</b>	<b>146</b>	<b>14</b>	<b>284</b>	<b>57</b>
Exchange adjustments	14	71	—	85	1
Additions	30	—	1	31	1
Taxation paid by the Group	—	3	—	3	—
Share of retained profit	—	25	—	25	—
Impairments	(8)	—	(2)	(10)	—
Transferred to 'Assets held for sale'	—	(2)	—	(2)	—
Disposals	(13)	(9)	(8)	(30)	(6)
Cash flow hedging reserve movement <sup>2</sup>	—	(41)	—	(41)	—
At December 31, 2008	<b>147</b>	<b>193</b>	<b>5</b>	<b>345</b>	<b>53</b>

<sup>1</sup> These primarily comprise floating rate convertible loan stock.

<sup>2</sup> One of the Group's joint ventures, Airtanker Holdings Limited, holds interest rate and inflation swaps for which cash flow hedge accounting has been adopted.

Investments in joint ventures are represented by:

	2008 £m	2007 £m
Share of aggregate assets:		
Non-current assets <sup>3</sup>	1,041	658
Current assets	940	635
Share of aggregate liabilities: <sup>4</sup>		
Current liabilities	(841)	(523)
Non-current liabilities	(795)	(486)
	<b>345</b>	<b>284</b>

<sup>3</sup> Non-current assets include goodwill of

<sup>4</sup> Liabilities include borrowings of

	2008 £m	2007 £m
Share of income	104	94
Share of net financing	(16)	(21)
Share of taxation	(14)	(7)
Share of profit of joint ventures recognised in the income statement	74	66
Dividends received	(59)	(42)
Share of retained profit	15	24

The tax charge on joint venture profits represents an effective tax rate of **16 per cent** (2007 10 per cent), an increase of 6 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 143 and 144.

## 11 Inventory

	2008 £m	2007 £m
Raw materials	328	223
Work in progress	1,008	732
Long-term contracts work in progress	34	93
Finished goods	1,192	1,123
Payments on account	38	32
	<b>2,600</b>	<b>2,203</b>
Inventories stated at net realisable value	144	154
Amount of inventory write-down	81	79
Reversal of inventory write-down	15	6

## 12 Trade and other receivables

	2008 £m	2007 £m
Trade receivables	1,421	889
Amounts recoverable on contracts	1,448	904
Amounts owed by joint ventures	451	300
Other receivables	404	315
Prepayments and accrued income	205	177
	<b>3,929<sup>1</sup></b>	<b>2,585<sup>1</sup></b>
Analysed as (note 16):		
Financial instruments:		
Trade receivables and similar items	1,939	1,211
Other non-derivative financial assets	369	321
Non-financial instruments	1,621	1,053
	<b>3,929</b>	<b>2,585</b>

<sup>1</sup> Trade and other receivables expected to be recovered in more than one year:

Trade receivables	24	26
Amounts recoverable on contracts	1,222	704
Amounts owed by joint ventures	28	29
Other receivables	59	40
Prepayments and accrued income	38	28
	<b>1,371</b>	<b>827</b>

## 13 Cash and cash equivalents

	2008 £m	2007 £m
Cash at bank and in hand	940	1,265
Short-term deposits	1,531	632
	<b>2,471</b>	1,897
Overdrafts (note 14)	(9)	(25)
Cash and cash equivalents per cash flow statement (page 88)	<b>2,462</b>	1,872
Cash held as collateral against third party obligations	85	60

## 14 Borrowings

	Current		Non-current	
	2008 £m	2007 £m	2008 £m	2007 £m
<b>Unsecured</b>				
Overdrafts	9	25	—	—
Bank loans	11	3	5	2
7 ¾% Notes 2016 £200m	—	—	200	200
5.84% Notes 2010 US\$187m <sup>1</sup>	—	—	136	97
6.38% Notes 2013 US\$230m <sup>1</sup>	—	—	178	123
6.55% Notes 2015 US\$83m <sup>1</sup>	—	—	67	46
4 ½% Notes 2011 €750m <sup>2</sup>	—	—	738	534
Other loan 2008 (interest rate nil)	—	1	—	—
<b>Secured</b>				
Bank loans <sup>3</sup>	—	—	—	24
Obligations under finance leases: <sup>4</sup> (note 22)				
Less than one year	3	5	—	—
Between one and two years	—	—	—	3
Between two and five years	—	—	—	—
After five years	—	—	1	1
	<b>23</b>	34	<b>1,325</b>	1,030
<b>Repayable</b>				
Between one and two years – by instalments			2	4
– otherwise			136	—
Between two and five years – by instalments			1	1
– otherwise			916	655
After five years – by instalments			3	1
– otherwise			267	369
			<b>1,325</b>	1,030

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> Secured on aircraft.

<sup>4</sup> Obligations under finance leases are secured by related leased assets.

## 15 Trade and other payables

	Current		Non-current	
	2008 £m	2007 £m	2008 £m	2007 £m
Payments received on account <sup>1</sup>	1,635	1,226	549	332
Trade payables	1,042	778	—	—
Amounts owed to joint ventures	372	272	9	32
Other taxation and social security	55	64	—	—
Other payables	1,170	766	206	103
Accruals and deferred income	1,461	1,220	554	498
	<b>5,735</b>	<b>4,326</b>	<b>1,318</b>	<b>965</b>

<sup>1</sup> Includes payments received from joint ventures 209      195      107      25

Total trade and other payables are analysed as (note 16):

	2008 £m	2007 £m
Financial instruments:		
Trade payables and similar items	2,264	1,872
Other non-derivative financial liabilities	430	315
Non-financial instruments	4,359	3,104
	<b>7,053</b>	<b>5,291</b>

## 16 Financial instruments

This note should be read in conjunction with the Finance Director's review on pages 54 to 63.

### Carrying values and fair values of financial instruments

The carrying values of the Group's assets and liabilities are analysed as follows:

	Notes	2008				2007			
		Financial instruments			Total £m	Financial instruments			Total £m
		Derivative £m	Non- derivative £m	Non-financial instruments £m		Derivative £m	Non- derivative £m	Non-financial instruments £m	
<b>Assets:</b>									
Unlisted non-current asset investments <sup>1,2</sup>	10	—	53	—	53	—	57	—	57
Other non-current assets		—	—	5,764	5,764	—	—	4,149	4,149
Trade and other receivables: <sup>3</sup>									
Trade receivables and similar items <sup>1</sup>	12	—	1,939	—	1,939	—	1,211	—	1,211
Other non-derivative financial assets <sup>1</sup>	12	—	369	—	369	—	321	—	321
Non-financial instruments	12	—	—	1,621	1,621	—	—	1,053	1,053
Other financial assets <sup>4</sup>		390	—	—	390	514	—	—	514
Short-term investments <sup>1,3</sup>		—	1	—	1	—	40	—	40
Cash and cash equivalents: <sup>3</sup>									
Cash at bank and in hand	13	—	940	—	940	—	1,265	—	1,265
Short-term deposits	13	—	1,531	—	1,531	—	632	—	632
Other current assets		—	—	2,621	2,621	—	—	2,217	2,217
		390	4,833	10,006	15,229	514	3,526	7,419	11,459
<b>Liabilities:</b>									
Borrowings – current <sup>4</sup>	14	—	(23)	—	(23)	—	(34)	—	(34)
– non-current <sup>4</sup>	14	—	(1,325)	—	(1,325)	—	(1,030)	—	(1,030)
Other financial liabilities: <sup>4</sup>									
Financial RRSPs		—	(455)	—	(455)	—	(315)	—	(315)
B Shares		—	—	—	—	—	(16)	—	(16)
Other		(2,386)	—	—	(2,386)	(57)	—	—	(57)
Trade and other payables: <sup>3</sup>									
Trade payables and similar items	15	—	(2,264)	—	(2,264)	—	(1,872)	—	(1,872)
Other non-derivative financial liabilities	15	—	(430)	—	(430)	—	(315)	—	(315)
Non-financial instruments	15	—	—	(4,359)	(4,359)	—	—	(3,104)	(3,104)
Other liabilities		—	—	(1,456)	(1,456)	—	—	(1,167)	(1,167)
		(2,386)	(4,497)	(5,815)	(12,698)	(57)	(3,582)	(4,271)	(7,910)
<b>Net assets/(liabilities)</b>		<b>(1,996)</b>	<b>336</b>	<b>4,191</b>	<b>2,531</b>	<b>457</b>	<b>(56)</b>	<b>3,148</b>	<b>3,549</b>

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 described below.

<sup>1</sup> Loans and receivables.

<sup>2</sup> These primarily comprise floating rate convertible loan stock. The conversion conditions are such that fair value approximates to the book value.

<sup>3</sup> 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.

<sup>4</sup> 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.

