Rolls-Royce

Rolls-Royce plc

Report of the directors, business review and financial statements

December 31, 2006

Company number: 1003142

Contents

Board of directors
At February 7, 2007

Simon Robertson
Non-executive Chairman since 2005
Appointed to the Board in 2004 He is the founder member of Simon Robertson Associates LLP and a non-executive director of HSBC Holdings plc, Berry Bros & Rudd Ltd, and The Economist Newspaper Limited He is Chairman of the Royal Academy Trust, 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 65

Sir John Rose
Chief Executive since 1996
Appointed to the Board in 1992 having joined Rolls Royce in 1984 He is a Trustee of The Eden Project Age 54

Peter J Byrom BSc, FCA
Non-executive director, Senior Independent Director
Appointed to the Board in 1997 He is Chairman of Domino Printing Sciences plc and Molins PLC, and a non-executive director of both Wilson Bowden plc and 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 62

John P Cheffins BSc, Ing, FREng, FRAeS
Chief Operating Officer
Appointed to the Board in 2001 having joined Rolls-Royce in 1967 He has held a number of senior positions including President and Chief Executive Officer of Rolls-Royce Industries Canada Inc. in 1991, Director, Civil Engine Business in 1993 and President – Civil Aerospace in 1998 He is a Fellow of the Royal Academy of Engineering and of the Royal Aeronautical Society He is a member of the Institution of Electrical Engineers and of the Order of Engineers of Quebec. Age 59

Iain Conn
Non-executive director
Appointed to the Board in 2005 He is an executive director of BP p.l.c. having held a range of executive positions within the BP Group worldwide He is Chairman of the Advisory Board of The Imperial College London Tanaka Business School Age 44

James M Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Appointed to the Board in 1998 having joined Rolls-Royce in 1997 He is a director of the Private Bank and Trust Company of Chicago, Illinois and of priceline.com Inc. Until 1995 he was Executive Vice President, Marketing and Planning of United Airlines Age 61

Andrew B Shilston MA, ACA, MCT
Finance Director
Appointed to the Board in 2003 having joined Rolls-Royce in 2002 He is a non-executive director of Cairn Energy PLC and he was Finance Director of Enterprise Oil plc from 1993 until 2002 Age 51

Colin P Smith BSc Hons, FREng, FRAeS, FIMechE
Director – Engineering and Technology
Appointed to the Board in 2005 having joined Rolls-Royce in 1974 He has held a variety of key positions within Engineering including Director – Research and Technology and Director of Engineering and Technology – Civil Aerospace He is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers Age 51

Ian C Strachan
Non-executive director
Appointed to the Board in 2003 He is a non-executive director of Reuters Group plc, Johnson Matthey plc, Xstrata plc and Transocean Inc. He 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 Age 63

Carl G Symon BSc, MSc
Non-executive director
Appointed to the Board in 1999 He is Chairman of HMV Group plc, the BT Group Equality of Access Board and Clearswift Systems Ltd He is also a non executive director of BT Group plc, Senior Independent Director of Rexam plc and an Advisory Board member of Cross Atlantic Capital Partners. He was previously Chairman and Chief Executive Officer IBM UK and held numerous executive positions with IBM Corp in Canada USA, Latin America, Asia and Europe during a 32 year international career Age 60

Prof Sir John Taylor OBE, FRS, FREng
Non-executive director
Appointed to the Board in 2004 He is currently Chairman of Roke Manor Research Ltd, and a member of Council of the Royal Academy of Engineering, an honorary fellow of Emmanuel College, Cambridge and a visiting professor at Oxford University He is the former Director General of Research Councils and the former director of Hewlett Packard Laboratories Bristol He was chair of the South West RDA's Shadow Science and Industry Council and director of the UK Foresight project on Cognitive Systems He previously served as President of the Institution of Electrical Engineers and as Chairman of the UK Technology Foresight Panel in IT Electronics and Communications Age 63

Charles E Blundell MA
Company Secretary since 1995
He joined Rolls-Royce in 1993 Age 55

Report of the directors

The directors present their report and the audited financial statements of Rolls-Royce plc (the Company) and its subsidiaries (together referred to as the Group) for the year ended December 31 2006

Business review
A review of the business can be found on pages 4 to 18.

Share capital
No new shares were issued during the year

Going concern
After making enquiries, the directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future For this reason they continue to adopt the going concern basis in preparing the financial statements

Political donations
In line with its established policy, the Group made no political donations during 2006

Directors
The directors' biographical details including their other significant commitments, are set out on page 2 During the year there were a number of Board changes Colin Green retired as an executive director on April 4, 2006 Hon Amy Bondurant and Carl-Peter Forster retired as non-executive directors on September 14, 2006

As at December 31 2006 all the directors were also directors of Rolls-Royce Group plc, the ultimate parent company As directors of the ultimate parent company, there is no requirement to disclose their individual remuneration or their interests in the shares of companies in the Rolls-Royce group in this report, as they are disclosed in the Annual report of Rolls-Royce Group plc

The closing mid-market price of the ordinary shares of Rolls-Royce Group plc at December 31, 2006 was 447 75p and the range during the year was 379.5p in June to 490p in April

The Company has entered into separate Deeds of Indemnity in favour of its directors. The deeds provide substantially the same protection as that already provided to directors under the indemnity in Article 170 of the Company's Articles of Association The Company has also arranged appropriate insurance cover for any legal action taken against its directors.

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 49 days purchases outstanding at December 31, 2006, 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

By order of the Board

Charles Blundell Company Secretary
February 7, 2007

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

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

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

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

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

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

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

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

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 ought to have taken as a director in order to make himself 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

Business review

Chief Executive's review

Sir John Rose

Our market sectors present global growth opportunities. We continued to make progress in 2006

The Group continued to make good progress in 2006 increasing sales to £7,156 million (2005 £6 603 million), with underlying sales growth of 14 per cent, and increasing underlying profit before tax by 23 per cent to £712 million (2005 £579 million) Importantly our ability to access growing markets on a global basis enabled us to continue to grow our order book, which ended the year at £26 1 billion (2005 £24 4 billion)

We continue to invest in technologies, products, people and capabilities with the objective of broadening and strengthening our product portfolio, improving our efficiency and enhancing the environmental performance of our products In 2006 total investment in research and development amounted to £747 million (2005 £663 million)

After increasing investment in manufacturing capability and research and development, there was a strong cash inflow of £491 million resulting in an improvement of £410 million in our average cash balance, with a cash balance of £825 million at the end of the year (2005 £334 million)

Our overall performance in 2006 was strong in an undoubtedly challenging year The underlying financial results were achieved after accommodating a further seven cent deterioration in the dollar achieved rate relative to 2005 We expect to absorb similar further deterioration in the exchange rate we achieve in 2007

We manage our exposure to the US dollar by long-term hedging Today we have the benefit of a hedge book of approximately US$10 billion, which means that we have clear visibility of the exchange rate we can achieve over the next three years Whilst it is impossible to offset sustained dollar weakness through hedging the cover we have taken reduces the volatility that exchange rate fluctuations cause and creates the opportunity for us to take other mitigating actions such as cost reduction and the 'dollarisation' of our cost base

Raw material price inflation has been a significant factor for all manufacturing industry It is helpful that, as a high value-added business the cost of raw materials forms a relatively small proportion of our total costs We have maintained our focus on productivity and efficiency measures and, where appropriate, we hedge our exposure in the financial commodities markets The nature of the business also enables us to enter into long-term procurement contracts, which help protect us from future fluctuations in raw material prices and give us visibility of our cost base

We are continuing to invest globally in new facilities and to improve the performance of our international supply chain These changes, which are occurring at the same time as a significant increase in load have been managed well in tough conditions

We operate in a competitive and challenging environment and, in doing so, we benefit from a consistent strategy, a strong order book, long programme life cycles and the revenue generated by the provision of value-added services to the users of our products. Consequently we have good visibility of our future workload and market opportunity The results in 2006 demonstrate the resilience of the Group and its business model

We are continuing our discussions with the relevant parties about our UK pension funds Our proposals include a cash injection of £500 million Our overall intent is to make a significant step towards reducing deficits and limiting the impact on the business of volatility in interest rates and share prices We expect to make progress in 2007

A strong balance sheet

The Group ended 2006 with a net cash balance of £825 million In 2007, a substantial portion of this balance is earmarked to address the pension fund deficit We believe that a strong balance sheet is essential for a long-term business such as ours We compete against large competitors across programmes where returns are measured over decades, where we enter into long-term service commitments and where significant investments to gain market access are the norm It was pleasing to see that both the major credit rating agencies reflected their positive view of our progress by promoting the rating of our parent company, Rolls-Royce Group plc, into the 'A' category in 2006 During 2007, we will be reviewing our financial strategy in light of the Group's continuing cash generation investment needs, progress on resolving the pension deficit and underlying performance

One of the most frequent questions we are asked by financial analysts is whether we will seek to use our growing cash balances to buy businesses We can, of course, grow organically, as we have been demonstrating for a number of years However we do not rule out acquisitions and, indeed today's performance benefits from a number of successful past acquisitions We intend, however, to remain a highly focused power systems business and any potential acquisition must deliver relevant technology, products or routes to market

Today's business is the result of the implementation of a consistent strategy over many years and we believe that, as a focused power systems business, we can create most value for shareholders by continuing to pursue this strategy

Priorities

We addressed four priority areas in 2006

Investment in technology and products

We have a structured approach to technology acquisition, looking ahead over five ten and 20-year time horizons We can see significant opportunities for the introduction of new products in each of our markets and our strategy is to ensure that we have innovative technologies 'on the shelf' for future generations of product Each product investment is subject to a rigorous examination of the risks and rewards to ensure that only business cases that create shareholder value are pursued

Operational and unit cost reduction

We continued to make progress with the modernisation of our factories, introduction of more efficient working practices, simplification of the supply chain and improvement of business processes These initiatives remain a priority in 2007, when we will also be introducing measures to reduce overhead costs

Continued development of aftermarket services

Underlying aftermarket services revenues grew by 13 per cent in 2006 and represented 53 per cent of Group sales This is a consequence of the successful introduction of new products, the growing installed base of engines in service and the investment we have made in innovative aftermarket service capabilities We have continued to be successful in the introduction of comprehensive through life service arrangements in each of our business sectors These align our interests with those of our customers and enable us to add value through the application of our skills and assets

Responding to the challenge of climate change

We believe strongly that Rolls-Royce has a positive role to play in the way that we participate in the debate about climate change including helping to shape the responses to current concerns about the environment

This is not a new subject for Rolls Royce We have an established track record of reducing the emissions of our products and our manufacturing facilities

We published our first environmental report, 'Powering a better world', for 1998 and over many years, our research programmes have been directed at improving both the energy efficiency of our products and their environmental impact That experience will stand us in good stead as we respond to the new opportunities presented by climate change

Rolls-Royce offers a centre of excellence in terms of the engineering and technical skills which we can apply to these new challenges, and we can contribute to a proper understanding of the science and facts on which the current debate on climate change should be based That is why we see Rolls-Royce as representing part of the solution to climate change

We do, of course, accept that our gas turbines and diesels have an environmental impact through carbon dioxide, other emissions and noise However, they also enable fast and reliable trade and travel, help safeguard world security generate efficient electricity and contribute to the quality of life enjoyed by millions of people all over the world Our challenge is to preserve these critical benefits on a sustainable basis

Improving the environmental performance of our products
We invest over £100 million every year on research and technology, two thirds of which is directed at improving the environmental performance of our products. In addition, we spend around £350 million a year on the development and introduction of new products which embody these technologies and therefore have significantly enhanced environmental performance In the aviation sector Rolls-Royce is playing a leading role in the achievement of the long-term environmental goals set by the Advisory Council for Aeronautics Research in Europe (ACARE) Under the ACARE programme, fuel burn and carbon dioxide emissions are targeted to be reduced by 50 per cent by 2020, noise by 50 per cent and nitrous oxide by 80 per cent, all from a 2000 baseline

