



Rolls-Royce

Rolls-Royce plc

Annual report 2008

Rolls-Royce plc is incorporated as a public limited company and is registered in England under the UK Companies Act 1985 with the registered number 1003142. The registered office of Rolls-Royce plc 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 and audited financial statements for the year. References to 'Rolls-Royce', the 'Group', the 'Company', 'we', or 'our' are to Rolls-Royce plc and/or its subsidiaries, or any of them as the context may require. Pages 01 to 34, 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.

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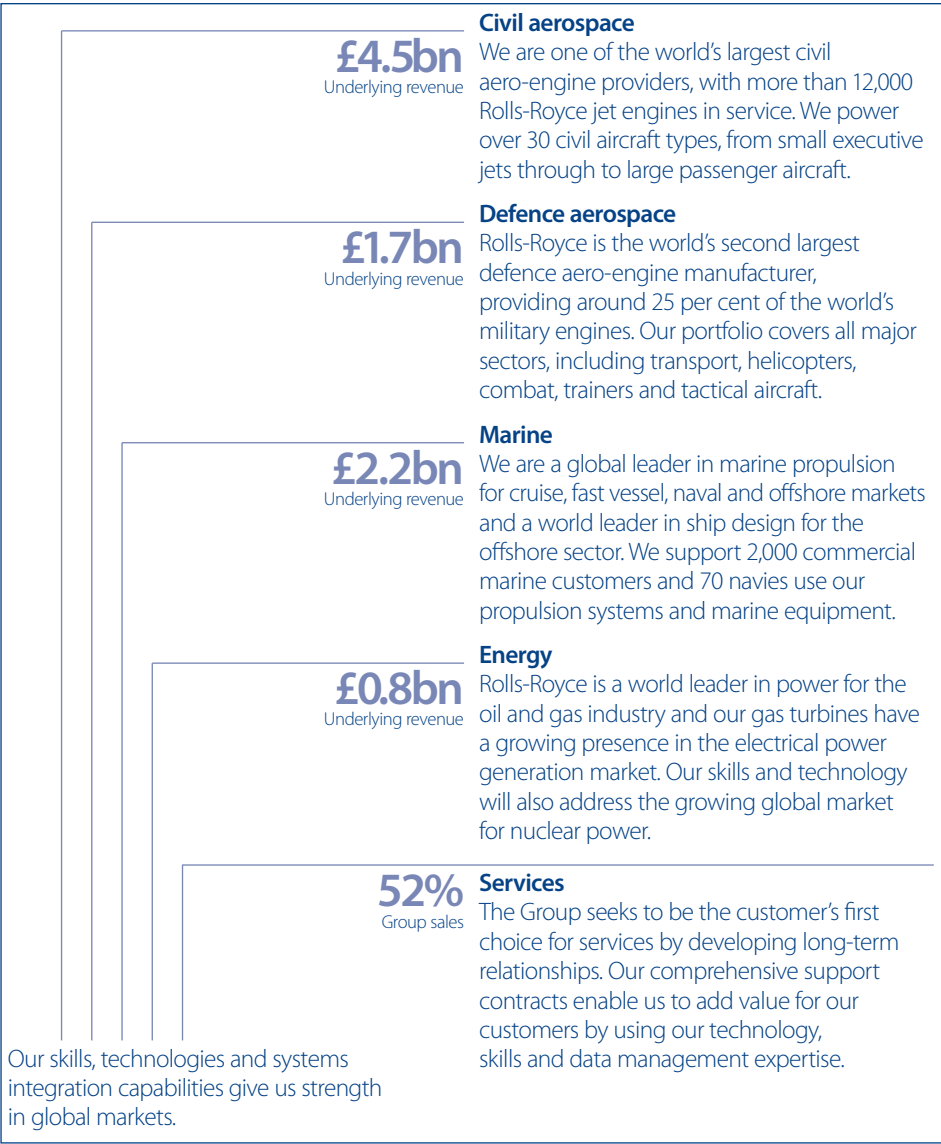
Cautionary statement regarding forward-looking statements

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)	55.5	45.9	21%	26.1	24.4	21.3
Underlying revenue (£m)*	9,147	7,817	17%	7,353	6,458	5,947
Profit before financing (£m)	862	512	68%	700	855	417
Underlying profit before tax (£m)**	883	845	4%	851	579	364
Underlying EBITDA (£m)	1,244	1,065	17%	986	911	717



*Underlying revenues reflect actual US\$ exchange rates on settled derivative contracts.
**Reconciliation of underlying results is provided in note 2 on page 46.

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 £7,435million), with underlying sales growth of 17 per cent. The published loss before tax was £1,889 million (2007 profit £778 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 26, and the reported earnings do not reflect the underlying trading performance of the Group in 2008. Underlying profit before tax rose by four per cent to £883 million (2007 £845 million). We ended the year with a net cash balance of £1,456 million (2007 £887 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.

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.

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.

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.

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

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\$.

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 5. These indicators are chosen to monitor both current performance and the success of investments that will sustain and enhance future performance. Key performance indicators are included in the appropriate sections of the business review and are as follows:

Underlying revenue £m					
					9,147
	5,947	6,458	7,353	7,817	
	2004	2005	2006	2007	2008

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

Underlying profit before financing £m					
					919
	417	657	755	832	
	2004	2005	2006	2007	2008

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 46 of the consolidated financial statements.

Cash flow £m					
					569
	251	551	491	62	
	2004	2005	2006	2007	2008

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.

Return on capital employed

%

		9.5	18.0	18.7	19.6	17.3
	2004	2005	2006	2007	2008	

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

		288	282	370	381	403
	2004	2005	2006	2007	2008	

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

		601	663	747	824	885
	2004	2005	2006	2007	2008	

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

%

		4.7	5.2	5.4	5.8	5.4
	2004	2005	2006	2007	2008	

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

			303	304	283
	191	232			
	2004	2005	2006	2007	2008

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

				45.9	55.5
	21.3	24.4	26.1		
	2004	2005	2006	2007	2008

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.

Sales per employee

£000

					233
	169	186	192	193	
	2004	2005	2006	2007	2008

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

Product cost index

Year-on-year increase/(decrease) %

Increase			5	7	
		0			4
Decrease	(5)				
	2004	2005	2006	2007	2008

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.

Engine deliveries

	1,430	1,519	1,426	1,393	1,579
	2004	2005	2006	2007	2008

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 – civil

lbs million

	288	305	320	334	348
	2004	2005	2006	2007	2008

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

%

	45	45	48	55	57
	2004	2005	2006	2007	2008

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.

Underlying services revenue

£m

	3,251	3,457	3,901	4,265	4,755
	2004	2005	2006	2007	2008

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.

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 21 to 25).

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.

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.

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	4,502 +11%	4,038 +3%	3,907 +15%	3,406 +11%	3,072 +13%
Underlying profit before financing £m	566 +0%	564 +8%	523 +19%	441 +112%	208 +24%
Net assets £m	246	2,260	1,889	1,315	1,357
Other key performance indicators					
Order book £bn	43.5 +21%	35.9 +80%	20.0 +5%	19.0 +17%	16.2 +13%
Engine deliveries	987	851	856	881	824
Underlying services revenues £m	2,726	2,554	2,310	2,016	1,838
Underlying services revenues %	61	63	59	59	60
% of fleet under management	57	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.

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

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.

Key financial data	2008	2007	2006	2005	2004
Underlying revenue £m	1,686 +1%	1,673 +4%	1,601 +13%	1,420 +3%	1,374 -2%
Underlying profit before financing £m	223 +12%	199 +2%	195 +11%	175 -2%	179 +22%
Net assets £m	(228)	(247)	(83)	(56)	(48)
Other key performance indicators					
Order book £bn	5.5 +25%	4.4 +38%	3.2 -3%	3.3 0%	3.3 +22%
Engine deliveries	517	495	514	565	548
Underlying services revenues £m	947	877	853	787	768
Underlying services revenues %	56	52	53	55	56
% of fleet under management	12	11	11	8	5
Underlying revenue £1.7bn		Market opportunity over 20 years US\$450bn			

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.

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	2,204 +42%	1,548 +19%	1,299 +18%	1,097 +14%	963 -4%
Underlying profit before financing £m	183 +62%	113 +11%	102 +17%	87 +12%	78 0%
Net assets £m	453	508	543	595	523
Other key performance indicators					
Order book £bn	5.2 +11%	4.7 +96%	2.4 +41%	1.7 +21%	1.4 +17%
Underlying services revenues £m	712	545	487	435	397
Underlying services revenues %	32	35	37	40	41
% of fleet under management	35	33	3	3	0
Underlying revenue £2.2bn		Market opportunity over 20 years US\$320bn			

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.

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

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.

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.

Key financial data	2008	2007	2006	2005	2004
Underlying revenue £m	755 +35%	558 +2%	546 +2%	535 -1%	538 +2%
Underlying profit before financing £m	(2) -140%	5 +128%	(18) -1700%	(1) +86%	(7) +61%
Net assets £m	377	346	355	353	395
Other key performance indicators					
Order book £bn	1.3 +44%	0.9 +80%	0.5 +25%	0.4 0%	0.4 0%
Engine deliveries	64	32	44	61	47
Underlying services revenues £m	370	289	251	219	248
Underlying services revenues %	49	52	46	41	46
% of fleet under management	9	7	6	5	5
Underlying revenue £0.8bn		Market opportunity over 20 years US\$120bn			

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

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.

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.

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

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

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.

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

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

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.

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

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.

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 12 and 13.

External recognition

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

BitC BiE Index

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.

BitC Corporate Responsibility Index

In the 2008 Business in the Community Corporate Responsibility Index, Rolls-Royce achieved Gold status.

Dow Jones Sustainability (World and European) Indexes

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.

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.

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.

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.

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.

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. 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. 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.

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.