## 16 Financial instruments continued

Fair values equate to book values for both 2008 and 2007, with the following exceptions:

	Book value £m	2008 Fair value £m	Book value £m	2007 Fair value £m
Borrowings – current	(23)	(23)	(34)	(34)
– non-current	(1,325)	(1,291)	(1,030)	(1,058)
Financials RRSPs	(455)	(487)	(315)	(340)

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

	2008 £m	2007 £m
<b>Assets</b>		
Held for trading <sup>1</sup>	390	514
Loans and receivables <sup>2</sup>	3,892	2,221
Available for sale <sup>2</sup>	1	40
Cash	940	1,265
<b>Liabilities</b>		
Held for trading <sup>1</sup>	(2,386)	(57)
Financial liabilities at amortised cost	(4,497)	(3,582)
	(1,660)	401

<sup>1</sup> All financial assets and liabilities classified as held for trading are treated as current.

<sup>2</sup> In the comparative figures, £592m has been reclassified from available for sale to loans and receivables.

### Carrying values of other financial assets and liabilities

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	B Shares £m	Total £m
<b>At December 31, 2008</b>						
Assets	112	—	278	—	—	390
Liabilities	(2,293)	(89)	(4)	(455)	—	(2,841)
	(2,181)	(89)	274	(455)	—	(2,451)
<b>At December 31, 2007</b>						
Assets	433	39	42	—	—	514
Liabilities	(54)	—	(3)	(315)	(16)	(388)
	379	39	39	(315)	(16)	126

Other financial liabilities are analysed as follows:

	2008 £m	2007 £m
Current liabilities	(2,450)	(85)
Non-current liabilities	(391)	(303)
	(2,841)	(388)

## 16 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, 2007	554	254	—	39	—	—
Fair value changes to derivative contracts not in accounting hedging relationships <sup>1</sup>	215	—	215	36	—	36
Fair value changes to fair value hedges <sup>1,2</sup>	(6)	—	(6)	—	—	—
Fair value of contracts settled	(384)	—	—	(36)	—	—
Transferred to revenue	—	(149)	149	—	—	—
At January 1, 2008	<b>379</b>	<b>105</b>	<b>—</b>	<b>39</b>	<b>—</b>	<b>—</b>
Fair value changes to derivative contracts not in accounting hedging relationships <sup>1</sup>	(2,383)	—	(2,383)	(96)	—	(96)
Fair value changes to fair value hedges <sup>1,2</sup>	83	—	83	—	—	—
Fair value of contracts settled	(236)	—	—	(32)	—	—
Fair value of derivative contracts assumed on formation of joint venture	(24)	—	—	—	—	—
Transferred to revenue	—	(80)	80	—	—	—
At December 31, 2008	<b>(2,181)</b>	<b>25</b>	<b>—</b>	<b>(89)</b>	<b>—</b>	<b>—</b>

<sup>1</sup> Included in financing.

<sup>2</sup> Loss on related hedged items: **£83m** (2007 £6m gain).

### 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, 2007	15	18	(3)	—
Fair value changes <sup>1,2</sup>	24	24	—	24
At January 1, 2008	<b>39</b>	<b>42</b>	<b>(3)</b>	<b>—</b>
Fair value changes <sup>1,2</sup>	<b>235</b>	<b>236</b>	<b>(1)</b>	<b>235</b>
At December 31, 2008	<b>274</b>	<b>278</b>	<b>(4)</b>	<b>—</b>

<sup>1</sup> Included in financing.

<sup>2</sup> Loss on related hedged items: **£236m** (2007 £24m).

## 16 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:

	2008 £m	2007 £m
At January 1	315	324
Cash paid to partners	(53)	(55)
Addition	40	—
Exchange adjustments direct to reserves	6	7
Financing charge <sup>1</sup>	26	26
Excluded from underlying profit:		
Exchange adjustments <sup>1</sup>	118	(7)
Restructuring of financial RRSP agreements and changes in forecast payments <sup>1</sup>	3	20
At December 31	455	315

<sup>1</sup> 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.

*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. The profile of the maturity of the Group's committed facilities is discussed in the Finance Director's review.

*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 effective monitoring and controlling of credit risk is a key component of the Group's risk management activities. The Group has credit policies covering both trading and financial exposures. Credit risks arising from treasury activities are managed by a central treasury function in accordance with the Group credit policy. The objective of the policy is to diversify and minimise the Group's exposure to credit risk from its treasury activities by ensuring the Group transacts strictly with single A or higher rated financial institutions based on pre-established limits per financial institution. At the balance sheet date, there were no significant concentrations of credit risk to individual customers or counterparties. 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.

*Interest rate risk* – The Group's interest rate risk is primarily in relation to its fixed rate borrowings (fair value risk), floating rate borrowings, cash and cash equivalents (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 debt at floating rates of interest as a natural hedge to the net cash position. 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.

## 16 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:

	Expected maturity					2008	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Fair value	
						Assets £m	Liabilities £m
Foreign exchange contracts:							
Fair value hedges	(280)	—	(106)	(128)	(46)	56	—
Non-hedge accounted	9,653	1,760	2,080	5,711	102	56	(2,293)
Interest rate contracts:							
Fair value hedges	848	—	130	660	58	278	—
Non-hedge accounted	65	25	22	—	18	—	(4)
Commodity contracts:							
Non-hedge accounted	271	106	73	92	—	—	(89)
	<b>10,557</b>	<b>1,891</b>	<b>2,199</b>	<b>6,335</b>	<b>132</b>	<b>390</b>	<b>(2,386)</b>
	Expected maturity					2007	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Fair value	
						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	—
	<b>5,879</b>	<b>2,246</b>	<b>1,889</b>	<b>1,742</b>	<b>2</b>	<b>514</b>	<b>(57)</b>

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.

## 16 Financial instruments continued

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

	Currencies purchased forward				2008
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Currencies sold forward:					
Sterling	—	280	—	43	323
US dollar	10,096	—	1,189	1,097	12,382
Euro	—	—	—	614	614
Other	2	44	166	91	303

	Currencies purchased forward				2007
	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

Other derivative financial instruments are denominated in the following currencies:

	2008 £m	2007 £m
Sterling	18	20
US dollar	791	470
Euro	500	500

## 16 Financial instruments continued

### Non-derivative financial instruments

Non-derivative financial instruments are denominated in the following currencies:

					2008
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
<b>Assets:</b>					
Unlisted non-current investments	46	1	4	2	53
Trade receivables and similar items	249	1,228	211	251	1,939
Other non-derivative financial assets	91	110	85	83	369
Short-term investments	—	—	—	1	1
Cash at bank and in hand	99	552	129	160	940
Short-term deposits	479	287	744	21	1,531
	964	2,178	1,173	518	4,833
<b>Liabilities:</b>					
Borrowings – current	(3)	(4)	(2)	(14)	(23)
– non-current	(200)	(381)	(744)	—	(1,325)
Financial RRSPs	—	(455)	—	—	(455)
Trade payables and similar items	(763)	(979)	(250)	(272)	(2,264)
Other non-derivative financial liabilities	(144)	(151)	(58)	(77)	(430)
	(1,110)	(1,970)	(1,054)	(363)	(4,497)
	(146)	208	119	155	336
<hr/>					
					2007
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
<b>Assets:</b>					
Unlisted non-current investments	46	6	2	3	57
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	161	376	608	120	1,265
Short-term deposits	319	293	3	17	632
	949	1,463	786	328	3,526
<b>Liabilities:</b>					
Borrowings – current	(5)	(3)	(1)	(25)	(34)
– non-current	(203)	(290)	(537)	—	(1,030)
Financial RRSPs	—	(315)	—	—	(315)
B Shares	(16)	—	—	—	(16)
Trade payables and similar items	(959)	(495)	(248)	(170)	(1,872)
Other non-derivative financial liabilities	(148)	(85)	(35)	(47)	(315)
	(1,331)	(1,188)	(821)	(242)	(3,582)
	(382)	275	(35)	86	(56)

## 16 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:

					2008
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Functional currency of Group operation					
Sterling	—	11	(4)	1	8
US dollar	6	—	—	8	14
Other	—	—	(2)	5	3

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

### Ageing beyond contractual due date

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

					2008
	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
<b>Assets:</b>					
Unlisted non-current asset investments	53	—	—	—	53
Trade receivables and similar items	1,516	322	93	8	1,939
Other non-derivative financial assets	354	9	4	2	369
Other financial assets	390	—	—	—	390
Short-term investments	1	—	—	—	1
Cash at bank and in hand	940	—	—	—	940
Short-term deposits	1,531	—	—	—	1,531
	4,785	331	97	10	5,223

					2007
	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
<b>Assets:</b>					
Unlisted non-current asset investments	57	—	—	—	57
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	1,265	—	—	—	1,265
Short-term deposits	632	—	—	—	632
	3,777	194	69	—	4,040

## 16 Financial instruments continued

## Contractual maturity analysis

	Gross cash flows					2008
	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	(20)	(2)	(1)	(3)	1	(25)
Unsecured bond issues	(69)	(200)	(1,004)	(309)	263	(1,319)
Other secured	(3)	—	—	(1)	—	(4)
	(92)	(202)	(1,005)	(313)	264	(1,348)
Other:						
Trade payables and similar items	(2,255)	(5)	(4)	—	—	(2,264)
Derivative financial liabilities	(252)	(225)	(817)	(963)	(129)	(2,386)
Financial RRSPs	(56)	(177)	(127)	(198)	103	(455)
Other non-derivative financial liabilities	(408)	(21)	(1)	—	—	(430)
	(2,971)	(428)	(949)	(1,161)	(26)	(5,535)
	(3,063)	(630)	(1,954)	(1,474)	238	(6,883)
2007						
	Gross cash flows					
	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	(13)	(2)	(4)	20	(58)	(57)
Financial RRSPs	(38)	(34)	(201)	(141)	99	(315)
B Shares	(16)	—	—	—	—	(16)
Other non-derivative financial liabilities	(271)	(1)	(29)	(14)	—	(315)
	(2,200)	(39)	(241)	(136)	41	(2,575)
	(2,292)	(100)	(1,041)	(569)	363	(3,639)