Working towards a more sustainable future
As a technology based company, we believe we can help society identify new solutions to environmental concerns. We are committed to developing low carbon technologies, including alternative energy sources For example, we are investing in a major programme to develop solid oxide fuel cells, a technology which will reduce carbon dioxide emissions and offer other environmental benefits such as low noise and improved air quality

We are also engaging in 'blue skies' research, including the feasibility of using synthetic kerosene to power aircraft of the future

Reducing the environmental impact of our operations
Our manufacturing facilities already operate to world class levels of environmental performance as recognised by a number of external bodies. Over a number of years we have delivered significant reductions in greenhouse gas emissions, waste, the use of solvents and water There has also been a significant increase in recycling We will continue to seek opportunities to minimise our environmental impact Over the period 1998-2005, our revenues increased by 47 per cent but, in absolute terms, the energy used in our facilities reduced by 15 per cent and greenhouse gas emissions by 30 per cent. A programme of continuous improvement is in place to maintain this performance

In 2006, we were again placed first in our business sector in the Business in the Environment index of corporate environmental management, retaining our 'Premier League' status

A global business
Our market sectors each present global opportunities, with our business split evenly between the Americas, Asia and Europe

In 2006, we expanded our international presence with new partners in Japan, Korea, Germany and Canada, covering a range of activities to improve the performance of our gas turbine engines. Our fuel cell business launched a subsidiary in the US and announced a partnership with Ohio-based, American Electric Power (AEP)

Collaboration agreements were extended in Europe, for helicopter engine manufacture, in China, for the training and development of senior aviation executives, and in India, for engine component design and manufacture

We continued to develop and globalise our manufacturing facilities, including our factory modernisation programme in the UK, the transfer of V2500 engine assembly to Germany and a new outdoor jet engine testing facility in the US We have begun the process of considering options for potential new facilities in various locations, to cater for the anticipated growth in each of our businesses

Of our 38000 employees, 22,700 are in the UK with the balance primarily in the US, Asia, Germany, Scandinavia and Brazil Our sales and order book are evenly spread across Europe, Asia and the Americas. Research and development is conducted in facilities in the UK, Germany, Italy, Singapore, Japan, the US and Scandanavia including important relationships with 27 universities where we have University Technology Centres. Our international presence means we have facilities in over 50 countries.

Reflecting the global nature of our business, we established a new International Advisory Board (IAB) in 2006 This board will provide the Group with an invaluable high level source of advice about international, economic, political and business trends

There have been a number of changes recently in the international management team Dr Saul Lanyado is retiring after helping build our marine business into a global leader He is succeeded by John Paterson who also has a strong international background, and was previously running our global repair and overhaul (R&O) business The R&O business now forms part of the Group's overall services activity led by Miles Cowdry, President – Services

Future prospects
Each of our businesses offers significant opportunities for organic growth Over the next 20 years, we estimate the global accessible market to be worth some two trillion US dollars, of which about half will relate to the provision of aftermarket services

The civil aerospace business is developing as we predicted and we expect the installed base of jet engines in service to continue to grow, providing the basis for sustained growth in our aftermarket services revenues We are developing our market positions such as those on the Boeing 787 and Airbus A350 XWB which will ensure long-term growth for the business

The defence aerospace business has proved resilient as a result of our broad portfolio of engine programmes. We are continuing to strengthen our presence in defence markets through new programmes such as the Joint Strike Fighter and the Airbus A400M transport aircraft, whilst also extending the range of aftermarket services which we offer Consequently we expect steady growth from our defence business

Our marine business is experiencing strong growth as a result of the high level of demand in the offshore oil and gas sector and our success as a systems supplier Our order book, at over £2 billion, is at a record level and we are developing with our customers, a series of innovative support initiatives

In the energy sector, we see opportunities to strengthen our market presence Our oil & gas business performed strongly in 2006 In power generation, where we are building a relatively new business, we achieved an encouraging order intake which bodes well for the future The cost of developing our fuel cell technology will continue to affect the bottom line for the energy business, leading again to modest losses in 2007

For 2007, we are confident that the measures we are taking to improve productivity, coupled with the underlying growth of the Group and the robust business model will enable us to continue to grow underlying revenues and profits and generate a positive cash flow

Finally I would like to take this opportunity to thank all our employees for their hard work and commitment.

Sir John Rose
Chief Executive
February 7, 2007

Market outlook

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

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

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

Civil aerospace

The Group publishes a 20 year global market outlook, which covers passenger and cargo jets, corporate and regional aircraft Over the next 20 years 114 000 engines worth over US$600 billion, are predicted to be required, powering 51,000 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 continue to benefit from more liberal air service agreements, which boost demand

Factors affecting the demand for aircraft and engines include GDP growth, aircraft productivity, operating costs, environmental issues and the number of retirements of old aircraft Whilst the market can be temporarily disrupted by external events, such as war or acts of terrorism, it has, in the past, always returned to its long-term growth trend

In addition to the demand for engines, the Group forecasts a market opportunity worth US$500 billion for the provision of product related aftermarket services

Defence aerospace

The Group forecasts that demand for military engines will be worth US$180 billion over the next 20 years. The largest single market is expected to be the US, followed by Europe and the Far East Within the Far East 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 Groups 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 of their assets have accelerated the move in this direction The Group estimates the value of services revenues over the next 20 years to be US$250 billion

Marine

The Group forecasts demand for marine propulsion systems of US$180 billion over the next 20 years. Demand will be greatest in the commercial sector, where the merchant market represents 45 per cent of the total and the offshore market, 34 per cent

Commercial shipping plays a crucial role in the world economy The need to transport raw material, finished goods, people and oil and gas requires a large fleet which has to be renewed progressively The expansion of trade and technical advances mean more ship construction for growth and for replacement as older designs become obsolete

Finding and extracting oil and gas offshore requires a large number of floating drilling and production units which, in turn are supported by a variety of service craft Merchant and offshore markets are rarely at the same stage of the business cycle, which helps to reduce overall volatility

In naval markets, the Group expects surface vessels to represent 15 per cent of the total demand and submarines, six 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$100 billion over the next 20 years.

Energy

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

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

While the oil and gas market is large and growing demand for aero derivatives in the power generation segment is four times that of oil and gas, driven largely by mid merit and peaking applications

Strategy

We have followed a consistent strategy for many years, based on five key elements

Address four global markets

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

Invest in technology, capability and infrastructure

Over the past five years, we have invested more than £3 billion in research and development We invest approximately £30 million annually on training and some £250 million a year on capital projects

Develop a competitive portfolio of products and services

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

Grow market share and installed product base

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

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

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

Principal risks and uncertainties

The Group is exposed to a number of risks and has an established structured approach to risk management The risk committee has accountability for the system of risk management and regularly reports to the Board the key risks facing the business and the mitigating actions the Group has put in place to deal with them

Risks are analysed under four broad headings

Business environment risks

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

The Group is committed to high ethical standards and a new Global Code of Business Ethics will be launched in 2007 An employee engagement programme will be undertaken in 2007 to strengthen employee awareness of the Group's values The Group communicates its standards to its first tier supply base through a supplier code of conduct

External events which might affect demand for air travel
Civil aerospace is an important contributor to Group revenues and profits The willingness of passengers to travel by air is influenced by a range of factors including economic, health and security issues For example, following the tragic events of September 11, 2001, the Group's civil aerospace profits more than halved as a result of a short-term reduction in the demand for aero engines

The impact of this risk is mitigated by the Group's business strategy, which has enabled it to develop a broader business base, with the defence marine and energy businesses being less susceptible to this type of risk. In addition the developing civil aerospace business model with its emphasis on increasing aftermarket services revenues, has proved to be resilient, providing a high degree of protection against any shortfall in demand The Group has also demonstrated its ability to respond rapidly to changes in demand through the adjustment of its cost base

Strategic risks

Aftermarket
Aftermarket revenues contribute over half of the Group's annual sales and are an essential element of the returns the Group expects to make from its investments Any threat to the security of aftermarket revenues through, for example, a failure to provide an operational service which meets customers' expectations, would threaten the Group's level of profitability

The Group is focused on providing a high standard of service to all its customers, investing in capabilities such as its recently established Operations Centres which monitor engine operations in real time, co-ordinating and integrating data to enable Rolls-Royce to provide better predictive information and operational advice to its customers Increasingly customers are selecting a broader range of services through long-term service agreements, under which the Group assumes a higher level of responsibility for the maintenance and availability of its engines (over periods which average 12 years) in return for a usage-based fee The Group deploys customer satisfaction surveys to monitor its service level

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

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

Financial risks
These are risks that arise as a result of movements in financial markets Principal risks are movements in foreign currency exchange rates, interest rates commodity prices and counterparty credit risk. A description of these risks and details of the Group's risk mitigation actions in this area are provided in the Finance Director's review on pages 14 and 15

Operational risks

Performance of supply chain
The Group manufactures approximately 30 per cent by value of its gas turbine products and some 70 per cent is provided through supply chains external to the Group Any failure of the supply chain would present a risk to the Group's ability to meet customer requirements and to achieve its financial goals

The Group's strategy is to simplify the external supply chain, forging deeper, strategic relationships with fewer but stronger suppliers including the allocation of a significant portion of new civil programmes to risk and revenue sharing partners

The Group is also investing in its manufacturing facilities replacing old factories with modern facilities, which will enable it to improve productivity and reduce costs by developing world-class manufacturing facilities and processes In addition, the Group has a business continuity programme, to manage the risk of a loss of a major capability or facility

IT security
Increased globalisation of the business and advances in technology have resulted in more data being transmitted across global communication links, posing an increased security risk.

Security systems have been upgraded with the latest technology and Rolls-Royce maintains effective communications with other industrial companies and the appropriate government agencies to share information on potential threats

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

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

Civil aerospace

2006 highlights	2006	2005	2004	2003	2002
Revenue* £m	3,775	3,561	3,072	2,715	2,761
Underlying profit before financing costs* £m	523	441	208	168	186
Net assets* £m	1,898	1,315	1,257	1,338	1,470
Order book £bn	20 0	19 0	16 2	14 4	12 6
Engine deliveries	856	881	824	746	856
Installed engine base	11,900	11,500	10970	10450	9,910
Employees	22,300	21 050	21,150	19,850	21,150

*2003 and earlier figures are as reported under UK GAAP

The civil aerospace business continued to expand its broadly-based installed fleet and once again generated growth in customer services.

New orders announced during 2006 amounted to approximately £7 billion, resulting in a record order book of £20 billion

The Trent-powered Airbus A380 received its Type Certificate from the US FAA and the European EASA airworthiness authorities, the first time clearance has been awarded simultaneously by the two bodies

The Trent 900, chosen by seven A380 customers, continued to build maturity through testing completing almost 31 000 engine cycles by the end of 2006.