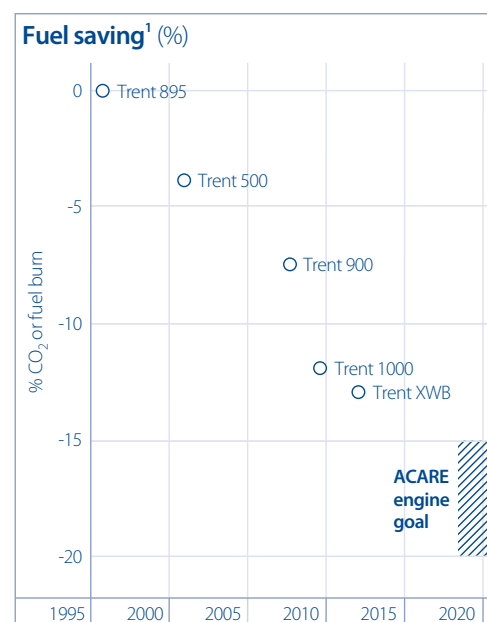
We are taking a leading role in research, including the Environmentally Friendly Engine (EFE), a joint Government, industry and university programme, aimed at improving the environmental performance of an aero engine. In 2008, the European Commission approved the launch of the Clean Sky, Joint Technology 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.



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

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.

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.

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.

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.

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.

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.

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.

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 £569 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.

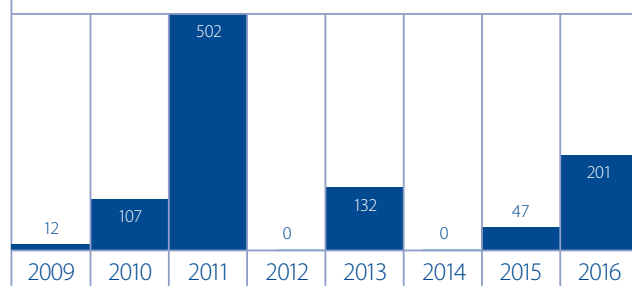
The published results were heavily influenced by the significant adjustments in foreign exchange rates in 2008, especially the GBP/USD and the GBP/EUR which are explained below.

The Group benefited from a strong financial position and credit rating with net cash of £1,456 million at the year end and with average net cash throughout the year of £374 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 17 of the financial statements on page 74. 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 £1,889 million. These adjustments are non-cash, accounting adjustments required under IAS 39 *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 results 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 7 and in note 2 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 were £36 million (2007 income £13 million) including a gain of £3 million (2007 £43 million) on parent company shares held under trust. Excluding these gains, underlying financing costs remained relatively stable and principally comprised net interest of £10 million and finance costs associated with financial risk and revenue sharing partnerships. The trust holding the parent company shares was transferred to the parent company during the year.

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.

No dividend is proposed.

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 £569 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 £229 million during the year with increased inventory of £208 million, and increased financial working capital of £21 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 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 £374 million (2007 £350 million). The net cash balance at the year end was £1,456 million (2007 £887 million).

Taxation

The overall tax credit on the loss before tax was £547 million (2007 £133 million charge), a rate of 30.0 per cent (2007 17.1 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 24.6 per cent (2007 22.8 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 17 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 41.

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 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 Group's internal control framework.

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 basis 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's parent company, Rolls-Royce Group plc, subscribes to both Moody's Investors Service and Standard & Poor's for its official publicised credit ratings. As at December 31, 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 this investment grade credit rating, which it views as necessary for the business to operate effectively.

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

Currency risk

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

The Group regards its interests in overseas subsidiary companies as long-term investments 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:

- 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).
- 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	1.438	1.991
– Average spot rate	1.854	2.001
EUR per GBP		
– Year-end spot rate	1.034	1.362
– Average spot rate	1.258	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 15 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 22 to the financial statements describes the Group's contingent liabilities. There were no material changes to the Group's gross and net contingent liabilities 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.

Andrew Shilston

Finance Director
February 11, 2009

Other matters

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, FEng, 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.

Directors

The directors' biographical details, including their other significant commitments, are set out on page 31. 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 on May 7, 2008; and John Neill CBE joined the Board as a non-executive director on November 13, 2008.

As at December 31, 2008 all the directors were also directors of Rolls-Royce Group plc, the ultimate parent company. As directors of the ultimate parent company, there is no requirement to disclose their individual remuneration or their interests in the shares of companies in the Rolls-Royce group in this report, as they are disclosed in the Annual report of Rolls-Royce Group plc.

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

Share capital

Throughout 2008, the Company's authorised share capital was £400 million, comprising 2,000,000,000 ordinary shares of 20p. On December 31, 2008, there were 1,630,996,508 ordinary shares in issue. The ordinary shares are not listed.

Dividends

No dividends were paid or declared during 2008.

Political donations

In line with its established policy, the Group made no political donations during 2008.

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.

Payment to suppliers

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

The Company had the equivalent of 51 days purchases outstanding at December 31, 2008, based on the average daily amount invoiced by suppliers during the year.

Auditors

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

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.

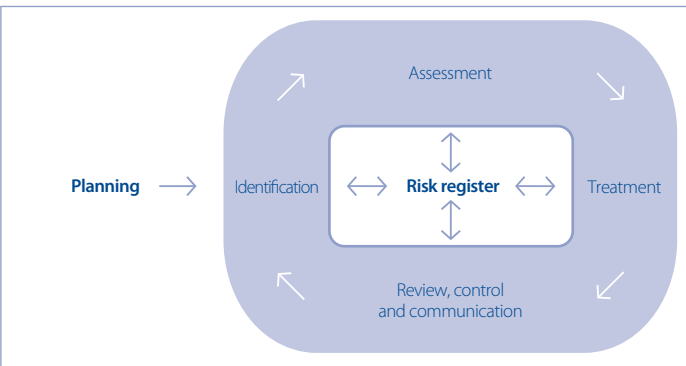
There is an ongoing process to identify, assess and manage risk, including those risks affecting the Group's reputation. This process is subject to continuous improvement and has been in place throughout the financial year to which these statements apply and up to the date of their approval. In 2008, 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.

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.

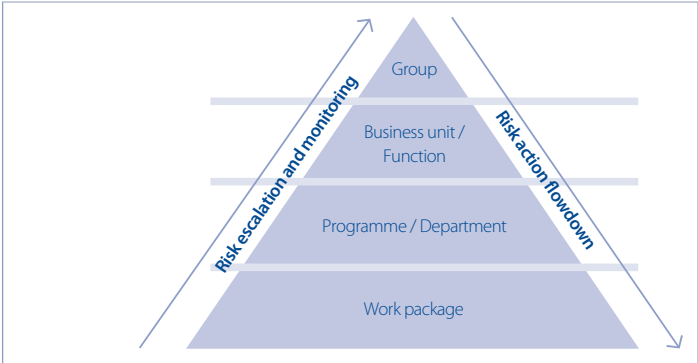
The risk management system

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 12 and 13.

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 Rolls-Royce Group plc audit and risk committees twice a year.

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 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 29 and 30 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 34 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

Independent auditors' report

To the members of Rolls-Royce plc

We have audited the Group and parent Company financial statements (the 'financial statements') of Rolls-Royce plc for the year ended December 31, 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.

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU, and for preparing the parent Company financial statements in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the Statement of directors' responsibilities on page 34.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the 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 read the other information contained in the Annual report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at December 31, 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 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

Consolidated income statement

For the year ended December 31, 2008

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	Notes	2008 £m	2007 £m
Revenue	2	9,082	7,435
Cost of sales		(7,311)	(6,003)
Gross profit		1,771	1,432
Other operating income		79	50
Commercial and administrative costs		(666)	(653)
Research and development costs		(403)	(381)
Share of profit of joint ventures	9	74	66
Operating profit		855	514
Profit/(loss) on sale of businesses	24	7	(2)
Profit before financing	2	862	512
Financing income	3	435	762
Financing costs	3	(3,186)	(496)
Net financing		(2,751)	266
(Loss)/profit before taxation	2	(1,889)	778
Taxation	4	547	(133)
(Loss)/profit for the year		(1,342)	645
Attributable to:			
Equity holders of the parent		(1,337)	651
Minority interests	19	(5)	(6)
(Loss)/profit for the year		(1,342)	645

Consolidated balance sheet

At December 31, 2008

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	Notes	2008 £m	2007 £m
ASSETS			
Non-current assets			
Intangible assets	7	2,286	1,761
Property, plant and equipment	8	1,995	1,813
Investments – joint ventures	9	345	284
Other investments	9	53	89
Deferred tax assets	4	685	81
Post-retirement scheme surpluses	17	453	210
		5,817	4,238
Current assets			
Inventory	10	2,600	2,203
Trade and other receivables	11	3,929	2,585
Taxation recoverable		9	7
Other financial assets	15	390	514
Short-term investments		1	40
Cash and cash equivalents	12	2,469	1,896
Assets held for sale		12	7
		9,410	7,252
Total assets		15,227	11,490
LIABILITIES			
Current liabilities			
Borrowings	13	(23)	(34)
Other financial liabilities	15	(2,450)	(69)
Trade and other payables	14	(5,900)	(4,736)
Current tax liabilities		(184)	(188)
Provisions	16	(181)	(121)
		(8,738)	(5,148)
Non-current liabilities			
Borrowings	13	(1,325)	(1,030)
Other financial liabilities	15	(391)	(303)
Trade and other payables	14	(1,318)	(965)
Non-current tax liabilities		(1)	—
Deferred tax liabilities	4	(307)	(345)
Provisions	16	(188)	(180)
Post-retirement scheme deficits	17	(595)	(333)
		(4,125)	(3,156)
Total liabilities		(12,863)	(8,304)
Net assets		2,364	3,186
EQUITY			
Capital and reserves			
Called-up share capital	18	326	326
Share premium account	19	631	631
Hedging reserves	19	(22)	77
Translation reserve	19	660	59
Retained earnings	19	760	2,081
Equity attributable to equity holders of the parent		2,355	3,174
Minority interests	19	9	12
Total equity		2,364	3,186

The financial statements on pages 36 to 83 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