## 16 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.

	Effective interest rate %	Total £m	2008 Period in which interest rate reprices				
			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 <sup>1</sup>	9.6769%	1	1	—	—	—	—
Cash at bank and in hand <sup>2</sup>		940	940	—	—	—	—
Short-term deposits <sup>3</sup>		1,531	1,531	—	—	—	—
<b>Unsecured bank loans</b>							
€2.5m floating rate loan	EURIBOR +1.2	(2)	(2)	—	—	—	—
€5m floating rate loan	EURIBOR +0.5	(5)	(5)	—	—	—	—
Overdrafts <sup>4</sup>		(9)	(9)	—	—	—	—
55m Indian Rupee Fixed Rate Loan	13.5455%	(1)	—	(1)	—	—	—
79.4m Norwegian Kroner Floating Rate Loan	NIBOR + 1.1	(8)	(8)	—	—	—	—
Effect of interest rate swaps	3.3521%	—	40	—	(22)	—	(18)
<b>Unsecured bond issues</b>							
7 ¾% Notes 2016 £200m	7.3750%	(200)	—	—	—	—	(200)
5.84% Notes 2010 US\$187m	5.8400%	(136)	—	—	(136)	—	—
Effect of interest rate swaps	USD LIBOR +1.159	—	(136)	—	136	—	—
6.38% Notes 2013 US\$230m	6.3800%	(178)	—	—	—	(178)	—
Effect of interest rate swaps	USD LIBOR +1.26	—	(178)	—	—	178	—
6.55% Notes 2015 US\$83m	6.5500%	(67)	—	—	—	—	(67)
Effect of interest rate swaps	USD LIBOR +1.24	—	(67)	—	—	—	67
4 ½% Notes 2011 €750m	4.5000%	(738)	—	—	—	(738)	—
Effect of interest rate swaps	GBP LIBOR +0.911	—	(738)	—	—	738	—
<b>Other secured</b>							
Obligations under finance leases	5.5226%	(4)	(3)	—	—	—	(1)
		1,124	1,366	(1)	(22)	—	(219)

## 16 Financial instruments continued

## Interest rate risk continued

	Effective interest rate %	Total £m	2007 Period in which interest rate reprices				
			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 <sup>1</sup>	5.5913%	40	14	6	—	12	8
Cash at bank and in hand <sup>2</sup>		1,265	1,265	—	—	—	—
Short-term deposits <sup>3</sup>		632	632	—	—	—	—
<b>Unsecured bank loans</b>							
€4m floating rate loan	EURIBOR +1.2	(3)	(3)	—	—	—	—
Overdrafts <sup>4</sup>		(25)	(25)	—	—	—	—
Effect of interest rate swaps	1.2277%	—	54	—	(18)	(16)	(20)
<b>Other unsecured</b>							
South Korean Won floating rate loan	KRW LIBOR +0.9	(2)	(2)	—	—	—	—
Other loan 2008 (interest rate nil)	0.0000%	(1)	(1)	—	—	—	—
<b>Unsecured bond issues</b>							
7 ¾% 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	—
<b>Secured bank loans</b>							
US\$ floating rate loan	USD LIBOR +0.53	(24)	(24)	—	—	—	—
<b>Other secured</b>							
Obligations under finance leases	6.0183%	(9)	(2)	(3)	(3)	—	(1)
		873	1,108	3	(21)	(4)	(213)

<sup>1</sup> Interest on the short-term investments are at fixed rates.

<sup>2</sup> Cash at bank and in hand comprises bank balances and demand deposits and earns interest at rates based on daily bank deposit rates.

<sup>3</sup> 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.

<sup>4</sup> 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:

	2008 £m	2007 £m
Expiring within one year	—	—
Expiring in one to two years	—	—
Expiring thereafter	650	450
	650	450

## 16 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, 2008 if sterling had weakened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been **£890m** lower (2007 £329m). If sterling had strengthened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been **£728m** higher (2007 £269m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2008 if the euro had weakened ten per cent against the US dollar with all other variables held constant, profit after tax and equity for the year would have been **£102m** lower (2007 £73m). If the euro had strengthened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been **£84m** higher (2007 £60m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2008 if the price of commodities had been ten per cent lower, with all other variables remaining constant, profit after tax for the year and equity would have been **£13m** lower (2007 £16m), arising mainly as the result of lower fair value gains on derivative contracts. If the price of commodities had been ten per cent higher, with all other variables remaining constant, profit after tax and equity would have been **£13m** higher (2007 £16m), 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.

At December 31, 2008 the Group had no material sensitivity to changes in interest rates on that date. The main interest rate sensitivity for the Group arises as a result of the gross up of net cash and this is mitigated as described under the interest rate risk management policies on page 61 and 62.

### B Shares and payments to shareholders

From July 2004 to July 2008, the Company issued non-cumulative redeemable convertible preference shares (B Shares) as an alternative to paying a cash dividend. B Shares in respect of a year are issued in the following year. Shareholders were able to redeem any number of their B Shares for cash or convert them into ordinary shares. Any B Shares retained attracted a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and had limited voting rights. In certain circumstances the Company had the option to compulsorily redeem the B Shares, at any time, if the aggregate number of B Shares in issue was less than ten per cent of the aggregate number of B Shares issued, or on the acquisition or capital restructuring of the Company. The Company exercised this option in September 2008 and redeemed all B Shares then in issue.

Since January 2009, following approval by shareholders at the 2008 Annual General Meeting, the Company has issued non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. The only significant difference is that C Shares, unlike B Shares, will not carry the right to convert into ordinary shares.

Movements in the B Shares during the year were as follows:

	2008		2007	
	B Shares of 0.1p each Millions	Nominal value £m	B Shares of 0.1p each Millions	Nominal value £m
<b>Authorised</b>				
At January 1, and December 31	1,000,000	1,000	1,000,000	1,000
<b>Issued and fully paid</b>				
At January 1	15,859	16	12,616	13
Issued	236,740	237	172,006	172
Converted into ordinary shares	(52,524)	(53)	(71,819)	(72)
Redeemed	(200,075)	(200)	(96,944)	(97)
At December 31	—	—	15,859	16

Payments to shareholders in respect of the year represent the value of B Shares or C Shares to be issued in respect of the results for the year.

Issues of B Shares and C Shares were declared as follows:

	2008		2007	
	Pence per share	£m	Pence per share	£m
Interim	5.72	105	4.04	73
Final	8.58	158	8.96	164
	14.30	263	13.00	237

## 17 Provisions

	At December 31, 2007 £m	Exchange adjustments £m	Acquisitions/ disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2008 £m
Warranties and guarantees	165	19	1	(6)	39	(36)	182
Contract loss	28	4	—	—	19	(13)	38
Customer financing	44	5	—	—	29	(5)	73
Insurance	40	—	—	(2)	4	(4)	38
Restructuring	11	—	—	(2)	16	(9)	16
Other	13	2	(2)	(1)	11	(1)	22
	301	30	(1)	(11)	118	(68)	369

Analysed as:

	2008 £m	2007 £m
Current liabilities	181	121
Non-current liabilities	188	180
	369	301

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 62. The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 23. Based on the assumptions used to estimate the customer finance provision, it is estimated that the provision will be utilised as follows:

	2008 £m	2007 £m
Potential claims with specific claim dates:		
In one year or less	—	1
In more than one year but less than five years	6	3
In more than five years	27	14
Potential claims that may arise at any time by date of expiry of the guarantee:		
Up to one year	31	16
Up to five years	4	4
Thereafter	5	6
	73	44

## 18 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 either their final or career average 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, 2008. 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
Vickers Group Pension Scheme	March 31, 2007

### Amounts recognised in the income statement

	2008			2007		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost	127	27	154	100	25	125
Past service cost	5	3	8	131	2	133
Ex-gratia payment paid directly by the Group	8	—	8	—	—	—
	140	30	170	231	27	258
Defined contribution schemes	6	20	26	3	17	20
Operating cost	146	50	196	234	44	278
Financing (income)/costs in respect of defined benefit schemes:						
Expected return on assets	(352)	(21)	(373)	(367)	(17)	(384)
Interest on liabilities	358	37	395	323	31	354
	6	16	22	(44)	14	(30)
Total income statement charge	152	66	218	190	58	248

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Cost of sales	124	223	19	15	143	238
Commercial and administrative costs	33	26	5	4	38	30
Research and development	13	9	2	1	15	10
	170	258	26	20	196	278

### Amounts recognised in the statement of recognised income and expense

	2008 £m	2007 £m
Actuarial gain on scheme assets	178	161
Experience gains on scheme liabilities	766	350
Movement in unrecognised surplus	(928)	(112)
	16	399

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 pension costs of **£38m** (2007 £3m) in the year.