Rolls Royce reacted swiftly to the announcement that A380 deliveries had been delayed by a further 12 months by halting production and procurement for the Trent 900 until October 2007 The strength and breadth of our business portfolio enable us to absorb such changes with little overall financial impact

We signed a commercial and technical agreement with Airbus to offer a next-generation Trent for all variants of the new A350 XWB, due to enter service in 2013

The Trent 1000, which had its first success in China, with an order to power Air China's fleet of Boeing 787s, completed a successful first run exactly on schedule against a date set three years earlier

Towards the end of the year, preparations began for the first flight-test of the Trent 1000 on the Company's Boeing 747 flying testbed in readiness for the maiden flight in the spring of 2007

Air New Zealand's decision to convert its existing Boeing 787-8 order to the larger 787-9 variant means that the Trent 1000 is now the launch engine for all three versions of the aircraft. It has been selected by 11 customers and operators

As the Trent series passed 20 million hours in service, the first member of the family, the Trent 700, continued to win new business with airlines including Lufthansa and Singapore Airlines

In Bangkok, celebrations with launch customer Thai Airways International marked the tenth anniversary of the Trent 800 in service, while in Australia, the RB211-524, workhorse of the Qantas Boeing 747 fleet, passed the milestone of ten million flying hours with the airline

International Aero Engines (IAE), in which Rolls-Royce is a major shareholder won a significant follow-on contract from China Southern for V2500s to power a further 50 Airbus A320 series airliners IAE booked orders for a total of 454 engines from 14 customers, with a value to Rolls-Royce of US$1.2 billion During 2006 the transfer of V2500 production from Derby in the UK to Dahlewitz in Germany, was completed, creating capacity in the UK for rising Trent production

Our long-standing relationship with Gulfstream Aerospace was reflected in a ceremony marking the delivery of its 3,000th Rolls-Royce engine

We also celebrated the tenth anniversary of the AE 3007C on the Citation X, the fastest business jet in service China's Hainan Airlines Group ordered 50 Embraer ERJ 145 regional jets, also powered exclusively by the AE 3007 engine

Civil engine deliveries reduced by three per cent to 856, with weak demand in the regional sector, partially offset by increased Trent engine deliveries. Our underlying original equipment revenues grew by 15 per cent, as a result of the increased proportion of high-value products in the sales mix

Civil fleet flying hours rose by eight per cent compared with 2005, driven by the increased number of engines in service and global traffic growth.

Underlying services revenues increased by 15 per cent to £2 3 billion, representing 59 per cent of civil aerospace revenues. More than 48 per cent of our modern jet fleet is covered by TotalCare or CorporateCare service agreements.

Defence aerospace

2006 highlights	2006	2005	2004	2003	2002
Revenue* £m	1,569	1,413	1,374	1,398	1,376
Underlying profit before financing costs* £m	195	175	179	147	183
Net assets* £m	(78)	(56)	(48)	81	25
Order book £bn	3 2	3 3	3 3	2 7	2 6
Engine deliveries	514	565	548	510	505
Employees	5,500	5,200	5,100	4 900	5,100

*2003 and earlier figures are as reported under UK GAAP

Defence aerospace continues to be a profitable and growing business. We have a wide range of defence engine programmes at all stages of the product life cycle, supported by a rapidly growing services business

In 2006, Rolls-Royce made steady progress with its combat programmes. Both the F136 engine and LiftSystem for the Joint Strike Fighter successfully continued their development testing Rolls-Royce also completed deliveries of EJ200 engines for Tranche 1 of the Eurofighter Typhoon and has now commenced Tranche 2 EJ200 engine deliveries

In the transport market, the first tests of the collaborative TP400 turboprop engine, for the Airbus A400M aircraft, were successfully undertaken The AE 2100 passed the one million hour milestone in powering the C-130J transport aircraft Rolls-Royce also signed an agreement with Alenia Aeronautica to supply 84 engines for the C-27J transport aircraft

Elsewhere in the common core AE engine family, the AE 3007-powered Global Hawk unmanned aerial vehicle (UAV) passed the 10,000 service hour mark and the 200th AE 1107C-Liberty engine was delivered for installation in the V-22 Osprey tiltrotor

In June, the Rolls-Royce and Honeywell joint venture, LHTEC, won a £75 million contract to supply the T800 helicopter engine for the UK's Future Lynx. The helicopter team also supported the successful first flights of the next generation Fire Scout unmanned helicopter, powered by the Model 250, and delivered nearly 300 Model 250 engines for a wide range of light helicopters

The collaborative Adour engine powered the first two Hawk trainer aircraft delivered to Bahrain and the UK Ministry of Defence (MoD) placed an order for 28 Adour Mk951-powered Hawk trainers

Rolls-Royce was selected to participate in Taranis, a new £124 million unmanned combat aerial vehicle (UCAV) technology demonstrator programme, and in the ASTRAEA programme to enable the routine use of UAVs in UK airspace

Underlying service revenues represented 53 per cent of defence sales for 2006 We continued to increase the scope of services offered by the business to its customers and in November, we entered into an alliance with Serco the leading services provider, to extend our service offerings and access new markets. More of the Group's long-term service arrangements in the form of Mission Ready Management Solutions (MRMS®) are now handled through the Operations Centre This hub for in-service support is now open 24 hours a day, seven days a week.

More than 2,800 engines and 4,150 modules are now covered by MRMS support contracts and a number of these were added in 2006 New or renewed services contracts were signed with all branches of the US military, covering the AE 2100, the F405 (Adour), AE 1107C-Liberty and the Model 250 engines In the UK, the £110 million contract for the support of the UK MoD's Hercules engines was expanded to cover T56 engines in addition to AE 2100s. The MoD also signed a £40 million services agreement to cover the Gem engines installed in the Lynx helicopter

Marine

2006 highlights	2006	2005	2004	2003	2002
Revenue* £m	1 300	1,097	963	1,003	984
Underlying profit before financing costs* £m	102	87	78	78	82
Net assets* £m	547	595	523	554	550
Order book £bn	24	1 7	1 4	1.2	1 3
Employees	7,600	7,200	7,100	7,300	6,500

*2003 and earlier figures are as reported under UK GAAP

Rolls-Royce is a world leader in the provision of marine propulsion systems, offering a unique set of products and services for both naval and commercial sectors

All of our marine business segments, offshore, merchant, naval and submarines, are performing well Across the business the order book stands at over £2 billion and factories are operating at capacity

The success of the marine business depends increasingly on delivering integrated power and propulsion systems for customers Over the past year, the business has made good progress towards its goal of being a complete system supplier

We are well positioned on US naval gas turbine programmes The first Lockheed Martin-designed Littoral Combat Ship, Freedom, was launched, powered by the MT30 engine In the UK, we continued to make good progress with the next generation of Royal Navy Type 45 destroyer, powered by the WR21 engine

We have a long history of supplying complete systems to customers through our UT Design and equipment packages Today, we are reaping the benefits of the expertise we have gained in this area Buoyed by high oil prices, the demand for service and support ships has been matched by similar growth in exploration and production

Our UT Design is one of the most successful ship designs in commercial shipbuilding We design true 'system' ships, powered equipped and controlled by us and usually incorporating Rolls-Royce power, propulsion, deck machinery and motion control equipment This can range from propellers, thrusters and diesel engines to increasingly sophisticated technology such as dynamic positioning and automation and control systems

The concept of selling systems to our offshore customers is well embedded and we are now successfully extending this area of our expertise for the benefit of our merchant customers Our merchant business is centred in Shanghai, in the middle of the North-East Asian triangle made up of Korea, Japan and China, which accounts for over 85 per cent of the world s commercial shipbuilding This location gives Rolls-Royce a strong position in the region to supply our customers with individual components and systems A number of shipbuilders in the Far East are new entrants to the market and we sell complete design, power and propulsion packages, thereby giving them a technological advantage in a very competitive marketplace

To support sales of Rolls-Royce propulsion systems, we will be opening a new diesels factory in Asia This is a significant investment in capability to meet increasing customer demand Automation and control systems form an increasing part of these systems, endorsing the Group's investment in high-value electronic equipment.

We are continuing to develop new customer relationships The Flotilla Reactor Plant Support (FRPS) will transform the relationship between the submarines business and our customer bringing increased propulsion system availability at lower cost This new approach – similar in style to TotalCare – together with opportunities in support of future submarine programmes, submarine rescue systems and emerging civil nuclear programmes, enables us to build and develop the full potential of our people and skill base in our submarine business

Many of our programmes are based upon propulsion systems In addition to the prime mover, the gas turbine, Rolls-Royce is supplying waterjets and smaller, secondary gas turbines that provide ships with auxiliary power We are also applying this approach to the power and propulsion systems for CVF – the future British aircraft carrier and its French PA2 equivalent. The MT30 forms the basis of our proposals for the propulsion system for each of these ships.

We have already introduced TotalCare type support packages for some of our naval customers, based on the successful model developed in our aerospace businesses About 40 per cent of our turnover is involved in aftermarket service support across our full range of products and we are expanding our capabilities at service centres around the world

Energy

2006 highlights	2006	2005	2004	2003	2002
Revenue* £m	512	532	538	529	667
Underlying (loss)/profit before financing costs* £m	(18)	(1)	(7)	(18)	(89)
Net assets* £m	357	353	395	546	587
Order book £bn	05	04	04	04	06
Engine deliveries	44	61	47	54	68
Employees	2,600	2,750	3050	3,150	4,550

*2003 and earlier figures are as reported under UK GAAP

Our energy business recorded a small loss in 2006, after expensing an investment of £22 million in fuel cell technology

The oil and gas market remains robust, primarily driven by strong fuel prices In Asia, we won orders worth over US$100 million for projects in Indonesia, Malaysia and Thailand and, for the first time, Vietnam Orders valued at over US$100 million were secured from customers in Africa and the Middle East, including equipment for the next pipeline to bring natural gas from Algeria to Spain The existing pipeline is already wholly driven by Rolls-Royce equipment

In power generation we are building momentum and, encouragingly, had a record year for order intake Whilst the market has been stabilising in Europe, the US marketplace is continuing to show signs of recovery

In 2006, we received our first order for two Trent 60 power generation packages to be installed in the US, our first order, from a customer in Belgium for Trent gas turbines featuring our new power-enhancing Inlet Spray Intercooling technology, and our first order for an industrial Trent power generation package to be installed in Israel

Our continued progress in the power generation segment will increase our installed base of engines and aftermarket services revenues

It was a record year for aftermarket order intake Aftermarket service activities for the energy business now account for 46 per cent of our total segment sales and, with last year's strong performance, our order book for Long-Term Service Agreements has grown to over US$270 million

We also continue to enhance customer value through product upgrades for increased power, better efficiency and reliability, lower emissions and greater ease of maintenance

Our fuel cell programme continued to meet its milestones In October we dedicated as our US fuel cell headquarters, a new, purpose-built fuel cell facility on the campus of Stark State College of Technology in Canton, Ohio The Group also announced an agreement with the US utility American Electric Power, to test and evaluate the first two fuel cell prototype systems at their Dolan Technology Center and Walnut Test Facility near Columbus Ohio With our additional presence in the UK and Singapore, this business is making progress in solid oxide fuel cell systems for megawatt scale stationary power applications, with the goal of introducing a competitive product by the end of this decade

Engineering and technology

The market continues to drive the need for robust, cost-effective and world-class technology

In 2006, Rolls-Royce invested a total of £747 million in research and development, of which £395 million was funded from Group resources The net charge to the income statement was £370 million

We are addressing the environmental challenge, building upon our achievements of previous years as we continue to improve the performance of our products. In addition to our existing demonstrator engine programmes, we launched a new £95 million technology demonstrator programme, the Environmentally Friendly Engine (EFE), which will deliver further improvements in turbine efficiency and combustion emissions EFE involves a range of industrial and university partners and will validate technologies for pull-through from 2008 into all of our gas turbine products

Rolls-Royce is a lead partner in the development of the European 'Clean Sky' Joint Technology Initiative Alongside our industrial partners, we hope to gain European Commission approval to launch this seven-year programme in mid 2007 In combining this programme with the EFE programme, we will continue with our progress towards achieving the Advisory Council for Aeronautics Research in Europe (ACARE) goals for environmental improvements by 2020

Through the UK Energy Technologies Institute (ETI) and other mechanisms we will be increasing our research and technology programmes on low carbon energy systems. This will include such topics as the potential for the use of bio-derived fuels in gas turbines, high performance and distributed generation electrical power systems, renewable energy sources such as tidal power and carbon sequestration

Over the past year, we increased the size of our research network of University Technology Centres (UTCs) by opening two new centres in Germany, taking the total number of UTCs to 27 In Dresden, we opened a UTC which specialises in lightweight structures and materials and in Darmstadt, our latest UTC was opened to research turbine and combustion aerothermal interactions

Building upon our research successes of previous years, we filed a record 330 patent applications in 2006