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	Notes	2008 £m	2007 £m
Reconciliation of cash flows from operating activities			
(Loss)/profit before taxation		(1,889)	778
Share of profit of joint ventures	9	(74)	(66)
(Profit)/loss on sale or termination of businesses	24	(7)	2
(Profit)/loss on sale of property, plant and equipment		(11)	1
Net interest payable	3	10	5
Net post-retirement scheme financing	3	22	(30)
Net other financing	3	2,719	(241)
Taxation paid		(117)	(71)
Amortisation of intangible assets	7	107	63
Depreciation of property, plant and equipment	8	208	170
Increase/(decrease) in provisions		39	(42)
Increase in inventories		(208)	(359)
Increase in trade and other receivables		(1,072)	(125)
Increase in trade and other payables		1,051	709
Decrease in other financial assets and liabilities		144	358
Additional cash funding of post-retirement schemes		(117)	(441)
Share-based payments charge	20	40	36
Transfers of hedge reserves to income statement	15	(80)	(149)
Dividends received from joint ventures	9	59	42
Net cash inflow from operating activities		824	640
Cash flows from investing activities			
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	24	(50)	(6)
Disposals of businesses	24	6	3
Investments in joint ventures		(32)	(13)
Disposals of joint ventures		30	—
Additions to parent company shares		(41)	(77)
Disposals of parent company shares		—	31
Net cash outflow from investing activities		(689)	(618)
Cash flows from financing activities			
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)
Net cash outflow from financing activities		10	(362)
Increase/(decrease) in cash and cash equivalents		145	(340)
Cash and cash equivalents at January 1		1,871	2,170
Foreign exchange		441	41
Net cash of businesses acquired/disposed		3	—
Cash and cash equivalents at December 31		2,460	1,871

	2008 £m	2007 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Increase/(decrease) in cash and cash equivalents	145	(340)
Cash (inflow)/outflow from (decrease)/increase in government securities and corporate bonds	(39)	6
Net cash outflow from decrease in borrowings	27	355
Change in net funds resulting from cash flows	133	21
Net funds of businesses acquired	(3)	—
Exchange adjustments	439	41
Fair value adjustments	(319)	(18)
Movement in net funds	250	44
Net funds at January 1 excluding the fair value of swaps	872	828
Net funds at December 31 excluding the fair value of swaps	1,122	872
Fair value of swaps hedging fixed rate borrowings	334	15
Net funds at December 31	1,456	887

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	1,264	(551)	1	224	—	—	938
Overdrafts	(25)	18	—	(2)	—	—	(9)
Short-term deposits	632	678	2	219	—	—	1,531
Cash and cash equivalents	1,871	145	3	441	—	—	2,460
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)
	872	133	(3)	439	(319)	—	1,122
Fair value of swaps hedging fixed rate borrowings	15	—	—	—	319	—	334
	887	133	(3)	439	—	—	1,456

Consolidated statement of recognised income and expense

For the year ended December 31, 2008

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	Notes	2008 £m	2007 £m
Foreign exchange translation differences from foreign operations		603	117
Net actuarial gains	17	944	511
Movement in unrecognised post-retirement surplus	17	(928)	(112)
Transfers from transition hedging reserve	15	(80)	(149)
Transfers to cash flow hedging reserve		(41)	—
Movement in fair value of available for sale assets		(8)	(28)
Related tax movements	4	15	(86)
Change in rates of corporation tax	4	—	(9)
Net income recognised directly in equity		505	244
(Loss)/profit for the year		(1,342)	645
Total recognised income and expense for the year		(837)	889
Attributable to:			
Equity holders of the parent		(834)	895
Minority interests		(3)	(6)
Total recognised income and expense for the year		(837)	889

1 Significant accounting policies

The Company

Rolls-Royce plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended December 31, 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 and financial RRSPs are classified as other liabilities.
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading.

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

- Loans and receivables and other liabilities are held at amortised cost and not revalued (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, on behalf of its parent company, 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. The costs of these share-based payments are treated as a capital contribution from the parent company. Any payments made by the Group to its parent company in respect of these arrangements are treated as return of this capital contribution.

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

Contingent liabilities

In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers. These arrangements fall into two categories; credit-based guarantees and asset value guarantees. In accordance with the requirements of IAS 39 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 17.

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 22, 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

IFRS 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
Analysis by business segments for the year ended December 31, 2008							
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
Profit/(loss) before financing and taxation	501	232	176	4	(51)	—	862
Financing income					435		435
Financing costs					(3,186)		(3,186)
Taxation					547		547
Loss for the year							(1,342)
Other information							
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					2,470		2,470
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	3,951	(477)	15,227
Segment liabilities	(7,297)	(1,265)	(1,886)	(457)	—	477	(10,428)
Borrowings					(1,348)		(1,348)
Income tax liabilities					(492)		(492)
Post-retirement scheme deficits					(595)		(595)
Total liabilities	(7,297)	(1,265)	(1,886)	(457)	(2,435)	477	(12,863)
Net assets/(liabilities)	246	(228)	453	377	1,516	—	2,364
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
Analysis by business segments for the year ended December 31, 2007							
Revenue from sale of original equipment	1,417	782	996	251	—	—	3,446
Revenue from aftermarket services	2,301	854	546	288	—	—	3,989
Total revenue	3,718	1,636	1,542	539	—	—	7,435
Operating profit excluding share of profit of joint ventures	263	159	90	(15)	(49)	—	448
Share of profit of joint ventures	45	11	1	9	—	—	66
Loss on sale or termination of businesses	—	—	—	(2)	—	—	(2)
Profit/(loss) before financing and taxation	308	170	91	(8)	(49)	—	512
Financing income					762		762
Financing costs					(496)		(496)
Taxation					(133)		(133)
Profit for the year							645
Other information							
Segment assets	6,051	998	1,698	644	—	(461)	8,930
Investments in joint ventures	214	34	5	31	—	—	284
Cash and short-term investments					1,936		1,936
Fair value of swaps hedging fixed rate borrowings					42		42
Income tax assets					88		88
Post-retirement scheme surpluses					210		210
Total assets	6,265	1,032	1,703	675	2,276	(461)	11,490
Segment liabilities	(4,005)	(1,279)	(1,195)	(329)	—	461	(6,347)
Borrowings					(1,064)		(1,064)
Fair value of swaps hedging fixed rate borrowings					(27)		(27)
Income tax liabilities					(533)		(533)
Post-retirement scheme deficits					(333)		(333)
Total liabilities	(4,005)	(1,279)	(1,195)	(329)	(1,957)	461	(8,304)
Net assets/(liabilities)	2,260	(247)	508	346	319	—	3,186
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
	9,082	7,435

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	10,273	7,768	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)	—	—
	15,227	11,490	676	600

2 Segmental analysis continued

Underlying performance

As discussed in the Finance Director's review on page 26, 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
Profit/(loss) per consolidated income statement	862	(1,889)	512	778
Release of transition hedging reserve	(80)	(80)	(149)	(149)
Realised gains on settled derivative contracts ¹	185	292	415	420
Net unrealised fair value changes to derivative contracts ²	(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 ³	—	—	130	130
Total underlying adjustments	57	2,772	320	67
Underlying profit/(loss)	919	883	832	845

¹ 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.

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

³ During 2007, the Group, as part of its ongoing discussions with the Trustees of its UK pension schemes, 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.

Underlying profit reconciliation:

	2008			2007		
	£m	Underlying adjustments £m	Underlying results £m	£m	Underlying adjustments £m	Underlying results £m
Profit before financing						
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	(2,751)	2,715	(36)	266	(253)	13
Profit before taxation	(1,889)	2,772	883	778	67	845
Taxation	547	(764)	(217)	(133)	(60)	(193)
Profit for the year	(1,342)	2,008	666	645	7	652

3 Net financing

	2008		2007	
	£m	Underlying financing ¹ £m	£m	Underlying financing ¹ £m
Financing income				
Interest receivable	59	59	83	83
Fair value gains on foreign currency contracts (note 15) ²	—	—	215	—
Fair value gains on commodity derivatives (note 15) ²	—	—	36	—
Expected return on post-retirement scheme assets (note 17)	373	—	384	—
Fair value adjustments relating to parent company shares held under trust	3	3	43	43
Other financing income	—	—	1	1
	435	62	762	127
Financing costs				
Interest payable	(69)	(69)	(88)	(88)
Fair value losses on foreign currency contracts (note 15) ²	(2,383)	—	—	—
Financial RRSPs – foreign exchange differences and changes in forecast payments (note 15)	(121)	—	(13)	—
Financial charge relating to financial RRSPs (note 15)	(26)	(26)	(26)	(26)
Fair value losses on commodity derivatives (note 15) ²	(96)	—	—	—
Interest on post-retirement scheme liabilities (note 17)	(395)	—	(354)	—
Net foreign exchange losses	(91)	—	(15)	—
Other financing charges	(5)	(3)	—	—
	(3,186)	(98)	(496)	(114)
Net financing	(2,751)	(36)	266	13
Analysed as:				
Net interest payable	(10)	(10)	(5)	(5)
Net post-retirement scheme financing	(22)	—	30	—
Net other financing	(2,719)	(26)	241	18
Net financing	(2,751)	(36)	266	13
¹ See note 2				
² Net 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
Current tax						
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
Deferred tax						
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 ¹	—	(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 ¹	(15)	95
Recognised directly in equity – current tax	—	(43)
– deferred tax ¹	11	23
	(4)	75

¹ In 2007, the deferred tax assets and liabilities reflected the reductions in the corporate tax rates in 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	(1,889)	778
Less share of profits of joint ventures (note 9)	(74)	(66)
(Loss)/profit before taxation excluding joint ventures	(1,963)	712
Nominal tax charge at UK corporation tax rate 28.5% (2007 30%)	(559)	214
UK R&D credit	(25)	(22)
Rate differences	16	12
Other permanent differences	14	(17)
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 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 Employee information

	2008 Number	2007 Number
Average weekly number of Group employees during the year		
United Kingdom	22,500	22,900
Overseas	16,500	15,700
	39,000	38,600
Civil aerospace	22,700	22,800
Defence aerospace	5,700	5,600
Marine	8,100	7,700
Energy	2,500	2,500
	39,000	38,600
	£m	£m
Group employment costs ¹		
Wages and salaries	1,649	1,534
Social security costs	180	172
Share-based payments (note 20)	40	36
Pensions and other post-retirement scheme benefits (note 17)	218	248
	2,087	1,990

¹ Remuneration of key management personnel is shown in note 23.