## 18 Post-retirement benefits continued

### Defined benefit schemes

#### Assumptions

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

	2008		2007	
	UK schemes %	Overseas schemes %	UK schemes %	Overseas schemes %
Rate of increase in salaries	4.5	3.9	5.0	3.8
Rate of increase of pensions in payment <sup>1</sup>	2.9	0.5	3.5	0.4
Discount rate	6.4	6.1	5.8	6.0
Expected rate of return on scheme assets	4.1	6.9	5.4	7.5
Inflation assumption	3.0	2.6	3.5	2.5

<sup>1</sup> Benefits accruing after April 5, 2005 are assumed to increase in payment at a rate of 2.1 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 8.9 per cent grading down to 5.0 per cent over seven years.

#### Amounts recognised in the balance sheet

	2008			2007		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(5,719)	(390)	(6,109)	(6,335)	(293)	(6,628)
Fair value of scheme assets	7,163	283	7,446	6,626	277	6,903
	1,444	(107)	1,337	291	(16)	275
Present value of unfunded obligations	—	(437)	(437)	—	(284)	(284)
Unrecognised surplus <sup>1</sup>	(1,036)	(6)	(1,042)	(110)	(4)	(114)
Net asset/(liability) recognised in the balance sheet	408	(550)	(142)	181	(304)	(123)
Analysed as:						
Post-retirement scheme surpluses	453	—	453	210	—	210
Post-retirement scheme deficits	(45)	(550)	(595)	(29)	(304)	(333)
	408	(550)	(142)	181	(304)	(123)

<sup>1</sup> 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 economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet.

## 18 Post-retirement benefits continued

### Changes in present value of defined benefit obligations

	2008			2007		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At January 1	(6,335)	(577)	(6,912)	(6,338)	(561)	(6,899)
Exchange adjustments	—	(196)	(196)	—	(15)	(15)
Current service cost	(127)	(27)	(154)	(100)	(25)	(125)
Past service cost	(5)	(3)	(8)	(131)	(2)	(133)
Finance cost	(358)	(37)	(395)	(323)	(31)	(354)
Contributions by employees	(4)	(2)	(6)	(38)	(2)	(40)
Net benefits paid out	331	25	356	286	18	304
Actuarial gains/(losses)	776	(10)	766	309	41	350
Transfers	3	—	3	—	—	—
At December 31	(5,719)	(827)	(6,546)	(6,335)	(577)	(6,912)
Funded schemes	(5,719)	(390)	(6,109)	(6,335)	(293)	(6,628)
Unfunded schemes	—	(437)	(437)	—	(284)	(284)

### Changes in fair value of scheme assets

	2008			2007		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At January 1	6,626	277	6,903	5,673	233	5,906
Exchange adjustments	—	63	63	—	9	9
Expected return on assets	352	21	373	367	17	384
Contributions by employer	248	31	279	677	30	707
Contributions by employees	4	2	6	38	2	40
Benefits paid out	(331)	(25)	(356)	(286)	(18)	(304)
Actuarial gains/(losses)	264	(86)	178	157	4	161
At December 31	7,163	283	7,446	6,626	277	6,903

Actual return on scheme assets 551 545

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

	2008		2007	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
UK schemes:				
LDI portfolio <sup>1</sup>	3.5	5,833	4.7	4,595
Equities	7.2	1,141	7.8	1,651
Sovereign debt	3.9	110	4.6	48
Corporate bonds	5.5	110	5.1	88
Other	1.9	(31)	4.9	244
	4.1	7,163	5.4	6,626
Overseas schemes:				
Equities	9.0	134	9.0	165
Corporate bonds	4.9	130	4.8	86
Other	5.9	19	6.4	26
	6.9	283	7.5	277

<sup>1</sup> A portfolio of swap contracts, backed by short-term money market deposits, that is designed to hedge, on an economic basis, the majority of the interest rate and inflation risks associated with the schemes' obligations.

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 1.75 per cent per annum respectively.

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

## 18 Post-retirement benefits continued

### Future contributions

The Group expects to contribute approximately £292m to its defined benefit schemes in 2009.

### Sensitivities

The revised investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. A reduction of 0.25 per cent in the discount rate would increase the obligations of the principal UK defined benefit schemes by approximately £220m. An equivalent movement in interest rates would increase the fair value of the assets by approximately £320m. The difference arises largely due to differences in the methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is in excess of 85 per cent. The principal 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 £118m. If the rate of increase in salaries were 0.5 per cent higher, scheme liabilities would increase by £100m.

The defined benefit obligation relating to post-retirement medical benefits would increase by £50m if the healthcare trend rate increases by one per cent, and reduce by £41m 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 £5m if the healthcare trend increases by one per cent, and reduce by £4m 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:

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
<i>Balance sheet</i>					
Present value of defined benefit obligations	(6,546)	(6,912)	(6,899)	(7,220)	(6,107)
Fair value of scheme assets	7,446	6,903	5,906	5,563	4,698
Unrecognised surplus	(1,042)	(114)	(2)	(2)	—
Deficit	(142)	(123)	(995)	(1,659)	(1,409)
<i>Experience gains/losses</i>					
Actuarial gains on scheme assets	178	161	132	588	126
Experience gains/(losses) on scheme liabilities	766	350	470	(868)	(133)
Movement in unrecognised surplus	(928)	(112)	—	(2)	—
Total amount recognised in the statement of recognised income and expense	16	399	602	(282)	(7)
Cumulative since January 1, 2004	728	712	313	(289)	(7)

## 19 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
<b>Authorised</b>					
At January 1, 2007 and December 31, 2008	1	50,000	—	2,500	500
<b>Issued and fully paid</b>					
At January 1, 2007	1	—	—	1,781	356
Exercise of share options	—	—	—	24	5
B Share conversion into ordinary shares	—	—	—	15	3
At January 1, 2008	1	—	—	1,820	364
Exercise of share options	—	—	—	12	2
B Share conversion into ordinary shares	—	—	—	12	3
At December 31, 2008	1	—	—	1,844	369

The rights attaching to each class of share are set out in the Directors' report on page 81.

In accordance with IAS 32 *Financial Instruments: Presentation*, the Company's non-cumulative redeemable convertible preference shares (B Shares) are classified as financial liabilities. Accordingly, movements in B Shares are included in note 16.

## 20 Movements in capital and reserves

	Attributable to equity holders of the parent							Minority interests £m	Total equity £m
	Share capital £m	Share premium £m	Capital redemption reserves £m	Hedging reserves <sup>1</sup> £m	Other reserves <sup>2</sup> £m	Retained earnings <sup>3</sup> £m	Total £m		
At January 1, 2007	356	43	197	177	(55)	2,000	2,718	7	2,725
Total recognised income and expense for the year	—	—	—	(100)	117	861	878	(6)	872
Arising on issues of ordinary shares	5	24	—	—	—	—	29	—	29
Issue of B Shares	—	—	(172)	—	—	—	(172)	—	(172)
Redemption of B Shares	—	—	97	—	—	(97)	—	—	—
Conversion of B Shares into ordinary shares <sup>4</sup>	3	—	69	—	—	(1)	71	—	71
Ordinary shares purchased	—	—	—	—	—	(78)	(78)	—	(78)
Ordinary shares vesting in share-based payment plans	—	—	—	—	—	93	93	—	93
Share-based payments adjustment	—	—	—	—	—	(22)	(22)	—	(22)
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 January 1, 2008	<b>364</b>	<b>67</b>	<b>191</b>	<b>77</b>	<b>62</b>	<b>2,776</b>	<b>3,537</b>	<b>12</b>	<b>3,549</b>
Total recognised income and expense for the year	—	—	—	(99)	601	(1,331)	(829)	(3)	(832)
Arising on issues of ordinary shares	2	15	—	—	—	—	17	—	17
Issue of B Shares	—	—	(237)	—	—	—	(237)	—	(237)
Redemption of B Shares	—	—	200	—	—	(200)	—	—	—
Conversion of B Shares into ordinary shares <sup>4</sup>	3	—	50	—	—	—	53	—	53
Ordinary shares purchased	—	—	—	—	—	(44)	(44)	—	(44)
Ordinary shares vesting in share-based payment plans	—	—	—	—	—	37	37	—	37
Share-based payments adjustment	—	—	—	—	—	(1)	(1)	—	(1)
Transactions with minority interests	—	—	—	—	—	—	—	—	—
Related tax movements – current tax	—	—	—	—	—	—	—	—	—
– deferred tax	—	—	—	—	—	(11)	(11)	—	(11)
At December 31, 2008	<b>369</b>	<b>82</b>	<b>204</b>	<b>(22)</b>	<b>663</b>	<b>1,226</b>	<b>2,522</b>	<b>9</b>	<b>2,531</b>

<sup>1</sup> See accounting policies note 1 – hedge accounting. Hedging reserves include **£19m** (2007 £77m) in respect of the transition hedging reserve and **£(41)m** (2007 £nil) in respect of the cash flow hedging reserve.