The high efficiency solid oxide fuel cell programme for the energy business has continued to make significant progress with the successful demonstration of a 60kW power system

In 2006, our advanced technology development centre in North America, known as LibertyWorks™ continued to make progress with Lockheed Martin on the US Navy's RATTLRS (Revolutionary Approach To Time-Critical Long Range Strike) programme

In the defence sector, we completed the initial Flight Clearance Review of the LiftFan®, for use in the Joint Strike Fighter The multi-partner TP400 engine, for the Airbus A400M, successfully completed the first engine and propeller test. We also gained a key role on the recently launched Taranis UCAV (Unmanned Combat Aerial Vehicle) demonstrator programme

The Trent 1000 engine, which will power the Boeing 787, followed the successful trend of previous engine projects in achieving on schedule, the planned milestone of the first engine run The Trent 900 for the Airbus A380 has continued to gain maturity through engine and aircraft test activity

The US Navy accepted delivery of the Sea Jet demonstrator vessel, powered by lower noise underwater AWJ21™ waterjets. The successful test programme was completed and reported to the Office of Naval Research (ONR) and led to the contract award for a high power density waterjet development programme

The first Type 45 class destroyer, HMS Daring, was launched, powered by the advanced WR21 engine, which achieved the major milestone of first engine light in December Rolls-Royce delivered the first gas fuelled reciprocating engines for a passenger ferry application in the form of Bergen K-type engines, which received classification society approval in December

Operations

Rapid growth in manufacturing load continued in 2006, closing the year 12 per cent above 2005 even after the effect of temporarily ceasing manufacture of the Trent 900 in September All sectors and regions contributed to this growth

Operationally raw material supply constraints continued to have a disruptive effect but this improved steadily throughout the year, driving a general improvement in delivery performance by our external supply chain The delay to the Airbus A380 programme resulted in the Trent 900 manufacturing being suspended for one year with effect from September 2006 In spite of these issues, we were able to support our portfolio of manufacturing programmes and as usual I take this opportunity to thank all of our employees and suppliers for their efforts in 2006 in this regard

We continued our programme of Supply Chain Restructuring in 2006 Our supplier base reduced by 32 to 666 although we added 103 new suppliers Our sourcing in emerging low-cost markets increased from nine per cent to 11 per cent of purchases

Commodity prices continued to rise throughout the year, although by the year-end the peak appeared to have passed in the case of fuels and perhaps some metals During the year we successfully concluded new long-term agreements for the major primary metals we require giving us security of supply and cost stability

We continued to drive for lower operating costs focusing on overheads and added-value activities within our control We increased our employee population by 4.8 per cent and delivered an improvement from £186,000 to £192 000 in sales per employee via productivity improvements. We were not able to fully offset the effects of commodity price inflation in 2006 and, as a result, product unit costs rose slightly in the year

We commenced operations in our new UK facilities at Derby, Hucknall, Barnoldswick and Bristol during 2006 and we will cease operations in all the old factories during 2007 We reached agreement on modern working practices with all the remaining UK component manufacturing workforces as well as our repair and overhaul workforce in Montreal, Canada Our Global Council covering all employees met successfully twice during the year

We used our Process Excellence programme to continue the drive for better quality and continuous improvement In 2006 we saw a positive step change in the quality performance of our external supply chain This was the main driver of an improvement in overall supply chain quality of approximately 20 per cent.

We further reduced the operating cost of our IT estate allowing our new investment proportion of total IT cost to rise to its highest level to date Our total IT spend remained constant year-on-year resulting in a reduction as a percentage of turnover to 2 4 per cent

In 2006, we completed the standardisation of our Enterprise Resource Planning (ERP) systems for the energy business, the aero repair and overhaul business and the aero gas turbine units in Europe In 2007 the remaining units in the US and Canada will be standardised to give us a single and truly global supply chain management system

Implementation of Product Lifecycle Management Systems coupled with a thorough revision to the business process has driven considerable productivity improvement in engineering

As forecast, our inventories increased in 2006 to respond to the growth in output, to build aftermarket support stocks and to increase strategic stocks of rare metals. We continued to offset these increases by improvements in the management of financial working capital to effect a further improvement in working capital utilisation

In 2007, our priorities will be to complete all our ERP IT projects and implement a Global Supply Chain management structure which will allow us to consolidate commodity management and increase the dollar based proportion of our purchase bill We will also complete all of our UK factory moves which have been protracted due to stronger market growth and disruption caused by shortages of raw materials. Our drive for operating and unit cost reduction will continue as will our Process Excellence initiative whilst we prepare for the load increase in 2008 when Airbus A380 production will recommence and Boeing 787 production begins.

Services

Our services strategy remains unchanged with a continued focus on providing the right equipment availability at the right price for all of our customers in each of our business sectors. Frequently, this will entail long-term fixed price contracts in which we apply our skills to managing our customers' assets and we are proud of our record of delivering our availability commitments We are building a record of repeat business and contract renewals, often involving increases in scope This demonstrates customer confidence in our approach and ability to deliver and gives us confidence in the sustainability of our model

In the civil aerospace market, we continued to make progress, with 48 per cent of the fleet by value now under management. Often these contracts will involve the maintenance and associated logistics of accessories in addition to the engines and, consequently, we developed 'ComponentCare' Thirty seven such contracts have now been implemented The business jet market has been particularly strong and 165 CorporateCare contracts were signed in 2006 exceeding the previous year's record of 103

The defence business had a strong year Highlights included the Hercules Integrated Operational Support Contract covering 244 AE 2100 and T56 engines and the extension of the Spey engine contract and the inclusion of accessories in its scope A series of contract wins in the US over the past two years, including the third renewal of the F405 contract, have resulted in more than 1 000 engines now being subject to Performance Based Logistics contracts for the US Department of Defense

The successful execution of these service contracts requires a well co-ordinated approach, from pricing and monitoring and building the appropriate supply chains to day-to-day management of service delivery As we invest to support our service business two themes recur closeness and responsiveness to the customer and partnership and integration across the supply chain

Our operations rooms exemplify this commitment to responsiveness and integration by collecting, analysing, sharing and acting upon customer data to deliver the performance our customers demand They are the focal point for our service delivery, assessing the condition of the fleets and instructing logistics and field maintenance activity accordingly

To complement the operations rooms and our remote diagnostic capability, we are building up the local service infrastructure in each of our sectors In the civil market we have On-Wing Care centres in Hong Kong, London and Newark in the US with additional centres opening in 2007 In the energy and marine sectors, we have embarked upon a multi-year plan to expand our global service network in the Americas Europe Middle East and Asia to provide engineering and logistics support closer to the point of demand In defence markets, we have teamed with Kellogg Brown & Root to win a support contract for the Australian Navy and have entered into agreements with Serco and Goodrich to support the delivery of extended scope contracts

Comprehensive global repair networks are central to our strategy Our new facility in Derby opened and the joint venture with Lufthansa Technik, N3, in Germany will commence operations in 2007 In the defence sector, we continue to support the UK Ministry of Defence's Combat Aero Engine Support Alignment Study and our Ansty facility has a key role to play in the support of the RAF's requirements

Finance Director's review

Andrew Shilston

We have continued to improve our financial performance whilst increasing our levels of investment in the business

Results for the year

Underlying profit before tax increased by 23 per cent to £712 million (2005 £579 million)

Organic sales growth

Underlying sales increased by 14 per cent.

- While civil aerospace engine deliveries reduced by three per cent to 856 engines, underlying original equipment revenues grew by 15 per cent, as a result of the increase of high-value products in the sales mix Underlying civil services revenues grew by 15 per cent
- Underlying defence aerospace sales increased by 13 per cent, with an 18 per cent increase in original equipment sales and an eight per cent increase in services revenues.
- Underlying marine sales increased by 18 per cent, with continued strong growth in the offshore oil & gas support market sector
- Underlying energy sales were almost flat, with a 14 per cent increase in services revenues offsetting a decline in original equipment sales

Underlying Group aftermarket services revenues grew by 13 per cent to £3 9 billion and have grown by ten per cent per annum compound over the past ten years. Service revenues accounted for 53 per cent of total revenues

Eighty-seven per cent of sales were to customers outside the UK.

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

Underlying financing costs amounted to £43 million (2005 £78 million), comprising principally net interest (£18 million) and risk and revenue sharing partners' finance cost (£27 million)

Restructuring charges of £47 million (2005 £48 million), which were incurred for ongoing operational improvements, were included within operating costs

Profit before tax was £1,537 million (2005 £463 million) On the basis described below, underlying profit before tax was £712 million (2005 £579 million) The adjustments are detailed in note 2 on page 31

The Group is exposed to fluctuations in foreign currency exchange rates and commodity price movements These exposures are mitigated through the use of currency and commodity derivatives for which the Group does not apply hedge accounting As a result, reported earnings do not reflect the economic substance of derivatives that have been closed out in the financial year, but do include unrealised gains and losses on derivatives which will only affect cash flows when they are closed out at some point in the future

Underlying earnings are presented on a basis that shows the economic substance of the Group's hedging strategies in respect of transactional exchange rate and commodity price movements In particular, (a) revenues and costs denominated in US dollars and Euros are presented on the basis of the exchange rates achieved in 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 monetary assets and liabilities and long-term contracts on a consistent basis.

Order book

The order book at December 31 2006 at constant exchange rates, was £26 1 billion (2005 £24 4 billion) This included firm business that was announced but for which contracts had not yet been signed of £1 7 billion (2005 £1.5 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 38 per cent of the order book 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 13 per cent on an underlying basis in 2006 and accounted for 53 per cent of Group revenue

In particular, TotalCare packages in the civil aerospace sector now cover 48 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 £393 million (2005 £367 million)

Cash

Rising volumes and good management of costs resulted in the Group averaging a net cash surplus throughout the year The Group cash flow statement is shown in the financial statements The Group generated a positive cash flow of £491 million during 2006 (2005 £551 million) The net cash balance at the year-end was £825 million (2005 £334 million) The average net debt level position improved from £260 million to an average cash surplus of £150 million Net cash flow from operating activities was £990 million (2005 £1,033 million) Positive cash flow is expected again in 2007, before any additional cash injection into the pension funds

Taxation

The overall tax charge on the profit before tax was £397 million (2005 £126 million) a rate of 25.8 per cent (2005 27.2 per cent)

The tax charge was reduced by £19 million (2005 £18 million) in respect of the expected benefit of the UK research and development tax credit

The tax charge on underlying profit was £190 million (2005 £166 million) a rate of 26 7 per cent (2005 28 7 per cent)

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

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

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

Pensions

As for 2005, the charges for pensions are calculated in accordance with the requirements of IAS 19 Employee Benefits

Details of the pensions' charge and the defined benefit schemes' assets and liabilities are shown in note 22 to the financial statements This shows a net deficit, after taking account of deferred tax, of £681 million (2005 £1,154 million) Changes in this deficit are affected by the assumptions made in valuing the liabilities and the market performance of the assets. Most importantly, the discount rate used for measuring the UK defined benefit liabilities has increased from 4 7 per cent in 2005 to 5 1 per cent in 2006 In addition the mortality assumptions have been updated for the Rolls-Royce Pension Fund (the largest scheme in the Group) based on the actual mortality experience within the scheme and also to allow for future mortality improvements. Together with the better than expected returns on the scheme assets, overall, these factors have resulted in a reduction of the net deficit

During 2006, a revised benefit structure was agreed with the members of the Vickers Group Pension Scheme similar to that already agreed for the Rolls-Royce Group Pension Scheme and the Rolls-Royce Pension Fund

The formal report of the actuarial review as at March 31, 2006 in respect of the Rolls-Royce Pension Fund will be available by June 30, 2007

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 £747 million (2005 £663 million) Net research and development was £370 million (2005 £282 million) The level of self-funded investment in research and development is expected to remain at approximately five per cent of Group sales in the future The impact of this investment on the income statement will reflect the mix and maturity of individual development programmes and will result in a similar level of net research and development reported within the income statement in 2007 Investment in training was £30 million (2005 £30 million)