6 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	1.6	1.7
Fees payable to the Company's auditors and its associates for other services:		
The audit of the Company's subsidiaries pursuant to legislation	2.0	2.0
Other services pursuant to legislation	0.2	0.1
Other services relating to taxation	0.4	0.3
	4.2	4.1
Fees payable in respect of the Group's pension schemes		
Audit	0.2	0.2
Other services relating to taxation	—	0.1

7 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
Cost:						
At January 1, 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	801	504	514	366	109	2,294
Exchange adjustments	173	9	5	—	7	194
Additions	—	55	113	97	128	393
On acquisitions of businesses	41	—	—	—	11	52
On disposals of businesses	(2)	—	—	—	—	(2)
Disposals	—	—	—	—	(1)	(1)
At December 31, 2008	1,013	568	632	463	254	2,930
Accumulated amortisation and impairment:						
At January 1, 2007	—	143	132	176	19	470
Provided during the year ¹	—	7	18	28	10	63
At January 1, 2008	—	150	150	204	29	533
Exchange adjustments	—	3	—	—	2	5
Provided during the year ¹	5	12	26	46	18	107
Disposals	—	—	—	—	(1)	(1)
At December 31, 2008	5	165	176	250	48	644
Net book value at December 31, 2008	1,008	403	456	213	206	2,286
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	1,461

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

7 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 Holdings AS	Marine	42	—
Energy – arising from the acquisition of Rolls-Royce Energy Systems Inc.	Energy	73	54
Other	Various	28	30
		1,008	801

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.

8 Property, plant and equipment

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

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

8 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

9 Investments

	Joint ventures				Other	
	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m	Unlisted investments at cost £m ¹	Parent company shares held under trust £m
At January 1, 2007	110	116	14	240	51	74
Exchange adjustments	1	5	—	6	—	—
Additions	13	—	—	13	6	78
Taxation paid by the Group	—	2	—	2	—	—
Fair value adjustments	—	—	—	—	—	15
Share of retained profit	—	24	—	24	—	—
Disposals/amortisation	—	(1)	—	(1)	—	(135)
At January 1, 2008	124	146	14	284	57	32
Exchange adjustments	14	71	—	85	1	—
Additions	30	—	1	31	1	41
Taxation paid by the Group	—	3	—	3	—	—
Fair value adjustments	—	—	—	—	—	(5)
Share of retained profit	—	25	—	25	—	—
Impairments	(8)	—	(2)	(10)	—	—
Transferred to 'Assets held for sale'	—	(2)	—	(2)	—	—
Disposals/amortisation	(13)	(9)	(8)	(30)	(6)	(68)
Cash flow hedging reserve movement ²	—	(41)	—	(41)	—	—
At December 31, 2008	147	193	5	345	53	—

¹ These primarily comprise floating rate convertible loan stock.

² 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 ³	1,041	658
Current assets	940	635
Share of aggregate liabilities: ⁴		
Current liabilities	(841)	(523)
Non-current liabilities	(795)	(486)
	345	284

³ Non-current assets include goodwill of 10 (2007 7)

⁴ Liabilities include borrowings of (655) (2007 (372))

	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 105 and 106.

10 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
	2,600	2,203
Inventories stated at net realisable value	144	154
Amount of inventory write-down	81	79
Reversal of inventory write-down	15	6

11 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
	3,929¹	2,585¹
Analysed as (note 15):		
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
	3,929	2,585
¹ 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
	1,371	827

12 Cash and cash equivalents

	2008 £m	2007 £m
Cash at bank and in hand	938	1,264
Short-term deposits	1,531	632
	2,469	1,896
Overdrafts (note 13)	(9)	(25)
Cash and cash equivalents per cash flow statement (page 38)	2,460	1,871
Cash held as collateral against third party obligations	85	60

13 Borrowings

	Current		Non-current	
	2008 £m	2007 £m	2008 £m	2007 £m
Unsecured				
Overdrafts	9	25	—	—
Bank loans	11	3	5	2
7 ¾% Notes 2016 £200m	—	—	200	200
5.84% Notes 2010 US\$187m ¹	—	—	136	97
6.38% Notes 2013 US\$230m ¹	—	—	178	123
6.55% Notes 2015 US\$83m ¹	—	—	67	46
4 ½% Notes 2011 €750m ²	—	—	738	534
Other loan 2008 (interest rate nil)	—	1	—	—
Secured				
Bank loans ³	—	—	—	24
Obligations under finance leases: ⁴ (note 21)				
Less than one year	3	5	—	—
Between one and two years	—	—	—	3
Between two and five years	—	—	—	—
After five years	—	—	1	1
	23	34	1,325	1,030
Repayable				
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
			1,325	1,030

¹ 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.

² 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.

³ Secured on aircraft.

⁴ Obligations under finance leases are secured by related leased assets.

14 Trade and other payables

	Current		Non-current	
	2008 £m	2007 £m	2008 £m	2007 £m
Payments received on account ¹	1,635	1,226	549	332
Trade payables	1,042	778	—	—
Amounts owed to joint ventures	372	272	9	32
Amounts owed to parent undertaking	165	413	—	—
Other taxation and social security	55	64	—	—
Other payables	1,170	766	206	103
Accruals and deferred income	1,461	1,217	554	498
	5,900	4,736	1,318	965

¹ Includes payments received from joint ventures

Analysed as (note 15):

	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	4,524	3,514
	7,218	5,701

15 Financial instruments

This note should be read in conjunction with the Finance Director's review on pages 26 to 30.

Carrying values and fair values of financial instruments

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

		2008				2007			
		Financial instruments				Financial instruments			
	Notes	Derivative £m	Non- derivative £m	Non-financial instruments £m	Total £m	Derivative £m	Non- derivative £m	Non-financial instruments £m	Total £m
Assets:									
Unlisted non-current asset investments ^{1,2}	9	—	53	—	53	—	57	—	57
Parent company shares held under trust ³	9	—	—	—	—	—	32	—	32
Other non-current assets		—	—	5,764	5,764	—	—	4,149	4,149
Trade and other receivables: ⁴									
Trade receivables and similar items ¹	11	—	1,939	—	1,939	—	1,211	—	1,211
Other non-derivative financial assets ¹	11	—	369	—	369	—	321	—	321
Non-financial instruments	11	—	—	1,621	1,621	—	—	1,053	1,053
Other financial assets ⁴		390	—	—	390	514	—	—	514
Short-term investments ^{1,3}		—	1	—	1	—	40	—	40
Cash and cash equivalents: ⁴									
Cash at bank and in hand	12	—	938	—	938	—	1,264	—	1,264
Short-term deposits	12	—	1,531	—	1,531	—	632	—	632
Other current assets		—	—	2,621	2,621	—	—	2,217	2,217
		390	4,831	10,006	15,227	514	3,557	7,419	11,490
Liabilities:									
Borrowings – current ⁵	13	—	(23)	—	(23)	—	(34)	—	(34)
– non-current ⁵	13	—	(1,325)	—	(1,325)	—	(1,030)	—	(1,030)
Other financial liabilities: ⁵									
Financial RRSPs		—	(455)	—	(455)	—	(315)	—	(315)
Other		(2,386)	—	—	(2,386)	(57)	—	—	(57)
Trade and other payables: ²									
Trade payables and similar items	14	—	(2,264)	—	(2,264)	—	(1,872)	—	(1,872)
Other non-derivative financial liabilities	14	—	(430)	—	(430)	—	(315)	—	(315)
Non-financial instruments	14	—	—	(4,524)	(4,524)	—	—	(3,514)	(3,514)
Other liabilities		—	—	(1,456)	(1,456)	—	—	(1,167)	(1,167)
		(2,386)	(4,497)	(5,980)	(12,863)	(57)	(3,566)	(4,681)	(8,304)
Net assets/(liabilities)		(1,996)	334	4,026	2,364	457	(9)	2,738	3,186

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.

¹ Loans and receivables.

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

³ Fair value is determined using the market value bid price.

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

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

15 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
Assets		
Held for trading ¹	390	514
Loans and receivables ²	3,892	2,221
Available for sale ²	1	72
Cash	938	1,264
Liabilities		
Held for trading ¹	(2,386)	(57)
Financial liabilities at amortised cost	(4,497)	(3,566)
	(1,662)	448

¹ All financial assets and liabilities classified as held for trading are treated as current.

² 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	Total £m
At December 31, 2008					
Assets	112	—	278	—	390
Liabilities	(2,293)	(89)	(4)	(455)	(2,841)
	(2,181)	(89)	274	(455)	(2,451)
At December 31, 2007					
Assets	433	39	42	—	514
Liabilities	(54)	—	(3)	(315)	(372)
	379	39	39	(315)	142

Other financial liabilities are analysed as follows:

	2008 £m	2007 £m
Current liabilities	(2,450)	(69)
Non-current liabilities	(391)	(303)
	(2,841)	(372)

15 Financial instruments continued

Foreign exchange and commodity financial instruments

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

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

	Foreign exchange instruments			Commodity instruments		
	Total £m	Included in transition hedging reserve £m	Included in income statement £m	Total £m	Included in transition hedging reserve £m	Included in income statement £m
At January 1, 2007	554	254	—	39	—	—
Fair value changes to derivative contracts not in accounting hedging relationships ¹	215	—	215	36	—	36
Fair value changes to fair value hedges ^{1,2}	(6)	—	(6)	—	—	—
Fair value of contracts settled	(384)	—	—	(36)	—	—
Transferred to revenue	—	(149)	149	—	—	—
At January 1, 2008	379	105	—	39	—	—
Fair value changes to derivative contracts not in accounting hedging relationships ¹	(2,383)	—	(2,383)	(96)	—	(96)
Fair value changes to fair value hedges ^{1,2}	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	(2,181)	25	—	(89)	—	—

¹ Included in financing.