<sup>2</sup> 'Other reserves' include a merger reserve of **£3m** (2007 £3m) and a translation reserve of **£660m** (2007 £59m).

<sup>3</sup> At December 31, 2008, **8,017,635 shares** with a net book value of **£34m** (2007 5,838,501 shares with a net book value of £24m) were held and included in retained earnings.

<sup>4</sup> On conversion of B Shares, the nominal value of ordinary shares issued is credited to share capital and the excess to a capital reserve.

## 21 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 33 countries participate in ShareSave plans through arrangements which provide broadly comparable benefits to the UK plan. From 2007 onwards, the overseas plans are cash-settled schemes.

#### 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. The plan terminates in 2009.

#### 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 employed by 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, or equivalent, 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.

Further information regarding the operation of the plans can be found on pages 71 and 72 of the Directors' remuneration report.

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.

During the year the Group recognised a total expense of **£40m** (2007 £36m), of which **£0.4m** (2007 £0.1m) related to cash-settled arrangements. At December 31, 2008, the Group had a liability of **£0.6m** (2007 £0.2m) relating to cash-settled arrangements.

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

	Number of shares awarded	
	2008 Millions	2007 Millions
<b>PSP</b>		
Outstanding at January 1	14.0	15.7
Awarded during the year	5.1	4.6
Forfeited during the year	(0.7)	(0.8)
Additional entitlements arising from TSR performance	1.3	1.3
Vested during the year	(6.5)	(6.8)
Outstanding at December 31	13.2	14.0

	2008		2007	
	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
<b>ShareSave</b>				
Outstanding at January 1	43.3	260p	54.7	160p
Granted during the year	—	—	13.0	416p
Forfeited during the year	(1.7)	333p	(0.8)	207p
Exercised during the year	(11.9)	144p	(23.6)	116p
Outstanding at December 31	29.7	303p	43.3	260p
Exercisable at December 31	1.6	141p	—	—

## 21 Share-based payments continued

	2008		2007	
	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
<b>ESOP</b>				
Outstanding at January 1	2.3	175p	19.0	188p
Exercised during the year	(0.2)	156p	(16.7)	189p
Outstanding at December 31	2.1	177p	2.3	175p
Exercisable at December 31	2.1	177p	2.3	175p

	Number of shares awarded	
	2008 Millions	2007 Millions
<b>Deferred shares under APRA</b>		
Outstanding at January 1	3.4	4.9
Awarded during the year	1.5	1.9
Forfeited during the year	(0.1)	(0.1)
Additional shares accrued from conversion of B Shares	0.1	0.2
Vested during the year	(2.1)	(3.5)
Outstanding at December 31	2.8	3.4

	Number of shares awarded	
	2008 Millions	2007 Millions
<b>Free Shares under SIP</b>		
Awarded during the year	1.2	0.7

Options were exercised on a regular basis during the year. The average share price during the year was **382p** (2007 510p).

### 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:

	2008 Pence	2007 Pence	2006 Pence	2005 Pence	2004 Pence
PSP awards	458p	557p	494p	282p	249p
ShareSave – 3 year grants	—	230p	—	131p	—
ShareSave – 5 year grants	—	264p	—	154p	—
APRA deferred share awards	440p	502p	448p	260p	220p
SIP Free Share awards	439p	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 Company's share price over the seven years prior to the grant or award date. Until 2007, expected dividends were based on the Company's payments to shareholders over the five years prior to the grant or award date. From 2008, expected dividends were based on the Company's payments to shareholders in respect of 2007.

## 21 Share-based payments continued

### 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:

	2008	2007	2006	2005	2004
Weighted average share price	<b>430p</b>	501p	444p	262p	233p
Expected dividends	<b>13.00p</b>	8.30p	7.92p	7.81p	7.61p
Volatility	<b>29%</b>	29%	32%	34%	35%
Correlation	<b>29%</b>	26%	19%	19%	22%
Expected life	<b>3 years</b>	3 years	3 years	3 years	3 years
Risk free interest rate	<b>4.1%</b>	5.2%	4.3%	4.9%	5.2%

As explained on page 71 of the Directors' remuneration report, the PSP has a TSR market-based performance condition, such that the Company'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 Company'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 <sup>1</sup> – 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%

<sup>1</sup> 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.

At December 31, 2008, the following ordinary shares were subject to options:

	Date of grant	Number	Exercise price	Exercisable dates
Executive Share Option Plan	1999	52,403	269p	2009
	2000	193,831	194p	2009-2010
	2001	1,069,069	216p	2009-2011
	2001	8,161	218p	2009-2012
	2002	239,544	188p	2009-2012
ShareSave plans	2003	519,555	77p	2009-2013
	2001	5,451,109	108p	2009
	2003	1,597,604	142p	2009
	2005	10,414,054	298p	2009/2011
	2007	12,206,498	416p	2011/2013

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to 54 directors and senior executives were outstanding at December 31, 2008.

## 22 Operating and finance leases

### Operating leases

#### Leases as lessee

	2008 £m	2007 £m
Rentals paid – hire of plant and machinery	64	58
– hire of other assets	25	18
Non-cancellable operating lease rentals are payable as follows:		
Within one year	104	77
Between one and five years	163	179
After five years	205	99
	<b>472</b>	<b>355</b>

#### Leases as lessor

	2008 £m	2007 £m
Rentals received – credited within revenue from aftermarket services	26	27
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	6	5
Between one and five years	13	13
After five years	3	3
	<b>22</b>	<b>21</b>

The Group acts as lessee and lessor for both land and buildings and gas turbine engines, and acts as lessee for some plant and equipment.

- Sublease payments of **£15m** (2007 £15m) and sublease receipts of **£11m** (2007 £8m) were recognised in the income statement in the year.
- Purchase options exist on aero engines, land and buildings and plant and equipment with the period to the purchase option date varying between one to five years.
- Renewal options exist on aero engines, land and buildings and plant and equipment with the period to the renewal option varying between one to 21 years at terms to be negotiated upon renewal.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total future minimum sublease payments expected to be made is **£88m** (2007 £13m) and sublease receipts expected to be received is **£6m** (2007 £3m).

### Finance leases

Finance lease liabilities are payable as follows:

	2008			2007		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Within one year	4	1	3	6	1	5
Between one and five years	—	—	—	3	—	3
After five years	1	—	1	1	—	1
	<b>5</b>	<b>1</b>	<b>4</b>	<b>10</b>	<b>1</b>	<b>9</b>

There were no contingent rents recognised as an expense in the year (2007 £nil) and no future minimum sublease receipts are expected under non-cancellable subleases (2007 £nil).

## 23 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 value that is expected to crystallise. 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 values of contingent liabilities relating to delivered aircraft and other arrangements where financing is in place, less insurance arrangements and relevant provisions, were:

	2008		2007	
	£m	US\$m	£m	US\$m
Gross contingent liabilities	<b>755</b>	<b>1,086</b>	616	1,227
Contingent liabilities net of relevant security <sup>1</sup>	<b>155</b>	<b>222</b>	140	279
Contingent liabilities net of relevant security reduced by 20% <sup>2</sup>	<b>246</b>	<b>354</b>	218	434

<sup>1</sup> Security includes unrestricted cash collateral of:

**85**      **123**      60      120

<sup>2</sup> Although sensitivity calculations are complex, the reduction of relevant security by 20 per cent illustrates the sensitivity of the contingent liability to changes in this assumption.

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.

## 24 Related party transactions

	2008 £m	2007 £m
Sales of goods and services to joint ventures	1,555	1,289
Purchases of goods and services from joint ventures	(1,482)	(1,100)
Operating lease payments to joint ventures	(36)	(41)
Guarantees of joint ventures' borrowings	13	11
Dividends received from joint ventures	59	42
RRSP receipts from joint ventures	19	29
Interest received from joint ventures	2	2
Other income received from joint ventures	102	25

The aggregated balances with joint ventures are shown in notes 12 and 15. Transactions with Group pension schemes are shown in note 18.

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.

Key management personnel are deemed to be the directors and the members of the Group Executive as set out on pages 65 and 66. Remuneration for key management personnel is shown below:

	2008 £m	2007 £m
Salaries and short-term benefits	9	9
Post-retirement schemes	2	2
Share-based payments	6	5
	17	16

More detailed information regarding the directors' remuneration, shareholdings, pension entitlements, share options and other long-term incentive plans is shown in the Directors' remuneration report on pages 70 to 79.

## 25 Acquisitions and disposals

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

	Total £m
Intangible assets – software and other	11
Property, plant and equipment	18
Inventory	16
Trade and other receivables	16
Short-term deposits	2
Cash at bank and in hand	1
Trade and other payables	(43)
Borrowings – current liabilities	(6)
Deferred tax liabilities	(5)
Provisions	(1)
Net assets acquired	9
Goodwill arising	41
	<b>50</b>
Additions to investments in joint ventures <sup>1</sup>	31
	<b>81</b>
Represented by:	
Net cash outflow per cash flow statement	82
Net non-cash consideration	(1)
	<b>81</b>

<sup>1</sup> As part of the transaction to conclude the joint venture with Goodrich Corporation to develop and manufacture engine controls, the Group also paid US\$100m in cash and assumed a liability of £24m in respect of foreign exchange contracts. These amounts, totalling £93m, have been included in intangible asset additions in the year (note 8).