Capital expenditure on property, plant and equipment was £303 million (2005 £232 million)

Intangible assets

The Group carried forward £1,460 million (2005 £1,315 million, restated) of intangible assets This comprised purchased goodwill of £735 million, engine certification costs and participation fees of £231 million, development costs of £290 million, recoverable engine costs of £153 million and other intangible assets of £51 million Total capital expenditure on property, plant and equipment and intangible assets is expected to increase modestly in 2007

Partnerships

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

Joint ventures

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

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

Risk and revenue sharing partners (RRSPs)

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

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

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

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

In 2006 the Group received other operating income of £57 million (2005 £60 million), primarily in respect of the Trent 1000 engine programme Other operating income is expected to remain at a similar level in 2007

Payments to RRSPs are recorded within cost of sales and increase as the related programme sales increase These payments amounted to £162 million (2005 £146 million)

The classification of financial RRSPs as financial instruments has resulted in a liability of £324 million (2005 £423 million) being recorded in the balance sheet and an associated underlying financing cost of £27 million (2005 £43 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

Financial services

Following the disposal of the Group's interest in Pembroke Group, an aircraft leasing joint venture, the decision was announced to cease reporting financial services as a separate activity Engine leasing activities are now recorded within civil aerospace and power ventures are recorded within energy Restated comparatives are shown in note 2

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 all 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 Groups exposures and financial risk management and a specialist committee also considers these in detail All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework

Counterparty credit risk
The Group has an established policy towards managing counterparty credit risk A common framework exists to measure, report and control exposures to counterparties across the Group using Value at Risk and fair value techniques Counterparties are assigned a credit limit that reflects their credit standing 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

It employs derivatives where appropriate to generate the desired currency and interest rate profile

£62 million of borrowing facilities matured during 2006 This was replaced by a new £200 million borrowing facility relating to research and development established with the European Investment Bank (EIB) As at December 31, 2006 the Group had total committed borrowing facilities of £1.8 billion (2005 £1 7 billion)

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

The Group holds financial investments and maintains undrawn committed facilities at a level sufficient to ensure 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 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, 2006 the assigned long-term credit ratings were

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

The Group saw positive rating actions from both rating agencies during the year reflecting the improved business and financial profile of the Group Standard & Poor s upgraded the rating from BBB+' to 'A-' in June 2006 and Moody's upgraded its rating from 'Baa1' to 'A3' in November 2006

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

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

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

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

The Group is exposed to a number of foreign currencies The most significant transactional currency exposure is the US dollar followed by the Euro

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

1 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 net of US dollar costs represented 26 per cent of Group turnover in 2006 (2005 27 per cent)
2 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

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 2006 the Group had approximately US$10 billion of forward cover (2005 US$11 billion)

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates. Note 19 includes the impact of revaluing forward currency contracts at market values on December 31, 2006, showing a value of £554 million (2005 £228 million) which will fluctuate with exchange rates over time The Group has entered into these forward contracts as part of the hedging policy, described above, in order to mitigate the impact of volatile exchange rates

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

Commodity risk
The Group has an ongoing exposure to the price of jet fuel and base metals arising from business operations. The Group's objective is to minimise the impact of price fluctuations. The exposure is hedged in accordance with parameters contained in a written policy 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. 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 Airclaims Limited as an independent appraiser to value its security portfolio at both the half-year and year end Airclaims provides specific values (both current and forecast future values) for each asset in the security portfolio These values are then used to assess the Groups net exposure

The permitted levels of gross and net exposure are limited in aggregate, by counterparty, by product type and by calendar year The Group's gross exposures are divided approximately 60:40 between AVGs and credit guarantees They are spread over many years and relate to a number of customers and a broad product portfolio

The Board regularly reviews the Groups 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 29 to the accounts describes the Group's contingent liabilities

There were no material changes to the Group's gross and net contingent liabilities in this respect in 2006

Accounting standards
The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU In 2006, the Group has adopted the amendments to IAS 39 Financial Instruments and IFRS 4 Financial Guarantee Contracts, resulting in sales financing commitments being classified as insurance contracts This change has no impact on the reported results Other new standards, amendments to standards and interpretations effective in 2006 do not have a significant effect on the Group's financial statements.

A summary of other changes which have not been adopted in 2006, is included within the accounting policies in note 1 to the financial statements.

Andrew Shilston
Finance Director
February 7, 2007

Corporate responsibility

Why corporate responsibility matters
The Group believes that commitment to corporate responsibility delivers competitive advantage and contributes to the delivery of the Group's business strategy

The Group's Global Code of Business Ethics underpins our values and engages our stakeholders in building and maintaining the Group's reputation

Conducting business in an ethical and responsible way helps the Group in a number of ways

- we attract and retain the best people,
- we build goodwill and maintain successful working relationships with customers, suppliers and governments, and
- we encourage the giving of donations to charities which support the global communities in which we conduct business.

The sustained wealth, created by providing thousands of highly skilled jobs, represents the Group's single greatest contribution to those communities

The Group supports its own employees with well-developed policies and practices in occupational health, safety and environment, employment policy and employee learning and development

External recognition
The Group's achievements during the year were recognised when it held its high-ranking position in the 2005 UK Business in the Community Corporate Responsibility Index. It also retained its inclusion in the Dow Jones Sustainability Indices

Health, safety and the environment (HS&E)
The Group's approach to HS&E is first and foremost shaped by the desire to avoid harm to people and the environment, and it is also recognised that good HS&E performance is synonymous with good business performance The Rolls-Royce vision is that it will become known for the excellence of its health safety and environmental performance

The Chief Executive chairs the Company HS&E committee, which is comprised of the sector presidents and functional directors and is responsible for setting policy, objectives and targets, defining strategy and reviewing performance

The Group's objectives are to protect health, prevent injury and reduce environmental impact. Performance levels are achieved by the implementation of an integrated HS&E management system, which utilises a structured risk management approach All the Group's businesses have gained third-party certification to the international environmental management systems standard ISO 14001

The Group continues to participate in the voluntary UK carbon dioxide emissions trading scheme and the Chicago Climate Exchange and has programmes in place to reduce carbon dioxide emissions.

It is with great regret that the Group reports a fatal travel accident during 2006 involving a service engineer The Major Incident Board which is chaired by the Chief Operating Officer, has reviewed this tragic accident and measures have been implemented to avoid reoccurrence

The Group's HS&E audit programme independently assesses the effective implementation of all elements of the HS&E management system Audits completed in 2006 covered operations in the UK and Norway

The Group operates three sites in the UK which manufacture, test and support nuclear reactor cores for Royal Navy submarines All these sites continue to maintain a strong health, safety and environmental performance, which is independently monitored by the Nuclear Propulsion Assurance Committee, chaired by the Director – Engineering and Technology

The Group recognises HS&E initiatives and related improvements in performance through Company HS&E Awards presented by the Chief Executive Recognition is also given to those sites achieving zero lost time injuries over the year

In 2006, the Group was again placed first in its business sector in the Business in the Environment index of corporate environmental management and also retained 'Premier League' status Rolls-Royce was selected as the UK entry in the management category for the European Business Awards for the Environment 2006

The Group continues to build on these achievements, including running programmes to support the development of HS&E management systems in its suppliers This has included supplier workshops in the UK and North America and a continuation of the supplier HS&E visit programme The number of suppliers certified to ISO 14001 in 2006 more than doubled

A full report on the Group's HS&E performance over the period 2004-06 will be published in April 2007 Independent assurance will be provided by Deloitte & Touche LLP

Environment product performance
The Chief Executive has highlighted earlier in this report that Rolls-Royce is both committed and well placed to find solutions to the substantial challenges posed by climate change The Group's environmental team closely monitors developments in the underpinning science and their advice helps steer the significant research and development programmes, as well as providing input to the overall business strategy Such knowledge is also vital to the design process

In addition, the Group obtains independent expert advice from its Environmental Advisory Board This Board is made up of distinguished academics who are leading authorities in their respective fields

In the aviation sector, the fuel efficiency of Rolls-Royce aero engines has improved by 20 per cent over the past 25 years The Group is playing a leading role in the achievement of the long-term environmental goals set by the Advisory Council for Aeronautics Research in Europe and is investing substantial funds in research and development and in the introduction of new products with enhanced environmental performance

Rolls-Royce is an active member of the UK Sustainable Aviation Council (SAC), which published a sustainable aviation strategy in 2005, the first of its kind, and its first progress report in 2006 The SAC is an industry body committed to building a sustainable future, which comprises manufacturers, airlines, airports and air navigation service providers

The Group is involved in a range of product development initiatives across all business sectors. These include alternative energy and low-carbon technologies such as the development of the high-efficiency solid oxide fuel cell These fuel cells offer other environmental benefits, such as low noise and improved air quality

The Group endorses the principles of emissions trading, a mechanism which over time should enable markets to identify and invest where the most cost-effective improvements can be made

A full report on the environmental performance of the Group's products will be published in April 2007

Supply chain
The Group sets expected business requirements and performance standards through its supplier quality system, 'Supplier Advanced Business Relationships' (SABRe) SABRe includes a supplier code of conduct and a health, safety and environmental management system Regular meetings are held between Rolls-Royce and all levels of suppliers.

The Rolls-Royce purchasing code of conduct for employees complements the supplier code of conduct and ensures that employees act consistently with suppliers

Partnership approach
The Group's partnership approach to its supply chain

- delivers mutual business benefits
- minimises the environmental impact of business operations,
- encourages the highest standards of ethical behaviour, and
- promotes human rights.

We are establishing local purchasing offices around the world, which will develop mutual understanding between Rolls-Royce and its network of suppliers.

Regular visits are made to suppliers to assess their performance and an ongoing programme of communication continues to reinforce supplier partnerships

The introduction of Exostar, an e-business system accessible by our suppliers provides significant benefits including

- enabling virtual teamworking,
- reducing the need to travel, and

- encouraging more regular and effective communication.

The sourcing policies of Rolls-Royce in the US reflect US Government regulations on small and disadvantaged businesses

Social responsibility
During 2006, the Group concentrated on updating its supplier policy to include social responsibilities New guidelines will be issued during 2007

The Group is recognised for its continuing contribution to corporate responsibility through the recycling of material in its supply chain where significant metal recycle levels have been achieved Rolls-Royce has also introduced returnable container loops across its major UK suppliers to reduce the use of disposable packaging

Occupational health
The Group recognises the link between physical and mental health and the need for employees to work effectively and successfully with proper regard for their personal well-being

In response, the Occupational Health Policy Group develops the Group strategy and identifies relevant areas of changing occupational health needs

The Group is committed to promoting best practice in occupational health It hosted the UK national launch of a joint Faculty of Public Health and Faculty of Occupational Medicine initiative on 'Creating a healthy workplace'

Key areas of focus
The occupational health strategy concentrates on four key areas
- screening and surveillance
- rehabilitation,
- health promotion, and
- education

In screening and surveillance stringent targets are set for assessing fitness for work, reducing occupational disease and work-related ill-health A campaign to reduce noise-induced hearing loss continues and the Group has an international reputation for its management of hand-arm vibration syndrome cases

The priority in rehabilitation is early intervention and the active case management of individuals Training assists managers in managing absence and rehabilitation effectively The importance of health and productivity was included in the Group's management development programmes in 2006

Health promotion in 2006 included two awareness campaigns on physical activity and alcohol Employees were encouraged to Get active, Get up & Go' to highlight the benefits of physical activity on health and well-being The aim of the alcohol campaign, 'Know your limits', was to raise awareness of safe drinking levels and the effects of alcohol on health.

External recognition
Rolls-Royce was a winner of the National Obesity Forum Primary Care Award for Excellence in Weight Management 2006 This award recognised its achievements in the UK campaign, 'Reduce Hazardous Waist!'