² 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 ^{1,2}	24	24	—	24
At January 1, 2008	39	42	(3)	—
Fair value changes ^{1,2}	235	236	(1)	235
At December 31, 2008	274	278	(4)	—

¹ Included in financing.

² Loss on related hedged items **£236m** (2007 £24m).

15 Financial instruments continued

Financial risk and revenue sharing partnerships (RRSPs)

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

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

	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 ¹	26	26
Excluded from underlying profit:		
Exchange adjustments ¹	118	(7)
Restructuring of financial RRSP agreements and changes in forecast payments ¹	3	20
At December 31	455	315

¹ Included in financing.

Risk management policies and hedging activities

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

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

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

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

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 shown in the Finance Directors' 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 Groups 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 fixed 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.

15 Financial instruments continued

Derivative financial instruments

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

							2008
	Expected maturity					Fair value	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
Foreign exchange contracts:							
Fair value hedges	(280)	—	(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)
	10,557	1,891	2,199	6,335	132	390	(2,386)
							2007
	Expected maturity					Fair value	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
Foreign exchange contracts:							
Fair value hedges	(280)	—	—	(105)	(175)	—	(27)
Non-hedge accounted	5,168	2,135	1,816	1,217	—	433	(27)
Interest rate contracts:							
Fair value hedges	751	—	—	594	157	42	—
Non-hedge accounted	74	20	18	16	20	—	(3)
Commodity contracts:							
Non-hedge accounted	166	91	55	20	—	39	—
	5,879	2,246	1,889	1,742	2	514	(57)

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.

15 Financial instruments continued

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

	2008 Currencies purchased forward				
	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

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

Other derivative financial instruments are denominated in the following currencies:

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

Non-derivative financial instruments

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

Directors report

15 Financial instruments continued

Currency exposures

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

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

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

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
Assets:				
Unlisted non-current asset investments	53	—	—	—
Trade receivables and similar items	1,516	322	93	8
Other non-derivative financial assets	354	9	4	2
Other financial assets	390	—	—	—
Short-term investments	1	—	—	—
Cash at bank and in hand	938	—	—	—
Short-term deposits	1,531	—	—	—
	4,783	331	97	10
				5,221

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

15 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
	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)
Other non-derivative financial liabilities	(271)	(1)	(29)	(14)	—	(315)
	(2,184)	(39)	(241)	(136)	41	(2,559)
	(2,276)	(100)	(1,041)	(569)	363	(3,623)

15 Financial instruments continued

Interest rate risk

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

	Effective interest rate %	Total £m	Period in which interest rate reprices					2008
			6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m	
Short-term investments ¹	9.6769%	1	1	—	—	—	—	
Cash at bank and in hand ²		938	938	—	—	—	—	
Short-term deposits ³		1,531	1,531	—	—	—	—	
Unsecured bank loans								
€2.5m floating rate loan	EURIBOR +1.2	(2)	(2)	—	—	—	—	
€5m floating rate loan	EURIBOR +0.5	(5)	(5)	—	—	—	—	
Overdrafts ⁴		(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)	
Unsecured bond issues								
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	—	
Other secured								
Obligations under finance leases	5.5226%	(4)	(3)	—	—	—	(1)	
		1,122	1,364	(1)	(22)	—	(219)	

15 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 ¹	5.5913%	40	14	6	—	12	8
Cash at bank and in hand ²		1,264	1,264	—	—	—	—
Short-term deposits ³		632	632	—	—	—	—
Unsecured bank loans							
€4m floating rate loan	EURIBOR +1.2	(3)	(3)	—	—	—	—
Overdrafts ⁴		(25)	(25)	—	—	—	—
Effect of interest rate swaps	1.2277%	—	54	—	(18)	(16)	(20)
Other unsecured							
South Korean Won floating rate loan	KRW LIBOR +0.9	(2)	(2)	—	—	—	—
Other loan 2008 (interest rate nil)	0.0000%	(1)	(1)	—	—	—	—
Unsecured bond issues							
7 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	—
Secured bank loans							
US\$ floating rate loan	USD LIBOR +0.53	(24)	(24)	—	—	—	—
Other secured							
Obligations under finance leases	6.0183%	(9)	(2)	(3)	(3)	—	(1)
		872	1,107	3	(21)	(4)	(213)

¹ Interest on the short-term investments are at fixed rates.

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

³ Short-term deposits are deposits placed on money markets for periods up to three months and earn interest at the respective short-term deposit rates.

⁴ Overdrafts bear interest at rates linked to applicable LIBOR rates that fluctuate in accordance with local practice.

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

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

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

15 Financial instruments continued

Sensitivity analysis

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

At December 31, 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 30.

16 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 30. The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 22. Based on the assumptions used to estimate the customer finance provision, it is estimated that the provision will be utilised as follows:

	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

17 Post-retirement benefits

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

For the UK defined benefit schemes, the assets are held in separate trustee administered funds and employees are entitled to retirement benefits based on either their final or career 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 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.

17 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 ¹	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

¹ 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 ¹	(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)

¹ 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.

17 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
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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 ¹	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

¹ 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.

17 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)

18 Share capital

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At January 1, 2007 and December 31, 2008	2,000	400
Issued and fully paid		
At January 1, 2007 and December 31, 2008	1,631	326

19 Movements in capital and reserves

	Attributable to equity holders of the parent						Minority interests £m	Total equity £m
	Share capital £m	Share premium £m	Hedging reserves ¹ £m	Translation reserve £m	Retained earnings £m	Total £m		
At January 1, 2007	326	631	177	(58)	1,154	2,230	7	2,237
Total recognised income and expense for the year	—	—	(100)	117	878	895	(6)	889
Share-based payments adjustment	—	—	—	—	29	29	—	29
Transactions with minority interests	—	—	—	—	—	—	11	11
Related tax movements – current tax	—	—	—	—	43	43	—	43
– deferred tax	—	—	—	—	(18)	(18)	—	(18)
Change in rate of UK corporation tax – deferred tax	—	—	—	—	(5)	(5)	—	(5)
At January 1, 2008	326	631	77	59	2,081	3,174	12	3,186
Total recognised income and expense for the year	—	—	(99)	601	(1,336)	(834)	(3)	(837)
Share-based payments adjustment	—	—	—	—	26	26	—	26
Related tax movements – deferred tax	—	—	—	—	(11)	(11)	—	(11)
At December 31, 2008	326	631	(22)	660	760	2,355	9	2,364

¹ See accounting policies note 1 – hedge accounting.

20 Share-based payments

Share-based payment plans in operation during the year

The Group had the following share-based payment plans, in respect of shares in its parent company, Rolls-Royce Group plc, in operation during the year:

Performance Share Plan (PSP)

This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and Cash Flow Per Share) and a market based performance condition (Total Shareholder Return – TSR).

ShareSave share option plan

Based on a three or five year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into. Vesting of the options is not subject to the achievement of a performance target. 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)

This 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.

20 Share-based payments continued

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
PSP		
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
ShareSave				
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	—	—

	2008		2007	
	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
ESOP				
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
Deferred shares under APRA		
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
Free Shares under SIP		
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).

20 Share-based payments continued

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 Rolls-Royce Group plc's share price over the seven years prior to the grant or award date. Until 2007, expected dividends were based on Rolls-Royce Group plc's payments to shareholders over the five years prior to the grant or award date. From 2008, expected dividends were based on the payments to shareholders in respect of 2007.

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	430p	501p	444p	262p	233p
Expected dividends	13.00p	8.30p	7.92p	7.81p	7.61p
Volatility	29%	29%	32%	34%	35%
Correlation	29%	26%	19%	19%	22%
Expected life	3 years	3 years	3 years	3 years	3 years
Risk free interest rate	4.1%	5.2%	4.3%	4.9%	5.2%

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

ShareSave awards

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

	2007	2005	2003
Weighted average share price	553p	351p	173p
Exercise price	416p	298p	142p
Volatility	37%	40%	43%
Expected dividends	8.80p	7.86p	7.61p
Expected life ¹ – 3 year ShareSave	3.3-3.8 years	3.3-3.8 years	3.2-3.7 years
– 5 year ShareSave	5.3-5.8 years	5.3-5.8 years	5.2-5.7 years
Close periods:			
From January 1	6 weeks	6 weeks	6 weeks
From July 1	1 month	1 month	1 month
Risk free interest rate	5.0%	4.4%	4.6%

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

Deferred shares under APRA and Free Shares under SIP

The fair value of shares awarded under these plans is calculated as the share price on the date of the award.

21 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
	472	355

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
	22	21

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
	5	1	4	10	1	9

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).

22 Contingent liabilities

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

Contingent liabilities are disclosed on a discounted basis. As the directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a present value 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	\$m	£m	\$m
Gross contingent liabilities	755	1,086	616	1,227
Contingent liabilities net of relevant security ¹	155	222	140	279
Contingent liabilities net of relevant security reduced by 20% ²	246	354	218	434

¹ Security includes unrestricted cash collateral of: **85** **123** 60 120

² 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.

23 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 Rolls-Royce Group plc and joint ventures are shown in notes 11 and 14. Transactions with Group pension schemes are shown in note 17.

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

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

	2008 £m	2007 £m
Salaries and short-term benefits	9	9
Post-retirement schemes	2	2
Share-based payments	6	5
	17	16

24 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
	50
Additions to investments in joint ventures ¹	31
	81
Represented by:	
Net cash outflow per cash flow statement	82
Net non-cash consideration	(1)
	81

¹ 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 7).