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
Intangible assets – goodwill	2
Property, plant and equipment	2
Inventory	5
Trade and other receivables	11
Trade and other payables	(9)
Provisions	(2)
	<b>9</b>
Disposals of investments in joint ventures	30
Net assets	39
Profit on sale or termination of businesses	7
	<b>46</b>
Analysed as:	
Receipts outstanding at December 31, 2008	10
Net cash inflow per cash flow statement	36
	<b>46</b>

# Company balance sheet

At December 31, 2008

138

	Notes	2008 £m	2007 £m
<b>Fixed assets</b>			
Investments in shares in subsidiary undertakings at cost	2	2,230	2,212
<b>Current assets</b>			
Amounts owed by subsidiary undertakings due within one year		165	413
Cash at bank		2	1
		<b>167</b>	414
<b>Creditors – amounts falling due within one year</b>			
Financial liabilities	3	—	(16)
Accruals and deferred income		—	(3)
		—	(19)
		<b>167</b>	395
<b>Net current assets</b>			
		<b>167</b>	395
<b>Total assets less current liabilities</b>			
		<b>2,397</b>	2,607
<b>Net assets</b>			
		<b>2,397</b>	2,607
<b>Capital and reserves</b>			
Called-up share capital	4	369	364
Share premium account	5	82	67
Merger reserve	5	214	451
Capital redemption reserves	5	767	517
Other reserve	5	77	59
Own shares reserve	5	(35)	—
Profit and loss account	5	923	1,149
		<b>2,397</b>	2,607

The financial statements on pages 138 to 141 were approved by the Board on February 11, 2009 and signed on its behalf by:

**Simon Robertson**  
Chairman

**Andrew Shilston**  
Finance Director

## Reconciliation of movements in shareholders' funds

For the year ended December 31, 2008

	2008 £m	2007 £m
At January 1	2,607	2,755
Loss for the year	(1)	(1)
Arising on issue of ordinary shares	17	29
Issue of B Shares	(237)	(172)
Conversion of B Shares into ordinary shares	53	72
Ordinary shares purchased	(71)	—
Share-based payment adjustments	29	(76)
At December 31	<b>2,397</b>	2,607

## 1 Accounting policies

### Basis of accounting

The financial statements have been prepared in accordance with applicable UK Accounting Standards on the historical cost basis.

As permitted by section 230 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 the audit fee disclosure regulations, disclosure of non-audit fees information is not included in respect of the Company. As permitted by FRS 1 *Cash flow statements*, no cash flow statement for the Company has been included. As permitted by FRS 8 *Related party disclosures*, no related party disclosures for the Company have been included.

### Investments in subsidiary undertakings

Investments in subsidiary undertakings are reported at cost less amounts written off.

### Share-based payments

As described in the Directors' remuneration report on pages 70 to 79, the Company grants awards of its own shares to employees of its subsidiary undertakings, (see note 21 of the consolidated financial statements). The costs of share-based payments in respect of these awards are accounted for, by the Company, as an additional investment in its subsidiary undertakings. The costs are determined in accordance with FRS 20 *Share-based payment*. Any payments made by the subsidiary undertakings in respect of these arrangements are treated as a return of this investment.

### Own shares for settlement of share-based payment plans

Where the Company acquires its own shares for the purpose of satisfying share-based payment plans, the cost in excess of any exercise price payable by the plan participants is written off to the profit and loss reserve.

### Current assets

Amounts are recognised at the lower of cost and net realisable value.

### Financial instruments

In accordance with FRS 25 *Financial Instruments: Disclosure and Presentation*, the Company's B Shares are classified as financial liabilities and held at amortised cost from the date of issue until redeemed or converted.

### Taxation

Provision for taxation is made at the current rate and, in accordance with FRS 19 *Deferred tax*, for deferred taxation at the projected rate on timing differences that have originated, but not reversed at the balance sheet date.

## 2 Investments – subsidiary undertakings

	£m
Cost:	
At January 1, 2008	2,212
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	18
At December 31, 2008	2,230

### 3 Financial liabilities

#### B Shares

Movements in the B Shares during the year were as follows:

	B Shares of 0.1p Millions	Nominal value £m
<b>Authorised</b>		
At January 1, and December 31, 2008	1,000,000	1,000
<b>Issued and fully paid</b>		
At January 1, 2008	15,859	16
Shares issued	236,740	237
Shares converted into ordinary shares	(52,524)	(53)
Shares redeemed	(200,075)	(200)
At December 31, 2008	—	—

Rights attaching to B Shares, and C Shares that the Company will issue from January 2009, are described in note 16 of the Company's consolidated financial statements.

### 4 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
<b>Authorised</b>					
At January 1, 2007 and December 31, 2008	1	50,000	—	2,500	500
<b>Issued and fully paid</b>					
At January 1, 2007	1	—	—	1,781	356
Exercise of share options	—	—	—	24	5
B Share conversion into ordinary shares	—	—	—	15	3
At January 1, 2008	1	—	—	1,820	364
Exercise of share options	—	—	—	12	2
B Share conversion into ordinary shares	—	—	—	12	3
At December 31, 2008	1	—	—	1,844	369

The rights attaching to each class of share are set out in the Directors' report on page 81.

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's non-cumulative redeemable convertible preference shares (B Shares) are classified as financial liabilities. Accordingly, movements in B Shares are included in note 3.

## 5 Movements in capital and reserves

	Non-distributable reserves					Own shares reserve <sup>2</sup> £m	Profit and loss account £m	Total £m
	Share capital £m	Share premium £m	Merger reserve £m	Capital redemption reserves £m	Other reserve <sup>1</sup> £m			
At January 1, 2008	364	67	451	517	59	—	1,149	2,607
Loss for the year	—	—	—	—	—	—	(1)	(1)
Arising on issue of ordinary shares	2	15	—	—	—	—	—	17
Issue of B Shares	—	—	(237)	—	—	—	—	(237)
Redemption of B Shares	—	—	—	200	—	—	(200)	—
Conversion of B Shares into ordinary shares <sup>3</sup>	3	—	—	50	—	(2)	2	53
Own shares purchased	—	—	—	—	—	(71)	—	(71)
Own shares vesting in share-based payment plans	—	—	—	—	—	38	(38)	—
Share-based payment adjustments	—	—	—	—	18	—	11	29
At December 31, 2008	369	82	214	767	77	(35)	923	2,397

<sup>1</sup> The 'Other reserve' represents the value of share-based payments in respect of employees of subsidiary undertakings for which payment has not been received.

<sup>2</sup> During 2008, ordinary shares were transferred from a trust sponsored by Rolls-Royce plc to an equivalent trust sponsored by Rolls-Royce Group plc. At December 31, 2008, **8,017,635 shares** (2007 nil) with a net book value of **£35m** (2007 nil) were held.

<sup>3</sup> On conversion of B Shares, the nominal value of ordinary shares issued is credited to share capital and the excess to a capital reserve.

## 6 Contingent liabilities

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within the 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, 2008 these guarantees amounted to **£1,273m** (2007 £1,035m).

## 7 Other information

### Emoluments of directors

The remuneration of the directors of the Company is shown in the Directors' remuneration report on pages 70 to 79.

### Employees

The Company had no employees in 2008 and 2007.

### Share-based payments

Shares in the Company have been granted to employees of the Group as part of share-based payment plans, and are charged in the employing company.

At December 31, 2008

## Incorporated within the UK – held by Rolls-Royce Group plc

Rolls-Royce plc	<i>Principal trading company</i>
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## Incorporated within the UK – indirectly held

Optimized Systems and Solutions Limited	<i>Advanced controls and predictive data management</i>
Rolls-Royce Fuel Cell Systems Limited	<i>Development of fuel cell systems</i>
Rolls-Royce International Limited	<i>International support and commercial information services</i>
Rolls-Royce Leasing Limited	<i>Engine leasing</i>
Rolls-Royce Marine Electrical Systems Limited	<i>Marine electrical systems</i>
Rolls-Royce Marine Power Operations Limited	<i>Nuclear submarine propulsion systems</i>
Rolls-Royce Power Development Limited	<i>Generation of electricity from independent power projects</i>
Rolls-Royce Power Engineering plc	<i>Energy and marine systems</i>
Rolls-Royce Total Care Services Limited	<i>Aero engine aftermarket support services</i>