Independent research for Norwich Union Healthcare on ill-health and absence cited Rolls-Royce as promoting a healthy workplace and proactively managing adverse health effects to achieve a reduction in absence

Dr Ian Lawson, the Group's Chief Medical Officer, was made a Fellow of the American College of Occupational and Environmental Medicine in 2006

Employment policy
The Group's employment policies continue to develop the flexibility, capability and motivation of all employees
In recent years, we have introduced a range of policies including
- modern working practices in operations,
- improved methods of encouraging employee involvement, and
- a global approach to attracting and retaining talented people

Employee involvement
The Group provides competitive pay and benefits for employees in each locality and actively encourages share ownership All employees are regularly invited to participate in ShareSave plans and the workforce has committed to save some £90 million to buy shares in the Company Statutory arrangements enable UK employees to receive part of their annual bonus in Company shares and to make monthly share purchases from their salary

We continue to work closely with employee representatives to improve the quality of employee engagement and participation in the development of the business This progress is reinforced by the continuing development of the Global Council The Council comprises employee representatives from around the world and provides a structured approach to consultation and communication

During 2006, the Global Council met twice and additional interim meetings of its Executive Committee ensured that key issues identified by the Council were progressed

The Group launched its second Global Employee Engagement Survey in November 2006 (previous survey 2004), and the results will be fed back to employees in the first half of 2007 All employees will have the opportunity to discuss the issues emerging from the survey and will be involved in formulating action plans to address them

Human rights and ethics
In 2006, following consultation with the Global Council, the Group agreed a Global Code of Business Ethics and Human Rights policy

A global training and communication programme for leaders and employees will take place during 2007 to help promote effectively and widely the Global Code of Business Ethics.

Diversity
The Group is committed to developing a diverse workforce and equal opportunities for all In support of the Global Diversity Policy, a Global Steering Group was established and improvements made to local policies

These policies support initiatives to encourage more women and people from minority backgrounds to pursue careers in engineering In 2006 graduate recruitment comprised 30 per cent females and 23 per cent international trainees. The Group also introduced a targeted graduate programme in Asia

In addition the Group organised a global conference for women role models and a women's leadership conference in the US We also helped the launch of a network for female employees in the UK and plan to support similar networks in other countries

The Group's policy is to provide, wherever possible, employment training and development opportunities for disabled people It is also committed to supporting employees who become disabled and to helping disabled employees make the best possible use of their skills and potential

Learning and development
The Group has continued to invest in the training and development of employees, customers and suppliers to strengthen its competitive position In 2006, expenditure on the education, training and professional and leadership development of employees was £30 million.

Employees
The Group continued to focus on developing its leadership by strengthening its succession plans and talent pools. It also strengthened its management and development programmes by joining the consortium Global Leadership 20/20 programme led by the Amos Tuck School of Business at Dartmouth College in the US

Training programmes continued to help improve processes and to raise standards of performance and customer satisfaction New programmes were introduced to promote a new services behaviour

Training was delivered to support the introduction of new factories and the continued development of global operating systems This included
- modern working practices,
- team-based working, and
- the Rolls-Royce Production System

Training in support of Product Lifecycle Management and Enterprise Resource Planning continues to enable the Group and its supply chain to deliver products and services of a higher quality and with greater efficiency in support of the Group's services strategy

We have increased the availability of online learning and seen a 250 per cent increase in the use of e-learning packages over the past 12 months

During the year, the Group recruited 154 graduates and 155 apprentices and technicians. In addition, 599 undergraduate students were employed for training periods of between two and 12 months At the end of the year, a total of 295 graduates were on formal training programmes and there were 420 apprentices and technicians worldwide In 2006, the Group was ranked second in its business sector and 23rd overall in the UK Times Newspaper Top 100 Graduate Employers list.

At the end of 2006 the Group employed 38,020 employees in over 50 countries.

Educational sponsorship

The Group continues to work closely with schools, colleges and universities to promote science, engineering, technology and enterprise Our policy is to work with governments, local and national institutions to widen students' experience of industry and promote careers in the aerospace, marine and energy sectors In 2006, this included running two cohorts of the Young Apprentice programme in the UK for 14-16 year olds During 2006, Rolls-Royce also took an active part in the development of the National Skills Academy for Manufacturing in the UK.

In 2006, the Group hosted an awards dinner to recognise the first winner of the Rolls-Royce Science Prize The prize promotes and rewards innovation and excellence in science teaching throughout the UK and the Republic of Ireland The winning team, Crown Woods School from London, was awarded £20,000 to invest in science education The Group gives a total of £120 000 in prize money each year as part of the Science Prize

Another flagship education activity, Profitable Pursuit, is a business simulation to stimulate enterprise education in schools. During 2006, over 120 teachers and advisors were trained Other projects include Open Industry, Specialist Schools and Science and Engineering Ambassadors in the UK In the US, Rolls-Royce supports 'Project Lead the Way' to encourage students to consider careers in engineering and technology

Customers

The Group continues to meet customer training needs with management and business education and, during 2006, over 17,000 days of training were delivered to Rolls-Royce customers. This was completed either through the Group's dedicated Customer Training facilities in North America Europe and China, or at its customers' locations

Community investment

Rolls-Royce has a long and successful history of community involvement which benefits the societies in which it operates and contributes to its long-term business success.

Structure

The community investment and sponsorship committee of Rolls-Royce Group plc, chaired by the Chief Executive, is responsible for the Group's policy on charitable donations. The Group committee is supported by a number of national committees which operate within the following guidelines

'As a forward-looking, innovative and global company, Rolls-Royce Group plc is committed to being a good corporate citizen in its operations throughout the world The Group's policy on donations is to direct its support primarily to causes with educational, engineering and scientific objectives, as well as to social objectives connected with the Group's business and place in the wider community'

A list of the principal donations made in the year is available upon request to the Company Secretary

Focused support

In 2006, the Group achieved sixteenth position in the UK Guardian Newspaper's Giving List, demonstrating its commitment to supporting the communities in which its employees live and work around the world Our policy is to give priority to activities supporting education, the environment, arts and culture, and economic and social regeneration This approach supports the Group's values of reliability, integrity and innovation

In 2006, the Group's total charitable donations amounted to £1.2 million During 2006 charitable donations in the UK amounted to £728,000 They included support for The Prince's Trust, Community Foundations, SS Great Britain, The Industrial Trust and Duxford AirSpace

The Group has made charitable donations of £507,000 in other key regions. In North America, this included support for the work of United Way, the Smithsonian National Air and Space Museum, the United States Air Force Museum Foundation and Purdue University In Germany, we supported a range of organisations, including the Brandenburg Summer Festival, World Youth Day and the International Airport Race In the Nordic countries, Rolls-Royce supported a number of local sports and arts-based projects

In addition to charitable donations contributions of £2.5 million were made by the Group, primarily in sponsorship and to educational programmes

The Group also finances the administration of a Payroll Giving Scheme for UK employees In 2006, the scheme helped employees to donate over £400,000 to more than 200 charities of their choice Fifteen per cent of employees take part in the scheme, one of the highest levels of participation in the UK and the scheme is recognised as Gold Award standard by the UK Government's Payroll Giving Charter Mark. In addition, 37 per cent of employees in North America have contributed in excess of £180,000 to good causes through United Way schemes, a percentage of which is matched by the Company

In 2006, each completed questionnaire in the Global Employee Engagement Survey, guaranteed a donation to the Rolls-Royce Disaster Relief Fund, created to continue the activities undertaken following the 2004 tsunami and hurricane Katrina

In addition to providing financial support, the Group encourages employees to participate in community projects to enhance their own skills and experience In 2006, examples included
- a series of team challenges which involved 160 senior managers completing community projects in Berlin during the annual Senior Management Conference
- 250 new trainees taking part in a challenge in the UK as part of their induction programme,
- providing business mentors and advisers through The Prince's Trust, Young Enterprise and Arts & Business,
- running successful mentoring and literacy programmes for school pupils through education business partnerships in the UK and the Helping One Student to Succeed (HOSTS) programme in Indianapolis, USA,
- supporting employees who are School Governors,
- participating in the UK's Science and Engineering Ambassadors Scheme, and
- supporting students in the For Inspiration and Recognition of Science and Technology (FIRST) robotics programme in the US

The Group also offers support in-kind to local community organisations by donating surplus computer equipment and office furniture It also provides places on in-house training courses, and offers the use of meeting rooms and office accommodation

Rolls-Royce is a member of Business in the Community and actively supports Common Purpose programmes across the UK. These two organisations aim to promote greater business awareness and involvement in wider community issues and to encourage more employee participation.

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, 2006 which comprise the Group consolidated income statement, the Group and Parent Company balance sheets, the Group consolidated cash flow statement, the Group consolidated statement of recognised income and expense and the related notes. These financial statements have been prepared under the accounting policies set out therein

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU, and for preparing the parent Company financial statements in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities on page 3

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

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation We also report to you whether in our opinion the information given in the Report of the directors is consistent with the financial statements The information given in the Report of the directors includes that specific information presented in the business review that is cross referred from the business review section of the Report of the directors.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed

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, 2006 and of its profit for the year then ended,
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation,
- the parent Company financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the parent Company's affairs as at December 31 2006
- the parent Company financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Report of the directors is consistent with the financial statements.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants, Registered Auditor
London
February 7 2007

Consolidated income statement

For the year ended December 31, 2006

	Notes	2006 £m	Restated* 2005 £m
Revenue	2,3	**7,156**	6,603
Cost of sales		**(5,527)**	(4,924)
Gross profit		**1,629**	1,679
Other operating income	4	**57**	60
Commercial and administrative costs		**(664)**	(646)
Research and development costs		**(370)**	(282)
Share of profit of joint ventures	10	**47**	46
Operating profit		**699**	857
Profit/(loss) on sale of businesses	31	**1**	(2)
Profit before financing income/(costs)		**700**	855
Financing income	5	**1,335**	475
Financing costs	5	**(498)**	(867)
Net financing income/(costs)		**837**	(392)
Profit before taxation	4	**1,537**	463
Taxation	6	**(397)**	(126)
Profit for the year		**1,140**	337
Attributable to			
Equity holders of the parent		**1,144**	340
Minority interests	25	**(4)**	(3)
Profit for the year		**1,140**	337

* See note 5

Consolidated balance sheet

At December 31, 2006

	Notes	2006 £m	Restated* 2005 £m
ASSETS			
Non-current assets			
Intangible assets	8	**1,460**	1,315
Property, plant and equipment	9	**1,706**	1,649
Investments – joint ventures	10	**240**	247
Other investments	11	**125**	345
Deferred tax assets	20	**141**	391
		3,672	3,947
Current assets			
Inventory	12	**1,447**	1,309
Trade and other receivables	13	**2,465**	2 047
Taxation recoverable		**5**	3
Other financial assets	19	**644**	464
Short-term investments		**34**	37
Cash and cash equivalents	14	**2,184**	1,756
		6,779	5 616
Total assets		**10,451**	9,563
LIABILITIES			
Current liabilities			
Borrowings	15	**(400)**	(75)
Other financial liabilities	19	**(24)**	(227)
Trade and other payables	16	**(3,844)**	(3,518)
Current tax liabilities		**(191)**	(171)
Provisions	21	**(146)**	(138)
		(4,605)	(4,129)
Non-current liabilities			
Borrowings	17	**(990)**	(1,458)
Other financial liabilities	19	**(336)**	(339)
Trade and other payables	18	**(827)**	(650)
Deferred tax liabilities	20	**(252)**	(178)
Provisions	21	**(189)**	(223)
Post-retirement benefit obligations	22	**(995)**	(1,659)
		(3,589)	(4,507)
Total liabilities		**(8,194)**	(8,636)
Net assets		**2,257**	927
EQUITY			
Capital and reserves			
Called-up share capital	23	**326**	326
Share premium account	24	**631**	631
Transition hedging reserve	24	**177**	379
Translation reserve	24	**(58)**	17
Retained earnings	24	**1,174**	(432)
Equity attributable to equity holders of the parent		**2,250**	921
Minority interests	25	**7**	6
Total equity		**2,257**	927

* See note 8.