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)
	9
Disposals of investments in joint ventures	30
Net assets	39
Profit on sale or termination of businesses	7
	46
Analysed as:	
Receipts outstanding at December 31, 2008	10
Net cash inflow per cash flow statement	36
	46

Company financial statements

December 31, 2008

Company balance sheet

At December 31, 2008

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	Notes	2008 £m	2007 £m
Fixed assets			
Intangible assets	3	546	410
Tangible assets	4	1,029	1,041
Investments – subsidiary undertakings	5	1,647	1,807
Investments – joint ventures	5	71	78
Investments – other	5	46	79
		3,339	3,415
Current assets			
Stocks	6	1,328	1,302
Debtors – amounts falling due within one year	7	2,476	1,997
Debtors – amounts falling due after one year	7	1,433	353
Other financial assets	10	693	531
Post-retirement scheme surpluses	13	664	149
Short-term deposits		1,456	316
Cash at bank and in hand		554	941
Assets held for resale		9	—
		8,613	5,589
Creditors – amounts falling due within one year			
Borrowings	8	(637)	(352)
Other financial liabilities	10	(2,535)	(172)
Other creditors	9	(5,896)	(5,061)
Net current assets		(455)	4
Total assets less current liabilities		2,884	3,419
Creditors – amounts falling due after one year			
Borrowings	8	(1,319)	(1,003)
Other financial liabilities	10	(310)	(301)
Other creditors	9	(792)	(422)
Provisions for liabilities and charges	11	(100)	(60)
Post-retirement scheme deficits	13	(32)	(21)
		331	1,612
Capital and reserves			
Called-up share capital	14	326	326
Share premium account	15	631	631
Revaluation reserve	15	51	71
Transition hedging reserve	15	20	76
Other reserves	15	167	167
Profit and loss account	15	(864)	341
		331	1,612

The financial statements on pages 85 to 103 were approved by the Board on February 11, 2009 and signed on its behalf by:

Simon Robertson
Chairman

Andrew Shilston
Finance Director

Statement of total recognised gains and losses

For the year ended December 31, 2008

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	2008 £m	2007 £m
Profit attributable to the shareholders of Rolls-Royce plc	(1,656)	293
Net actuarial gains	1,040	466
Movement in unrecognised post-retirement surplus	(453)	(113)
Movement in fair value of available for sale assets	(8)	(28)
Related tax movements	(163)	(104)
Total recognised gains relating to the year	(1,240)	514

Reconciliation of movements in shareholders' funds

For the year ended December 31, 2008

	2008 £m	2007 £m
At January 1	1,612	1,184
Total recognised gains for the year	(1,240)	514
Transfer from transition hedging reserve	(78)	(149)
Share-based payment adjustments	15	16
Related tax movements	22	47
At December 31	331	1,612

1 Significant accounting policies

Basis of accounting

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

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 fee 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.

Revenue recognition

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

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

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

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

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

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

Government investment

Where a government or similar body invests in a development programme, the Company 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.

Risk and revenue sharing partnerships (RRSPs)

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

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

Research and development

The charge to the profit and loss account consists of research and development expenditure incurred in the year, excluding known recoverable costs on contracts, contributions to shared engineering programmes and application engineering. No research and development expenditure is capitalised.

Interest

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

Taxation

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

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 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.

Foreign currency translation

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

Financial instruments

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

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

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

- Loans and receivables and other liabilities are generally held at amortised cost and not revalued (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 profit and loss account.
- Available for sale assets are held at fair value. Changes in fair value arising from changes in exchange rates are included in the profit and loss account. All other changes in fair value are taken to reserves. On disposal of the related asset, the accumulated changes in value recorded in reserves are included in the gain or loss recorded in the profit and loss account.
- Held for trading instruments are held at fair value. Changes in fair value are included in the profit and loss account unless the instrument is included in a cash flow hedge. If the instruments are included in a cash flow hedging relationship, which is effective, changes in value are taken to reserves. When the hedged forecast transaction occurs, amounts previously recorded in reserves are recognised in the profit and loss account.

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

Hedge accounting

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

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

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

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

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

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting. At that time, for cash flow hedges 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 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 reserves. The ineffective portion is recognised immediately in the profit and loss account.

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

Certification costs and participation fees

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

Software

The cost of acquiring software that is not specific to an item of tangible fixed assets is classified as an intangible asset and amortised over its useful economic life, up to a maximum of five years.

Tangible fixed assets and depreciation

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

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

Estimated useful lives are as follows:

- i) Land and buildings, as advised by the Company's professional valuers:
 - a) Freehold buildings – five to 45 years (average 24 years).
 - b) Leasehold land and buildings – lower of valuers' estimates or period of lease.
 - c) No depreciation is provided in respect of freehold land.
- ii) Plant and equipment – five to 25 years (average 15 years).
- iii) Aircraft and engines – five to 20 years (average 17 years).
- iv) No depreciation is provided on assets in the course of construction.

Impairment of fixed assets

Impairment of fixed assets is considered in accordance with FRS 11 *Impairment of fixed assets and goodwill*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the income-generating unit to which the asset belongs.

Intangible assets not yet available for use are tested for impairment annually. Other fixed assets 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 income-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.

Accounting for leases

i) As Lessee

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

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

ii) As Lessor

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

Rentals receivable under operating leases are included in turnover on a straight-line basis.

Stock

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

Provisions

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

Post-retirement benefits

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

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

Share-based payments

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

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

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

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

2 Emoluments of directors

	2008		2007	
	Highest paid director £000	Other directors £000	Highest paid director £000	Other directors £000
Aggregate emoluments excluding deferred share plans	1,125	3,526	1,109	3,412
Aggregate amounts relating to deferred share plans ²	1,492	1,841	1,865	2,425
Aggregate value of Company contributions to Company defined contribution pensions schemes	—	558	—	433
Accrued pension of highest paid director	449	—	555	—
Gains realised on exercise of share options ³	—	9	3,339	7,025

	2008 Number	2007 Number
Number of directors with accruing retirement benefits:		
Defined contribution schemes	2	2
Defined benefit schemes ⁴	2	3
Number of directors registered for enhanced protection within defined benefit schemes ⁵	2	3
Number of directors exercising share options	1	5
Number of directors receiving shares as part of long-term incentive schemes	5	5

¹ Member of defined benefit scheme started to receive pension on February 1, 2008.

² 2007 restated from £153k and £314k to include shares vesting under the Rolls-Royce Group plc Performance Share Plan – see note 17.

³ Includes gains under the ShareSave plan.

⁴ Two directors were contributing members of both defined contribution and defined benefit schemes (2007 two directors).

⁵ In 2007, this was included within the number of directors accruing retirement benefits in defined benefit schemes.

3 Intangible assets

	Certification costs and participation fees £m	Software and other £m	Total £m
Cost:			
At January 1, 2008	483	92	575
Additions	43	119	162
At December 31, 2008	526	211	737
Accumulated amortisation:			
At January 1, 2008	140	25	165
Provided during the year	12	14	26
At December 31, 2008	152	39	191
Net book value at December 31, 2008	374	172	546
Net book value at January 1, 2008	343	67	410

4 Tangible assets

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost or valuation:					
At January 1, 2008	422	1,264	24	121	1,831
Additions	5	41	55	64	165
Reclassifications	13	45	—	(58)	—
Transferred to 'Assets held for sale'	(31)	—	—	—	(31)
Disposals/write-offs	(2)	(68)	(38)	—	(108)
At December 31, 2008	407	1,282	41	127	1,857
Accumulated depreciation:					
At January 1, 2008	109	680	1	—	790
Provided during the year	31	88	5	—	124
Transferred to 'Assets held for sale'	(22)	—	—	—	(22)
Disposals/write-offs	(2)	(60)	(2)	—	(64)
At December 31, 2008	116	708	4	—	828
Net book value at December 31, 2008	291	574	37	127	1,029
Net book value at January 1, 2008	313	584	23	121	1,041

Tangible fixed assets include:	2008 £m	2007 £m
Net book value of finance leased assets	17	22
Non-depreciable land	57	57
Land and buildings at cost or valuation comprise:		
Cost	248	232
Valuation at December 31, 1996	159	190
	407	422
Land and buildings at net book value comprise:		
Freehold	284	305
Long leasehold	5	6
Short leasehold	2	2
	291	313
On an historical cost basis the net book value of land and buildings would have been as follows:		
Cost	390	400
Depreciation	(139)	(159)
	251	241
Capital expenditure commitments – contracted but not provided for	86	67

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

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

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

In the United Kingdom the revaluation was carried out by Gerald Eve, Chartered Surveyors, Fuller Peiser, Chartered Surveyors and Storey Sons & Parker, Chartered Surveyors, in accordance with the appraisal and valuation manual of the Royal Institution of Chartered Surveyors.

5 Investments

	Subsidiary undertakings ¹		Joint ventures ²				Other
	Shares at cost £m	Shares at cost £m	Loans £m	Total £m	Unlisted investments at cost £m	Parent company shares held under trust £m ³	Total £m
At January 1, 2008	1,807	65	13	78	47	32	79
Additions	—	21	—	21	—	41	41
Fair value adjustments	—	—	—	—	—	(5)	(5)
Disposals/write-offs	(160)	(20)	(8)	(28)	(1)	(68)	(69)
At December 31, 2008	1,647 ⁴	66	5	71	46	—	46

¹ The principal subsidiary undertakings are listed on page 104.

² The principal joint ventures are listed on pages 105 and 106.

³ Shares in the parent company were held at fair value in a trust. During 2008, all the shares were transferred to an equivalent trust of which Rolls-Royce Group plc is the sponsor. At December 31, 2007 5,838,501 shares with a fair value of £32m were held.

⁴ The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited, one of its subsidiaries. At December 31, 2008, this guarantee was £25m (2007 £25m).