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 – indirectly held

Brazil	Rolls-Royce Brasil Limitada	<i>Aero engine repair and overhaul</i>
Canada	Rolls-Royce Canada Limited	<i>Industrial gas turbines and aero-engine sales, service and overhaul</i>
China	Rolls-Royce Marine (Shanghai) Limited	<i>Manufacture and supply of marine equipment</i>
Finland	Rolls-Royce OY AB	<i>Manufacture of marine winches and propeller systems</i>
France	Data Systems & Solutions SAS	<i>Instrumentation and control systems and life cycle management for nuclear power plants</i>
France	Rolls-Royce Technical Support SARL	<i>Aero engine project support</i>
Germany	Rolls-Royce Deutschland Ltd & Co KG	<i>Aero engine design, development and manufacture</i>
Guernsey	Nightingale Insurance Limited	<i>Insurance services</i>
India	Rolls-Royce Energy Systems India Private Limited	<i>Diesel engine project management and customer support</i>
India	Rolls-Royce Operations (India) Private Limited	<i>Engineering support services</i>
Italy	Europea Microfusioni Aerospaziali S.p.A.	<i>Manufacture of gas turbine engine castings</i>
Norway	Rolls-Royce Marine AS	<i>Design and manufacture of ship equipment</i>
Norway	Scandinavian Electric Holding AS	<i>Marine electrical systems</i>
Singapore	Rolls-Royce Singapore Pte Limited	<i>Energy and marine aftermarket support services</i>
Sweden	Rolls-Royce AB	<i>Manufacture of marine propeller systems</i>
US	Data Systems & Solutions LLC	<i>Advanced controls and predictive data management</i>
US	Rolls-Royce Commercial Marine Inc.	<i>Marine aftermarket support services</i>
US	Rolls-Royce Corporation	<i>Design, development and manufacture of gas turbine engines</i>
US	Rolls-Royce Crosspointe LLC	<i>Manufacture of aero-engine parts</i>
US	Rolls-Royce Energy Systems Inc.	<i>Energy turbine generator packages</i>
US	Rolls-Royce Engine Services – Oakland Inc.	<i>Aero engine repair and overhaul</i>
US	Rolls-Royce Defense Services Inc.	<i>Aero engine repair and overhaul</i>
US	Rolls-Royce Naval Marine Inc.	<i>Design and manufacture of marine equipment</i>
US	Seaworthy Systems Inc.	<i>Marine support services</i>

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.

## Incorporated within the UK – indirectly held

	Class	% of class held	% of total equity held
Airtanker Holdings Limited <i>Strategic tanker aircraft PFI project</i>	Ordinary	20	20
Airtanker Services Limited <i>Provision of aftermarket services for strategic tanker aircraft</i>	Ordinary	22	22
Alpha Partners Leasing Limited <i>Aero engine leasing</i>	A Ordinary B Ordinary	100 —	50
Composite Technology & Applications Limited <i>Development of aero-engine fan blades</i>	A Ordinary B Ordinary	100 —	51
Genistics Holdings Limited <i>Trailer-mounted field mobile generator sets</i>	A Ordinary B Ordinary	100 —	50
Rolls-Royce Goodrich Engine Control Systems Limited <i>Development and manufacture of aero-engine controls</i>	Ordinary	50	50
Rolls-Royce Snecma Limited (UK & France) <i>Aero engine collaboration</i>	A Shares B Shares	— 100	50
Rolls-Royce Turbomeca Limited (UK & France) <i>Aero engine collaboration</i>	A Shares B Shares	— 100	50
Rolls Wood Group (Repair and Overhauls) Limited <i>Industrial gas turbine repair and overhaul</i>	A Ordinary B Ordinary	100 —	50
Tidal Generation Limited <i>Development of tidal generation systems</i>	A Ordinary B Ordinary C Ordinary	— 100 —	42
TRT Limited <i>Aero-engine turbine blade repair services</i>	A Ordinary B Ordinary	— 100	49.5
Turbine Surface Technologies Limited <i>Aero-engine turbine surface coatings</i>	A Ordinary B Ordinary	— 100	50
Turbo-Union Limited (UK, Germany & Italy) <i>RB199 engine collaboration</i>	Ordinary A Shares	40 37.5	40

**Incorporated overseas – indirectly held**

		Class	% of class held	% of total equity held
China	Xian XR Aero Components Co Limited <i>Manufacturing facility for aero-engine parts</i>	Ordinary	49	49
Germany	EPI Europrop International GmbH (effective interest 35.5%) <i>A400M engine collaboration</i>	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) <i>EJ200 engine collaboration</i>	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) <i>MTR390 engine collaboration</i>	Ordinary	33.3	33.3
Germany	N3 Engine Overhaul Services Verwaltungsgesellschaft mbh <i>Aero engine repair and overhaul</i>	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited <i>Aero engine repair and overhaul</i>	Ordinary	45	45
Israel	TechJet Aerofoils Limited <i>Manufacture of compressor aerofoils for gas turbines</i>	A Ordinary B Ordinary	50 50	50
Malaysia	Advanced Gas Turbine Solutions Sdn Bhd <i>Industrial gas turbine aftermarket services</i>	Ordinary	49	49
Singapore	International Engine Component Overhaul Pte Limited <i>Aero engine repair and overhaul</i>	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%) <i>Aero engine repair and overhaul</i>	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA <i>Aero engine component manufacture and maintenance</i>	Ordinary	46.9	46.9
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & US) <i>V2500 engine collaboration</i>	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, Alpha Leasing (US) (No. 5) LLC, Rolls-Royce & Partners Finance (US) LLC <i>Aero engine leasing</i>	Partnerships	50	—
US	Exostar LLC <i>Business to business internet exchange</i>	Partnership	17.6	—
US	GE Rolls-Royce Fighter Engine Team LLC <i>F136 development engine for the Joint Strike Fighter (JSF) Programme</i>	Partnership	40	—
US	Texas Aero Engine Services, LLC <i>Aero engine repair and overhaul</i>	Partnership	50	—
US	Williams-Rolls Inc. (UK & US) <i>Small aero engine collaboration</i>	Common	15	15

**Unincorporated overseas – held by subsidiary undertakings**

US	Light Helicopter Turbine Engine Company (LHTEC) <i>Rolls-Royce Corporation has a 50 per cent interest in this unincorporated partnership which was formed to develop and market jointly the T800 engine</i>
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The countries of principal operations are stated in brackets after the name of the company, if not the country of incorporation.

We have audited the Group and parent Company financial statements (the 'financial statements') of Rolls-Royce Group plc for the year ended December 31, 2008 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. We have also audited the information in the Directors' remuneration report that is described as having been audited.

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

### Respective responsibilities of directors and auditors

The directors' 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 and the Directors' remuneration report 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 84.

Our responsibility is to audit the financial statements and the part of the Directors' remuneration report to be audited 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 whether the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985 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 Directors' report is consistent with the financial statements.

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 review whether the Corporate governance statement reflects the Company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual report 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 and the part of the Directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's 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 and the part of the Directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' remuneration report to be audited.

### Opinion

In our opinion:

- the 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, 2008 and of its loss 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, 2008;
- the parent Company financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' report is consistent with the financial statements.

### KPMG Audit Plc

Chartered Accountants, Registered Auditor

London

February 11, 2009

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
<b>Income statement</b>					
<b>Revenue</b>	<b>9,082</b>	7,435	7,156	6,603	5,947
<b>Profit before net research and development and share of joint venture profit</b>	<b>1,191</b>	827	1,016	1,113	686
Research and development (net) <sup>1</sup>	(403)	(381)	(370)	(282)	(288)
Share of profit of joint ventures	74	66	47	46	19
<b>Profit before financing</b>	<b>862</b>	512	693	877	417
Net financing	(2,754)	221	698	(400)	(53)
<b>(Loss)/profit before taxation <sup>2</sup></b>	<b>(1,892)</b>	733	1,391	477	364
Taxation	547	(133)	(397)	(130)	(100)
<b>(Loss)/profit for the year</b>	<b>(1,345)</b>	600	994	347	264

**Attributable to:**

Equity holders of the parent	(1,340)	606	998	350	263
Minority interests	(5)	(6)	(4)	(3)	1
<b>(Loss)/profit for the year</b>	<b>(1,345)</b>	600	994	347	264

<sup>1</sup> Research and development (gross) (885) (824) (747) (663) (601)

<sup>2</sup> Underlying profit before taxation 880 800 705 593 364

**Earnings per ordinary share:**

Underlying	36.70p	34.06p	29.81p	24.48p	15.62p
Basic	(73.63)p	33.67p	57.32p	20.11p	15.56p

**Payments to shareholders per ordinary share** 14.30p 13.00p 9.59p 8.72p 8.18p

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
<b>Balance sheet</b>					
Assets	15,229	11,459	10,798	9,627	8,419
Liabilities	(12,698)	(7,910)	(8,073)	(8,122)	(6,973)
	2,531	3,549	2,725	1,505	1,446

Called-up share capital	369	364	356	352	346
Reserves	2,153	3,173	2,362	1,147	1,096
Equity attributable to equity holders of the parent	2,522	3,537	2,718	1,499	1,442
Minority interests	9	12	7	6	4
	2,531	3,549	2,725	1,505	1,446

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
<b>Cash flow</b>					
Cash inflow from operating activities	1,015	705	1,072	1,060	610
Cash outflow from investing activities	(648)	(572)	(469)	(289)	(237)
Cash (outflow)/inflow from financing activities	(221)	(473)	(122)	(443)	189
<b>Increase/(decrease) in cash and cash equivalents</b>	<b>146</b>	(340)	481	328	562