The financial statements on pages 20 to 66 were approved by the Board on February 7, 2007 and signed on its behalf by

Simon Robertson Chairman **Andrew Shilston** Finance Director

Consolidated cash flow statement
For the year ended December 31, 2006

	Notes	2006 £m	Restated* 2005 £m
Reconciliation of operating cash flows			
Profit before taxation		**1,537**	463
Share of profit of joint ventures	10	**(47)**	(46)
(Profit)/loss on sale or termination of businesses	31	**(1)**	2
(Profit)/loss on sale of property, plant and equipment		**(9)**	1
Net interest expense	5	**18**	39
Net post retirement scheme financing (income)/costs	5	**(3)**	9
Net other financing (income)/costs	5	**(852)**	344
Taxation paid		**(25)**	(60)
Amortisation of intangible assets	8	**60**	59
Depreciation of property, plant and equipment	9	**161**	195
Decrease in provisions		**(36)**	(31)
Increase in inventories		**(136)**	(221)
Increase in trade and other receivables		**(397)**	(252)
Increase in trade and other payables		**700**	728
Decrease in other financial assets and liabilities		**250**	270
Post-retirement benefits adjustment		**(21)**	(69)
Share-based payments charge	26	**36**	26
Transfers of hedge reserves to income statement	24	**(289)**	(459)
Dividends received from joint ventures	10	**44**	35
Net cash inflow from operating activities		**990**	1,033
Cash flows from investing activities			
Disposals of unlisted investments		**—**	5
Additions to intangible assets		**(219)**	(132)
Disposals of intangible assets		**7**	—
Purchases of property, plant and equipment		**(298)**	(219)
Disposals of property, plant and equipment		**55**	69
Acquisition of businesses	31	**(5)**	—
Disposals of businesses	31	**1**	1
Investments in joint ventures		**(11)**	(13)
Disposals of joint ventures		**1**	—
Additions to parent company shares		**(44)**	—
Disposals of parent company shares		**76**	—
Net cash outflow from investing activities		**(437)**	(289)
Cash flows from financing activities			
Borrowings due within one year – repayment of loans		**(53)**	(202)
Borrowings due after one year – repayment of loans		**—**	(5)
Capital element of finance lease payments		**(8)**	(11)
Net cash outflow from decrease in borrowings		**(61)**	(218)
Interest received		**84**	41
Interest paid		**(96)**	(88)
Interest element of finance lease payments		**(2)**	(2)
Decrease/(increase) in government securities and corporate bonds		**3**	(1)
Settlement of financial liabilities to purchase/sell own shares		**—**	(149)
Net cash outflow from financing activities		**(72)**	(417)
Increase in cash and cash equivalents		**481**	327
Cash and cash equivalents at January 1		**1,744**	1 439
Foreign exchange		**(60)**	45
Net cash of businesses acquired/disposed		**5**	1
Adjustment on implementation of IAS 32 and IAS 39			(68)
Cash and cash equivalents at December 31		**2,170**	1,744

* See notes 5 and 8.

	2006 £m	2005 £m
Reconciliation of increase in cash and cash equivalents to movements in net funds		
Increase in cash and cash equivalents	481	327
Cash (inflow)/outflow from (decrease)/increase in government securities and corporate bonds	(3)	1
Net cash outflow from decrease in borrowings	61	218
Change in net funds resulting from cash flows	539	546
Borrowings of businesses disposed	—	1
Net funds of businesses acquired	1	—
Finance lease additions	—	(1)
Exchange adjustments	(49)	5
Fair value adjustments	77	47
Movement in net funds	568	598
Net funds/(debt) at January 1	260	(149)
Adjustment on implementation of IAS 32 and IAS 39		(189)
	828	260
Fair value of swaps hedging fixed rate borrowings	(3)	74
Net funds at December 31	825	334

Analysis of net funds	At January 1, 2006 £m	Cash flow £m	Net funds of businesses acquired £m	Exchange adjustments £m	Fair value adjustments £m	Other non-cash changes £m	At December 31, 2006 £m
Cash at bank and in hand	337	439	5	(25)	—	—	756
Overdrafts	(12)	(3)	—	1	—	—	(14)
Short term deposits	1,419	45	—	(36)	—	—	1,428
Cash and cash equivalents	1,744	481	5	(60)	—	—	2,170
Investments	37	(3)	—	—	—	—	34
Other borrowings due within one year	(55)	53	(1)	5	17	(398)	(379)
Borrowings due after one year	(1,444)	—	(3)	6	60	398	(983)
Finance leases	(22)	8	—	—	—	—	(14)
	260	539	1	(49)	77	—	828
Fair value of swaps hedging fixed rate borrowings	74				(77)		(3)
	334	539	1	(49)	—	—	825

Consolidated statement of recognised income and expense
For the year ended December 31, 2006

	2006 £m	Restated[1] 2005 £m
Foreign exchange translation differences from foreign operations[2]	**(75)**	49
Actuarial gains/(losses)	**602**	(282)
Transfers from transition hedging reserve	**(289)**	(462)
Transfers from cash flow hedging reserve	**—**	3
Movement in fair value of available for sale assets	**(126)**	121
Related tax movements	**(43)**	186
Net income/(expense) recognised directly in equity	**69**	(385)
Profit for the year	**1,140**	337
Total recognised income and expense for the year	**1,209**	(48)
Attributable to		
Equity holders of the parent	**1,213**	(45)
Minority interests	**(4)**	(3)
Total recognised income and expense for the year	**1,209**	(48)

[1] See note 5
[2] Loss on investment hedge relating to foreign subsidiaries £nil (2005 £26m loss)

Summary of movements in equity
For the year ended December 31, 2006

	2006 £m	2005 £m
At January 1 (including effect of adoption of IAS 32 and IAS 39 from January 1, 2005)	**927**	924
Total recognised income and expense for the year	**1,209**	(48)
Share-based payments adjustment	**40**	26
Sale of shares in subsidiary company to a minority interest	**5**	5
Related tax movements – current tax	**18**	—
– deferred tax	**58**	20
At December 31	**2,257**	927
Attributable to		
Equity holders of the parent	**2,250**	921
Minority interests	**7**	6
Total equity	**2,257**	927

Notes to the consolidated financial statements

1 Significant accounting policies

The Company

Rolls-Royce plc (the 'Company') is a company domiciled in the United Kingdom The consolidated financial statements of the Company for the year ended December 31 2006 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 7, 2007

Basis of preparation and statement of compliance

In accordance with European Union (EU) regulations, the consolidated 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, 2006 The Company has elected to prepare its parent company accounts under UK Accounting Standards

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

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

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

Basis of consolidation

The Group financial statements include the financial statements of the Company and all of its subsidiary undertakings made up to December 31, together with the 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 Transactions between members of the Group are eliminated on consolidation

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.

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

Significant accounting policies and judgements applied

Revenue recognition

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

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured On occasion the Group may participate in the financing of engines in conjunction with airframe manufacturers In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing whether significant risk and rewards of ownership have been transferred to the customer Where it is judged that sufficient risks and rewards are not transferred, the transaction is treated as a leasing transaction, resulting in an operating lease between the Group and the customer No deliveries of engines were treated as operating leases during 2006 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 The Group has consolidated one such entity (Pembroke 717 Holdings Limited)

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

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

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

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

Progress payments received, when greater than recorded revenues 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 and are accounted for using the amortised cost method

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

Interest
Interest receivable/payable is credited/charged to the income statement using the effective interest method

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 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, 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 predominately 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 are translated at the rate 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 The net investment hedging of overseas undertakings is described under hedge accounting

Financial instruments
IAS 39 Financial Instruments requires the classification of financial instruments into separate categories for which the accounting requirement is different Rolls-Royce has classified its financial instruments as follows

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

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

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

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

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

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

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

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

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

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

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

Until December 31, 2004, and as allowed by IFRS 1, the Group 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 income statement based on the designation of the hedges on January 1, 2005

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

i) To December 31, 1997 Goodwill was written off to reserves in the year of acquisition
ii) From January 1, 1998 Goodwill was recognised within intangible assets in the year in which it arose and amortised on a straight line basis over its useful economic life, up to a maximum of 20 years
iii) From January 1, 2004, in accordance with IFRS 3 Business Combinations goodwill is recognised as per (ii) above but is no longer amortised

Certification costs and participation fees
Costs incurred in respect of meeting regulatory certification requirements for new civil 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

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

Software
The cost of acquiring software that is not specific to an item of property, plant and equipment is classified as an intangible asset Amounts previously included within property plant and equipment have been transferred to intangible assets (see notes 8 and 9)

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

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

i) Land and buildings, as advised by the Groups professional advisors
   a) Freehold buildings – five to 45 years (average 23 years)
   b) Leasehold buildings – lower of advisors estimates or period of lease
   c) No depreciation is provided on freehold land
ii) Plant and equipment – five to 25 years (average 15 years)
iii) Aircraft and engines – five to 20 years (average 18 years)
iv) No depreciation is provided on assets in the course of construction

Joint ventures
Joint ventures are accounted for using the equity method

Leases
i) As Lessee
   Assets financed by leasing agreements that give rights approximating to ownership (finance leases) have been capitalised at their fair value and depreciation is provided on the basis of the Group depreciation policy The capital elements of future obligations under finance leases are included as liabilities in the balance sheet and the current year's interest element, having been allocated to accounting periods to give a constant periodic rate of charge on the outstanding liability, is charged to the income statement The annual payments under all other lease arrangements, known as operating leases, are charged to the income statement on a straight-line basis
ii) As Lessor
   Amounts receivable under finance leases are included within receivables and represent the total amount outstanding under the lease agreements less unearned income Finance lease income, having been allocated to accounting periods to give a constant periodic rate of return on the net investment, is included in revenue
   Rentals receivable under operating leases are included in revenue on a straight-line basis.

Impairment of non-current assets
Impairment of non-current assets is considered in accordance with IAS 36 Impairment of Assets 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 Impairment tests are undertaken by estimating the value in use of the asset

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 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

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

Share-based payments
The Group applied the requirements of IFRS 2 Share-based Payments from January 1, 2004 In accordance with the transition provisions, IFRS 2 has been applied to all grants made after November 7 2002 that were unvested as of January 1 2005

The Group provides share-based payment arrangements to certain employees These are predominantly equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares or options that will eventually vest

Fair value is measured using the binomial pricing model for the ShareSave plans and the Executive Share Option Plan (ESOP) Fair values of awards made under the Performance Share Plan (PSP) are measured using a pricing model adjusted to reflect non-entitlement to dividends (or equivalent) and the Total Shareholder Return market-based performance condition

See note 26 for a further description of the share-based payment plans

Contingent liabilities
In connection with the sale of its products, the Group will, on some occasions, 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, credit-based guarantees are treated as insurance contracts The Group considers asset value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts Provision for insurance liabilities is made as described above

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

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

Forecasts and discount rates
The carrying values of a number of items on the balance sheet are dependent on the estimates of future cash flows arising from the Groups operations

- The impairment tests for goodwill are dependent on forecasts of the cash flows of the cash generating units that give rise to the goodwill and the discount rate applied No impairment resulted from the annual impairment tests in 2006 (carrying value at December 31 2006 £735m, December 31, 2005 £751m)
- If the assessment of development, participation certification and recoverable engine costs recognised as intangible assets indicates the possibility of impairment, a detailed impairment test is undertaken No impairment resulted from the assessment in 2006 (carrying value at December 31, 2006 £674m, December 31, 2005 £530m)
- The financial liabilities arising from financial risk and revenue sharing partnerships are valued at each reporting date using the amortised cost method (carrying value at December 31, 2006 £324m, December 31, 2005 £423m) 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, 2006 £141m, December 31, 2005 £391m) 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 deficit of £995m before deferred taxation being recognised on the balance sheet at December 31 2006 (December 31, 2005 £1 659m) The size of the 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 22

Provisions
As described in the accounting policy above, the Group measures provisions (carrying value at December 31, 2006 £335m, December 31 2005 £361m) 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 29 the Group has significant long-term contingent obligations The directors consider that the possibility that there will be any significant loss arising from these contingencies as remote In reaching this opinion, the directors have considered the likelihood of the contingency crystallising and have taken account of forecast aircraft values that generally provide security against the contingent liability

Revisions to IFRS not applicable in 2006
IFRS 7 Financial Instruments Disclosures and Amendment to IAS 1 Capital Disclosures are applicable from 2007 These amendments to disclosure requirements will have no effect on the reported results.