6 Stocks

	2008 £m	2007 £m
Raw materials	44	52
Work in progress	368	349
Long-term contracts work in progress	22	13
Finished goods	881	880
Payments on account	13	8
	1,328	1,302

7 Debtors

	Falling due within one year		Falling due after one year	
	2008 £m	2007 £m	2008 £m	2007 £m
Trade debtors	408	241	3	16
Amounts recoverable on contracts	—	99	578	189
Amounts owed by – subsidiary undertakings	1,392	1,112	—	—
Amounts owed by – joint ventures	394	251	5	13
Deferred tax assets (note 12)	—	—	794	102
Other debtors	202	217	15	6
Prepayments and accrued income	80	77	38	27
	2,476	1,997	1,433	353

8 Borrowings

	Falling due within one year		Falling due after one year	
	2008 £m	2007 £m	2008 £m	2007 £m
Unsecured				
Overdrafts	634	347	—	—
7 ¼% Notes 2016 £200m	—	—	200	200
5.84% Notes 2010 US\$187m ¹	—	—	136	97
6.38% Notes 2013 US\$230m ¹	—	—	178	123
6.55% Notes 2015 US\$83m ¹	—	—	67	46
4 ½% Notes 2011 €750m ²	—	—	738	534
Secured				
Obligations under finance leases: ³				
Less than one year	3	5	—	—
Between one and two years	—	—	—	3
Between two and five years	—	—	—	—
	637	352	1,319	1,003
Repayable				
Between one and two years – by instalments			—	3
– otherwise			136	—
Between two and five years – otherwise			916	631
After five years – otherwise			267	369
			1,319	1,003

¹ These notes are subject of interest rate swap agreements under which the Company has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge.

² 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.

³ Obligations under finance leases are secured by related leased assets.

9 Other creditors

	Falling due within one year		Falling due after one year	
	2008 £m	2007 £m	2008 £m	2007 £m
Payments received on account ¹	383	394	547	331
Trade creditors	431	385	—	—
Amounts owed to subsidiary undertakings	2,995	2,245	—	—
Amounts owed to joint ventures	321	265	4	4
Amounts owed to parent and its subsidiaries	168	407	—	—
Corporate taxation	101	106	—	—
Other taxation and social security	18	20	—	—
Other creditors	905	616	190	87
Accruals and deferred income	574	623	51	—
	5,896	5,061	792	422

¹ Includes payments received from joint ventures

209 195 107 25

10 Other financial assets and liabilities

Details of the Company's policies on the use of financial instruments are given in the accounting policies on page 88.

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

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

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
At December 31, 2008					
Assets	415	—	278	—	693
Liabilities	(2,367)	(89)	(4)	(385)	(2,845)
	(1,952)	(89)	274	(385)	(2,152)
At December 31, 2007					
Assets	450	39	42	—	531
Liabilities	(153)	—	(3)	(317)	(473)
	297	39	39	(317)	58

Other financial liabilities are analysed as follows:

	2008 £m	2007 £m
Current liabilities	(2,535)	(172)
Non-current liabilities	(310)	(301)
	(2,845)	(473)

Foreign exchange and commodity financial instruments

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

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

	Foreign exchange instruments			Commodity instruments		
	Total £m	Included in transition hedging reserve £m	Included in profit and loss account £m	Total £m	Included in transition hedging reserve £m	Included in profit and loss account £m
At January 1, 2007	508	252	—	39	—	—
Fair value changes to derivative contracts not in accounting hedging relationships	55	—	55	36	—	36
Fair value changes to fair value hedges ¹	(6)	—	(6)	—	—	—
Fair value of contracts settled	(260)	—	—	(36)	—	—
Transferred to turnover	—	(149)	149	—	—	—
At January 1, 2008	297	103	—	39	—	—
Fair value changes to derivative contracts not in accounting hedging relationships	(2,044)	—	(2,044)	(96)	—	(96)
Fair value changes to fair value hedges ¹	83	—	83	—	—	—
Fair value of derivative contracts assumed on formation of joint venture	(24)	—	—	—	—	—
Fair value of contracts settled	(264)	—	—	(32)	—	—
Transferred to turnover	—	(78)	78	—	—	—
At December 31, 2008	(1,952)	25	—	(89)	—	—

¹ Loss on related hedged items £83m (2007 £6m gain)

10 Other financial assets and liabilities continued

Interest rate financial instruments

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

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

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in profit and loss account £m
At January 1, 2007	16	18	(3)	
Changes during the year	23	24	—	24
At January 1, 2008	39	42	(3)	
Changes during the year	235	236	(1)	235
At December 31, 2008	274	278	(4)	

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

Financial risk and revenue sharing partnerships (RRSPs)

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

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

	2008 £m	2007 £m
At January 1	317	354
Cash paid to partners	(74)	(62)
Financing charge	26	28
Exchange adjustments	116	(3)
At December 31	385	317

11 Provisions for liabilities and charges

	At December 31, 2007 £m	Charged to profit and loss account £m	Utilised £m	At December 31, 2008 £m
Warranties and guarantees	31	3	(7)	27
Customer financing	29	30	(1)	58
Restructuring	—	15	—	15
	60	48	(8)	100

Provisions for warranties and guarantees primarily relate to products sold and generally cover a period of up to three years.

Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 18. Timing of utilisation is uncertain.

Provisions for restructuring are generally expected to be used within two years.

12 Deferred taxation

	£m
At January 1, 2008	52
Amount charged to profit and loss account	637
Amount charged to statement of total recognised gains and losses	(163)
Amount credited to equity	22
At December 31, 2008	548

There are other deferred tax assets totalling **£102m** (2007 £102m) that have not been recognised on the basis that their future economic benefit is uncertain.

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

The analysis of the deferred tax position is as follows:

	2008 £m	2007 £m
Fixed asset timing differences	(119)	(117)
Other timing differences	17	156
Pensions and other post-retirement scheme benefits	(246)	(50)
Foreign exchange and commodity financial assets and liabilities	655	(121)
Losses	180	123
Advance corporation tax	61	61
	548	52

Included within:

Debtors – amounts falling due after one year	794	102
Post-retirement scheme surpluses	(259)	(58)
Post-retirement scheme deficits	13	8
	548	52

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

13 Post-retirement benefits

Defined benefit schemes

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

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2008. The most recent funding valuations of the main 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

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

	2008 %	2007 %
Rate of increase in salaries	4.5	5.0
Rate of increase of pensions in payment ¹	2.9	3.5
Discount rate	6.4	5.8
Expected rate of return on scheme assets	4.1	5.4
Inflation assumption	3.0	3.5

¹ 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 schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. For less significant schemes the rate is determined as the market yield at the average duration of the forecast benefit payments. The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities.

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

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

Life expectancy from age 65

Current pensioner	17.5 years to 22.2 years
Future pensioner	19.5 years to 23.9 years

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

13 Post-retirement benefits continued

Amounts recognised in the balance sheet

	2008 £m	2007 £m
Present value of funded obligations	(5,719)	(6,335)
Fair value of scheme assets	7,163	6,626
Unrecognised surplus ¹	(566)	(113)
Surplus/(deficit)	878	178
Related deferred tax (liability)/asset	(246)	(50)
Net asset/(liability) recognised in the balance sheet	632	128
Analysed as:		
Post-retirement scheme surpluses	664	149
Post-retirement scheme deficits	(32)	(21)
	632	128

¹ Where a surplus has arisen on a scheme, in accordance with FRS 17 *Retirement benefits*, the surplus is recognised as an asset only if it represents a future economic benefit available to the Company. Any surplus in excess of this benefit is not recognised in the balance sheet. Surpluses have arisen largely as a result of differences between the actuarial and FRS 17 valuation assumptions.

Changes in present value of defined benefit obligations

	2008 £m	2007 £m
At January 1	(6,335)	(5,785)
Transfer from subsidiary company	—	(553)
Current service cost ¹	(127)	(100)
Past service cost	(5)	(131)
Finance cost	(358)	(323)
Contributions by employees	(4)	(38)
Net benefits paid out	331	286
Actuarial gains	776	309
Transfers	3	—
At December 31	(5,719)	(6,335)

¹ The Company also made ex-gratia payments directly to scheme members of £8m (2007 nil)

Changes in fair value of scheme assets

	2008 £m	2007 £m
At January 1	6,626	5,101
Transfer from subsidiary company	—	572
Expected return on assets	352	367
Contributions by employer	248	677
Contributions by employees	4	38
Benefits paid out	(331)	(286)
Actuarial gains	264	157
At December 31	7,163	6,626
Actual return on plan assets	616	524

The fair value of the scheme assets and the expected rates of return at December 31 were as follows:

	Expected rate of return %	2008 Market value £m	Expected rate of return %	2007 Market value £m
LDI portfolio ¹	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

¹ 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.

13 Post-retirement benefits continued

The scheme assets do not include any financial instruments of the Rolls-Royce Group plc group, nor any property occupied by, or other assets used by, the group.

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

The expected rates of return on individual categories of scheme assets are determined by reference to gilt yields. Equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25 per cent and 1.75 per cent per annum respectively.

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

Future contributions

The Company expects to contribute approximately £237m 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 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.

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
Balance sheet					
Present value of defined benefit obligations	(5,719)	(6,335)	(5,785)	(6,102)	(4,321)
Fair value of scheme assets	7,163	6,626	5,101	4,809	3,283
Unrecognised surplus	(566)	(113)	—	—	—
Asset/(deficit)	878	178	(684)	(1,293)	(1,038)
Actuarial gains on scheme assets	264	157	114	503	92
Experience gains/(losses) on scheme liabilities	776	309	477	(745)	(113)
Movement in unrecognised surplus	(453)	(113)	—	—	—
Total amount recognised in the statement of total recognised gains and losses	587	353	591	(242)	(21)
Cumulative amount recognised in the statement of total recognised gains and losses ¹	192	(395)	(748)	(1,339)	(1,097)

¹ Since January 1, 2002

Defined contribution schemes

The Company operates a number of defined contribution schemes. The total expense recognised in the profit and loss account was **£6m** (2007 £3m).