**Net funds/(debt)** 1,458 888 826 335 (149)

**Financial calendar 2009-2010**

Ex entitlement to C Shares	April 22, 2009
Record date for entitlement to C Shares	April 24, 2009
Annual General Meeting, Queen Elizabeth II Conference Centre, London	11.00am April 30, 2009
Deadline for receipt of C Share elections	5.00pm June 5, 2009
Record date for dividend payable on C Shares	June 5, 2009
Allotment of C Shares	July 1, 2009
Payment of C Share redemption monies	July 2, 2009
Purchase of ordinary shares for CRIP participants	By July 8, 2009
Announcement of interim results	July 30, 2009
Ex entitlement to C Shares	October 28, 2009
Record date for entitlement to C Shares	October 30, 2009
Deadline for receipt of C Share elections	5.00pm December 4, 2009
2009 financial year end	December 31, 2009
Allotment of C Shares	January 4, 2010
Payment of C Share redemption monies	January 5, 2010
Purchase of ordinary shares for CRIP participants	By January 8, 2010
Preliminary announcement – 2009 full year results	February, 2010
2009 Annual report published	March, 2010

**Registrar**

Our Registrar is Computershare Investor Services PLC. When making contact with the Registrar please quote your Shareholder Reference Number (SRN). This is an 11-digit number, which usually starts with the letter 'C' and which can be found on the right hand side of your share certificate. You can speak to a member of the Registrar's Rolls-Royce team by calling +44 (0)870 703 0162 between 8.30am to 5.30pm Monday to Friday or you can write to them at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8AE.

**Information available on the internet**

You can access copies of the Annual report, Company announcements and much more at [www.rolls-royce.com](http://www.rolls-royce.com).

You can also visit our Registrar's website at

**[www-uk.computershare.com/investor/](http://www-uk.computershare.com/investor/)** to:

- view your account balance, values and history;
- view your payment history;
- update your bank details;
- register to receive electronic shareholder communications;
- download forms;
- deal in Rolls-Royce shares online;
- vote online for forthcoming general meetings;
- view your holdings in all companies registered with Computershare and create a portfolio; and
- track the market value of your portfolio.

**Share dealing service**

Our Registrar offers both internet and telephone dealing services. You can deal over the telephone or on the internet Monday to Friday from 8.00am to 4.30pm excluding Bank holidays. Real time trading is available on the internet during market hours and there is no need to open a trading account in order to deal. The fee for the service is 0.5 per cent of the value of each sale or purchase of shares subject to a minimum fee of £15. The maximum value of shares you can trade using the internet is £25,000 for purchases and £50,000 for sales. Please note that the internet dealing service is only available to existing shareholders. [www-uk.computershare.com/investor/sharedealing.asp](http://www-uk.computershare.com/investor/sharedealing.asp).

The fee for the Telephone Share Dealing Service is one per cent of the value of the transaction subject to a minimum fee of £15. If you would like to use this service please call +44 (0)870 703 0084. Stamp duty of 0.5 per cent is also payable on all purchases.

A low-cost, execution only share-dealing service for the purchase and sale of Rolls-Royce Group plc shares is also available from NatWest Stockbrokers. NatWest Stockbrokers is authorised and regulated by the Financial Services Authority and is a member of the London Stock Exchange and PLUS. For details please contact NatWest Stockbrokers, Waterhouse Square, 138-14 Holborn, London EC1N 2TH. Tel: +44 (0)870 600 3070

**Share price**

You can obtain the current market price of the Company's shares on our website at [www.rolls-royce.com](http://www.rolls-royce.com) or from Teletext, Ceefax or similar services or on the London Stock Exchange website at [www.londonstockexchange.com](http://www.londonstockexchange.com).

**ADR programme**

For further information about the US ADR programme, please contact your broker or write to:

The Bank of New York Mellon  
Shareholder Relations  
PO Box 11258  
Church Street Station  
New York, NY 10286

Toll free telephone for callers from the US: 1-888-BNY-ADRS (1-888-269-2377)

For callers outside the US: +1-201-680-6825

Website: [www.adrbnymellon.com](http://www.adrbnymellon.com).

**Unsolicited mail**

The Company is legally obliged to make its share register publicly available. As a consequence, you may receive mail you have not asked for. If you want to limit the amount of personally addressed unsolicited mail you receive, and you have a UK registered address, please write to the Mailing Preference Service (MPS), DMA House, 70 Margaret Street, London W1W 8SS or register by telephoning +44 (0)845 703 4599 or online [www.mpsonline.org.uk](http://www.mpsonline.org.uk).

**ShareGift**

The Orr Mackintosh Foundation operates a charity donation scheme for shareholders with small numbers of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at [www.sharegift.org](http://www.sharegift.org) or you can write to Orr Mackintosh Foundation, 17 Carlton House Terrace, London SW1Y 5AH. Tel: +44 (0)20 7930 3737.

**Warning to shareholders**

We are aware that some shareholders have received unsolicited phone calls or correspondence concerning investment matters. These are typically from overseas based 'brokers' who target UK shareholders, offering to sell them what often turn out to be worthless or high risk shares in US or UK investments. Shareholders are advised to be very wary of any unsolicited advice, offers to buy shares at a discount or offers of free company reports.

If you receive any unsolicited investment advice:

- Make sure you get the correct name of the person and organisation;
- Check that they are properly authorised by the FSA before getting involved by visiting [www.fsa.gov.uk/register/](http://www.fsa.gov.uk/register/).

If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme. You can report approaches made by unauthorised firms to the FSA either by calling +44 (0)845 606 1234 or by completing the online reporting form at [www.fsa.gov.uk/pages/doing/regulated/law/alerts/overseas.shtml](http://www.fsa.gov.uk/pages/doing/regulated/law/alerts/overseas.shtml).

Details of any share dealing facilities that the Company endorses will be included in Company mailings. More detailed information can be found on the FSA website [www.moneymadeclear.fsa.gov.uk](http://www.moneymadeclear.fsa.gov.uk).

**Dividends paid on B Shares held**

B Share dividends: calculation period	Dividend rate	Record date for B Share dividend	Payment date
July 1, 2008 to September 22, 2008	1.0485000%	September 22, 2008	September 29, 2008
January 1, 2008 to June 30, 2008	2.2275000%	June 6, 2008	July 1, 2008
July 1, 2007 to December 31, 2007	2.2973400%	November 23, 2007	January 2, 2008
January 1, 2007 to June 30, 2007	2.0362500%	June 8, 2007	July 2, 2007
July 1, 2006 to December 31, 2006	1.8063300%	November 24, 2006	January 2, 2007
January 1, 2006 to June 30, 2006	1.7205487%	June 9, 2006	July 3, 2006
July 1, 2005 to December 31, 2005	1.7353125%	November 25, 2005	January 3, 2006
January 1, 2005 to June 30, 2005	1.8433613%	June 10, 2005	July 1, 2005
July 1, 2004 to December 31, 2004	1.8890625%	November 26, 2004	January 4, 2005

Copies of the Scheme Circular and Summary of Terms of B Share Issue, which contain more detailed information on B Shares, are available in the Investors section on the Group's website at [www.rolls-royce.com](http://www.rolls-royce.com).

**Previous B Shares issues**

B Share issues	B Shares per ordinary share	Conversion Share Value	First day of trading	Share price on first day of trading		CGT apportionment	
				Ordinary shares	B Shares	Ordinary shares	B Shares
June 30, 2008	89.6	422p	June 30, 2008	335.875p	0.0950p	97.53%	2.47%
January 2, 2008	40.4	553p	January 2, 2008	546.750p	0.1000p	99.27%	0.73%
June 29, 2007	59.2	486p	June 29, 2007	534.500p	0.1010p	98.88%	1.12%
January 2, 2007	36.7	477p	January 2, 2007	450.750p	0.1000p	99.19%	0.81%
June 30, 2006	53.8	443p	June 30, 2006	413.875p	0.1005p	98.71%	1.29%
January 3, 2006	33.4	356p	January 3, 2006	433.045p	0.1015p	99.22%	0.78%
July 1, 2005	50.0	253p	July 1, 2005	291.000p	0.0995p	98.32%	1.68%
January 4, 2005	31.8	250p	January 4, 2005	244.625p	0.0955p	98.77%	1.23%
June 25, 2004	50.0	212p	July 5, 2004	241.875p	0.1130p	97.72%	2.28%

**Analysis of ordinary shareholders at December 31, 2008**

Type of holder:	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	229,152	97.53	123,115,886	6.68
Institutional and other investors	5,810	2.47	1,720,624,250	93.32
Total	234,962	100.00	1,843,740,136	100.00
Size of holding:				
1 – 150	70,139	29.85	7,296,206	0.40
151 – 500	122,396	52.09	31,390,720	1.70
501 – 10,000	40,425	17.21	68,346,836	3.71
10,001 – 100,000	1,363	0.58	35,227,512	1.91
100,001 – 1,000,000	447	0.19	164,674,669	8.93
1,000,001 and over	192	0.08	1,536,804,193	83.35
Total	234,962	100.00	1,843,740,136	100.00



Designed by Radley Yeldar (London)  
Typeset by Charnwood Technic Art Limited

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Printed by St Ives Westerham Press Ltd. ISO 14001:2004,  
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