14 Share capital

	Equity ordinary shares of 20p each Millions	Nominal value £m
Authorised		
At January 1, and December 31, 2008	2,000	400
Issued and fully paid		
At January 1, and December 31, 2008	1,631	326

15 Movements in capital and reserves

	Non-distributable reserves					Profit and loss account £m	Total equity £m
	Share capital £m	Share premium £m	Revaluation reserve £m	Transition hedging reserve £m	Other reserves £m		
At January 1, 2008	326	631	71	76	167	341	1,612
Total recognised gains relating to the year	—	—	—	—	—	(1,240)	(1,240)
Transfers between reserves	—	—	(20)	—	—	20	—
Transfer from transition hedging reserve	—	—	—	(78)	—	—	(78)
Share-based payments adjustment	—	—	—	—	—	15	15
Related tax movements	—	—	—	22	—	—	22
At December 31, 2008	326	631	51	20	167	(864)	331

¹ See accounting policies note 1 – hedge accounting.

16 Operating lease annual commitments

	2008 £m	2007 £m
Leases of land and buildings which expire:		
Between one and five years	3	4
After five years	4	4
Other leases which expire:		
Within one year	—	1
Between one and five years	3	1

17 Share-based payments

Share-based payment plans in operation during the year

The Company participated in the following share-based payment plans of Rolls-Royce Group plc in operation during the year:

Performance Share Plan (PSP)

This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and Cash Flow Per Share) and a market based performance condition (Total Shareholder Return – TSR).

ShareSave share option plan

Based on a three or five year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into. Vesting of the options is not subject to the achievement of a performance target. The plan is HM Revenue & Customs approved.

Executive Share Option Plan (ESOP)

This plan involves the grant of market value share options to participants. The options are subject to a non-market based performance condition (growth in EPS). The options have a maximum contractual life of ten years. Following the introduction of the PSP, it is not intended to grant any further executive share options. The plan terminates in 2009.

Annual Performance Related Award (APRA) plan deferred shares

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

Share Incentive Plan (SIP)

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

In accordance with the transitional provisions of FRS 20 *Share-based payment*, the Company has recognised an expense in respect of all grants under these plans made after November 7, 2002 and unvested at January 1, 2005.

The Company recognised a total expense of **£24m** (2007 £22m).

17 Share-based payments continued

The movements in awards under the various share plans are shown in the tables below:

	Number of shares awarded	
	2008 Millions	2007 Millions
PSP		
Outstanding at January 1	8.7	9.8
Awarded during the year	2.8	2.7
Forfeited during the year	(0.5)	(0.4)
Additional entitlements arising from TSR performance	0.9	0.9
Vested during the year	(4.1)	(4.3)
Outstanding at December 31	7.8	8.7

	2008		2007	
	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
ShareSave				
Outstanding at January 1	29.5	241p	42.1	153p
Granted during the year	—	—	7.4	416p
Forfeited during the year	(0.8)	334p	(0.9)	219p
Exercised during the year	(9.8)	143p	(19.1)	116p
Outstanding at December 31	18.9	288p	29.5	241p
Exercisable at December 31	1.1	141p	—	—

	2008		2007	
	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
ESOP				
Outstanding at January 1	1.0	177p	12.1	191p
Exercised during the year	(0.1)	194p	(11.1)	193p
Outstanding at December 31	0.9	176p	1.0	177p
Exercisable at December 31	0.9	176p	1.0	177p

	Number of shares awarded	
	2008 Millions	2007 Millions
Deferred shares under APRA		
Outstanding at January 1	1.8	2.7
Awarded during the year	0.8	1.0
Additional shares accrued from conversion of B Shares	—	0.1
Vested during the year	(1.2)	(2.0)
Outstanding at December 31	1.4	1.8

	Number of shares awarded	
	2008 Millions	2007 Millions
Free Shares under SIP		
Awarded during the year	1.0	0.6

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

17 Share-based payments continued

Details of the assumptions used in the calculation of these fair values are set out below. Expected volatility was based on the historical volatility of the Rolls-Royce Group plc share price over the seven years prior to the grant or award date. Until 2007, expected dividends were based on payments to shareholders over the five years prior to the grant or award date. From 2008, expected dividends were based on payments to shareholders in respect of 2007.

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	430p	501p	444p	262p	233p
Expected dividends	13.00p	8.30p	7.92p	7.81p	7.61p
Volatility	29%	29%	32%	34%	35%
Correlation	29%	26%	19%	19%	22%
Expected life	3 years	3 years	3 years	3 years	3 years
Risk free interest rate	4.1%	5.2%	4.3%	4.9%	5.2%

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

ShareSave awards

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

	2007	2005	2003
Weighted average share price	553p	351p	173p
Exercise price	416p	298p	142p
Volatility	37%	40%	43%
Expected dividends	8.80p	7.86p	7.61p
Expected life ¹ – 3 year ShareSave	3.3-3.8 years	3.3-3.8 years	3.2-3.7 years
– 5 year ShareSave	5.3-5.8 years	5.3-5.8 years	5.2-5.7 years
Close periods:			
From January 1	6 weeks	6 weeks	6 weeks
From July 1	1 month	1 month	1 month
Risk free interest rate	5.0%	4.4%	4.6%

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

Deferred shares under APRA and Free Shares under SIP

The fair value of shares awarded under these plans is calculated as the share price on the date of the award.

18 Contingent liabilities

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

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

The discounted 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	\$m	£m	\$m
Gross contingent liabilities	755	1,086	616	1,227
Contingent liabilities net of relevant security ¹	155	222	140	279
Contingent liabilities net of relevant security reduced by 20% ²	246	354	218	434

¹ Security unrestricted cash collateral of: 85 123 60 120

² 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 Company in the ordinary course of business for product delivery, performance and reliability. The Company has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. The Company is party to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. As a consequence of the insolvency of an insurer as previously reported, the Company is no longer fully insured against known and potential claims from employees who worked for certain of the Company's UK based businesses for a period prior to the acquisition of those businesses by the Company. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Company.

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee. At December 31, 2008, there were Company guarantees in respect of joint ventures amounting to **£13m** (2007 £11m).

The Company participates in a Cash Pooling Arrangement. Under the Pooling Arrangement the Company benefits from more favourable interest rates than would be available outside of the Pooling Arrangement as well as more streamlined treasury functions. As part of the Pooling Arrangement, the Company cross-guarantees the borrowings of other pooling participants. At December 31, 2008 these guarantees amounted to **£24m** (2007 £19m)

19 Related party transactions

The Company is a wholly owned subsidiary of Rolls-Royce Group plc and therefore has taken advantage of the exemption in FRS 8 *Related party disclosures*, not to disclose related party transactions with its parent company and other group companies.

The aggregated balances with joint ventures are shown in notes 7 and 9.

20 Ultimate holding company

The ultimate holding company is Rolls-Royce Group plc, incorporated in Great Britain. The financial statements for Rolls-Royce Group plc may be obtained from the Company Secretary, Rolls-Royce Group plc, 65 Buckingham Gate, London SW1E 6AT.

Principal subsidiary undertakings

At December 31, 2008

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Incorporated within the UK – directly held unless marked *

Optimized Systems and Solutions Limited*	Advanced controls and predictive data management
Rolls-Royce Fuel Cell Systems Limited	Development of fuel cell systems
Rolls-Royce International Limited	International support and commercial information services
Rolls-Royce Leasing Limited	Engine leasing
Rolls-Royce Marine Electrical Systems Limited*	Marine electrical systems
Rolls-Royce Marine Power Operations Limited	Nuclear submarine propulsion systems
Rolls-Royce Power Development Limited	Generation of electricity from independent power projects
Rolls-Royce Power Engineering plc	Energy and marine systems
Rolls-Royce Total Care Services Limited	Aero engine aftermarket support services

The above companies operate principally in the UK and the effective Group interest is 100 per cent, other than Rolls-Royce Fuel Cell Systems Limited in which it is 80 per cent.

Incorporated overseas – directly held unless marked *

Brazil	Rolls-Royce Brasil Limitada	Aero engine repair and overhaul
Canada	Rolls-Royce Canada Limited*	Industrial gas turbines and aero-engine sales, service and overhaul
China	Rolls-Royce Marine (Shanghai) Limited*	Manufacture and supply of marine equipment
Finland	Rolls-Royce OY AB*	Manufacture of marine winches and propeller systems
France	Data Systems & Solutions SAS*	Instrumentation and control systems and life cycle management for nuclear power plants
France	Rolls-Royce Technical Support SARL*	Aero engine project support
Germany	Rolls-Royce Deutschland Ltd & Co KG*	Aero engine design, development and manufacture
Guernsey	Nightingale Insurance Limited*	Insurance services
India	Rolls-Royce Energy Systems India Private Limited*	Diesel engine project management and customer support
India	Rolls-Royce Operations (India) Private Limited*	Engineering support services
Italy	Europea Microfusioni Aerospaziali S.p.A.	Manufacture of gas turbine engine castings
Norway	Rolls-Royce Marine AS*	Design and manufacture of ship equipment
Norway	Scandinavian Electric Holding AS*	Marine electrical systems
Singapore	Rolls-Royce Singapore Pte Limited*	Energy and marine aftermarket support services
Sweden	Rolls-Royce AB*	Manufacture of marine propeller systems
US	Data Systems & Solutions LLC*	Advanced controls and predictive data management
US	Rolls-Royce Commercial Marine Inc.*	Marine aftermarket support services
US	Rolls-Royce Corporation*	Design, development and manufacture of gas turbine engines
US	Rolls-Royce Crosspointe LLC*	Manufacture of aero-engine parts
US	Rolls-Royce Energy Systems Inc.*	Energy turbine generator packages
US	Rolls-Royce Engine Services – Oakland Inc.*	Aero engine repair and overhaul
US	Rolls-Royce Defense Services Inc.*	Aero engine repair and overhaul
US	Rolls-Royce Naval Marine Inc.*	Design and manufacture of marine equipment
US	Seaworthy Systems Inc.*	Marine support services

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 – directly held unless marked *

	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 —	
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	
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	
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 —	
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	
Turbo-Union Limited (UK, Germany & Italy) <i>RB199 engine collaboration</i>	Ordinary A Shares	40 37.5	40

Incorporated overseas – directly held unless marked *

		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	
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.



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