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, electrical power generation and aftermarket services.

Following an internal reorganistion, financial services is no longer reported as a separate segment Aircraft and engine leasing activities are incorporated in civil aerospace (the Group's investment in Pembroke Group its aircraft leasing joint venture, was sold in July 2006) Electrical power development activities are incorporated in energy

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, 2006							
Total revenue	3,775	1,569	1,300	512	—	—	7,156
Operating profit excluding share of profit of joint ventures	446	183	103	(33)	(47)	—	652
Share of profit of joint ventures	36	5	1	5	—	—	47
Profit on sale of businesses	1	—	—	—	—	—	1
Profit/(loss) before financing income/(costs)	483	188	104	(28)	(47)	—	700
Financing income					1,335		1,335
Financing costs					(498)		(498)
Taxation					(397)		(397)
Profit for the year							1,140
Other information							
Segment assets	5,267	919	1,253	645	—	(264)	7,820
Investments in joint ventures	184	24	4	28	—	—	240
Cash and short-term investments					2,218		2,218
Fair value of swaps hedging fixed rate borrowings					27		27
Income tax assets					146		146
Total assets							10,451
Segment liabilities	(3,553)	(1,021)	(710)	(316)	—	264	(5,336)
Borrowings					(1,390)		(1,390)
Fair value of swaps hedging fixed rate borrowings					(30)		(30)
Income tax liabilities					(443)		(443)
Post-retirement benefit obligations					(995)		(995)
Total liabilities							(8,194)
Expenditure on intangible assets and property, plant and equipment	437	52	24	15			528
Depreciation and amortisation	162	30	20	19			231
Impairments	(10)	—	—	—			(10)

2 Segmental analysis continued

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Restated[1] Central items £m	Eliminations £m	Restated[1] Group £m
Analysis by business segments for the year ended December 31, 2005[2]							
Total revenue	3,561	1,413	1,097	532	—	—	6,603
Operating profit excluding share of profit of joint ventures	612	165	84	(5)	(45)	—	811
Share of profit of joint ventures	34	7	1	4	—	—	46
Loss on sale of businesses	—	—	—	(2)	—	—	(2)
Profit/(loss) before financing income/(costs)	646	172	85	(3)	(45)	—	855
Financing income					475		475
Financing costs					(867)		(867)
Taxation					(126)		(126)
Profit for the year							337
Other information							
Segment assets	4,553	860	1,158	738	—	(254)	7055
Investments in joint ventures	187	28	1	31	—	—	247
Cash and short term investments					1,793		1793
Fair value of swaps hedging fixed rate borrowings					74		74
Income tax assets					394		394
Total assets							9563
Segment liabilities	(3425)	(944)	(564)	(416)	—	254	(5,095)
Borrowings					(1,533)		(1,533)
Income tax liabilities					(349)		(349)
Post retirement benefit obligations					(1,659)		(1,659)
Total liabilities							(8,636)
Expenditure on intangible assets and property plant and equipment	270	48	29	17			364
Depreciation and amortisation	173	32	19	19			243
Impairments	11	—	—	—			11

[1] See note 5
[2] The segmental analysis has been restated to put it on a comparable basis to the current year

Geographical segments

The Group's revenue by destination is shown below

	2006 £m	2005 £m
United Kingdom	**944**	886
Rest of Europe	**1,159**	1,059
USA	**2,458**	2 408
Canada	**207**	191
Asia	**1,902**	1 516
Africa	**78**	152
Australasia	**146**	96
Other	**262**	295
	7,156	6,603

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

	Segment assets		Additions to intangible assets and property, plant and equipment	
	2006 £m	2005 £m	2006 £m	2005 £m
United Kingdom	**7,636**	6,974	**467**	316
North America	**1,268**	1 265	**22**	24
Nordic countries	**931**	832	**15**	11
Germany	**565**	652	**19**	5
Other	**331**	310	**5**	8
Eliminations	**(280)**	(470)	**—**	—
	10,451	9 563	**528**	364

Underlying profit reconciliation

	2006			2005		
	£m	Underlying adjustments £m	Underlying results £m	£m	Underlying adjustments £m	Underlying results £m
Profit before net financing income/(costs)						
Civil aerospace	**483**	**40**	**523**	646	(205)	441
Defence aerospace	**188**	**7**	**195**	172	3	175
Marine	**104**	**(2)**	**102**	85	2	87
Energy	**(28)**	**10**	**(18)**	(3)	2	(1)
Central items	**(47)**	**—**	**(47)**	(45)	—	(45)
	700	**55**	**755**	855	(198)	657
Net financing income/(costs)	**837**	**(880)**	**(43)**	(392)	314	(78)
Profit before tax	**1,537**	**(825)**	**712**	463	116	579

Underlying adjustments

	2006		2005	
	Profit before financing income/(costs) £m	Profit before tax £m	Profit before financing income/(costs) £m	Profit before tax £m
Release of transition hedge reserve	**(289)**	**(289)**	(452)	(452)
Realised gains on settled derivative contracts	**343**	**370**	328	396
Realised gains carried forward in contract balances	**(27)**	**(27)**	(32)	(32)
Net unrealised fair value changes to derivative contracts	**—**	**(730)**	—	345
Unrealised gains recognised in contract balances	**28**	**28**	(42)	(42)
Revaluation of trading assets and liabilities	**—**	**4**	—	(78)
Financial RRSPs – foreign exchange differences and changes in forecast payments	**—**	**(39)**	—	(30)
Net post-retirement scheme financing (income)/costs	**—**	**(3)**	—	9
Fair value adjustments relating to parent company shares held under trust	**—**	**(139)**	—	—
	55	**(825)**	(198)	116

3 Revenue

The Group's revenue is analysed as follows

	2006 £m	2005 £m
Revenue from sale of original equipment	**3,354**	3,061
Revenue from aftermarket services	**3,802**	3,542
Total revenue	**7,156**	6603

4 Operating profit and profit before taxation

	2006 £m	2005 £m
After crediting		
RRSP receipts – credited to other operating income	**57**	60
Operating lease rentals receivable – credited within revenue from aftermarket services	**30**	39
After charging		
Amortisation of certification costs	**5**	9
Amortisation of development costs	**16**	13
Amortisation of recoverable engine costs	**30**	32
Amortisation of other intangible assets	**9**	5
Depreciation and impairment of owned property plant and equipment[1]	**153**	187
Depreciation of property, plant and equipment held under finance leases[1]	**8**	8
Operating lease rentals payable – hire of plant and equipment	**62**	58
– hire of other assets	**23**	19
Research and development expenditure	**370**	282
RRSP payments – included in cost of sales	**162**	146

[1] Including appropriate amounts charged to inventories

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

	2006 £m	2005 £m
Fees payable to the Company s auditors for the audit of the Company's annual financial statements	**1.6**	1 5
Fees payable to the Company's auditors and its associates for other services		
The audit of the Company s subsidiaries pursuant to legislation	**1.8**	1 8
Other services pursuant to legislation	**0.2**	0.2
Other services relating to taxation	**0 4**	0 5
All other services	**0.3**	0 9
	4.3	4 9
Fees payable in respect of the Group's pension schemes		
Audit	**0 1**	0 1
Other services relating to taxation	**0 1**	—

5 Net financing income/(costs)

	2006 £m	2006 Underlying financing costs £m	2005[1] £m	2005[1] Restated Underlying financing costs £m
Interest receivable	**82**	***82***	65	*65*
Fair value gains on foreign currency contracts (note 19)	**696**	—	—	—
Financial RRSPs – foreign exchange differences and changes in forecast payments[2]	**39**	—	30	—
Fair value gains on commodity derivatives (note 19)	**34**	—	54	—
Expected return on post-retirement scheme assets (note 22)	**343**	—	312	—
Net foreign exchange gains	—	—	11	*1*
Fair value adjustments relating to parent company shares held under trust	**139**	—	—	—
Other financing income	**2**	***2***	3	*3*
Financing income	**1,335**	***84***	475	*69*
Interest payable	**(100)**	***(100)***	(104)	*(104)*
Fair value losses on foreign currency contracts (note 19)	—	—	(399)	—
Financial charge relating to financial RRSPs	**(27)**	***(27)***	(43)	*(43)*
Interest on post retirement scheme liabilities (note 22)	**(340)**	—	(321)	—
Net foreign exchange losses	**(31)**	—	—	—
Financing costs	**(498)**	***(127)***	(867)	*(147)*
Net financing income/(costs)	**837**	***(43)***	(392)	*(78)*

Analysed as:

Net interest payable	**(18)**	***(18)***	(39)	*(39)*
Net post-retirement scheme financing income/(costs)	**3**	—	(9)	—
Net other financing income/(costs)	**852**	***(25)***	(344)	*(39)*
Net financing income/(costs)	**837**	***(43)***	(392)	*(78)*

[1] In 2005 fair value adjustments relating to parent company shares held under trust were recognised in the income statement. Following amendments to IAS 39 effective in 2006, changes in fair value of financial assets classified as assets held for sale are recognised in equity until the shares are disposed of when amounts previously recorded in equity are recognised in the income statement. Accordingly £121m recognised in net financing costs in 2005 has been reclassified to the consolidated statement of recognised income and expense. The related deferred tax balance of £36m has also been transferred to the consolidated statement of recognised income and expense. There is no net effect on the consolidated balance sheet.

[2] In 2005 these amounts were offset against financial charges relating to financial RRSPs.

6 Taxation

	UK		Overseas		Total	
	2006 £m	Restated* 2005 £m	2006 £m	2005 £m	2006 £m	Restated 2005 £m
Current tax						
Current tax charge for the year	**51**	25	**66**	63	**117**	88
Less double tax relief	**(47)**	(25)	**—**	—	**(47)**	(25)
	4	—	**66**	63	**70**	63
Adjustments in respect of prior years	**(2)**	(3)	**(6)**	(4)	**(8)**	(7)
	2	(3)	**60**	59	**62**	56
Deferred tax						
Deferred tax charge/(credit) for the year	**296**	57	**33**	(2)	**329**	55
Adjustments in respect of prior years	**1**	3	**5**	12	**6**	15
	297	60	**38**	10	**335**	70
Recognised in the income statement	**299**	57	**98**	69	**397**	126
Other tax charges/(credits)						
Recognised in the statement of recognised income and expense – current tax					**—**	—
– deferred tax					**43**	186
Recognised directly in equity – current tax					**(18)**	—
– deferred tax					**(58)**	(20)

Deferred taxation balances are analysed in note 20

	2006 £m	2005 £m
Tax reconciliation		
Profit before taxation	**1,537**	463
Share of profits of joint ventures	**(47)**	(46)
Profit before taxation excluding joint ventures	**1,490**	417
Nominal tax charge at UK corporation tax rate **30%** (2005 30%)	**447**	125
UK R&D credit	**(19)**	(18)
Other items	**(29)**	11
Adjustments in respect of prior years	**(2)**	8
	397	126
Analysis of taxation charge		
Underlying items	**190**	166
Non underlying items	**207**	(40)
	397	126

* See note 5

7 Employee information

	2006 Number	2005 Number
Average weekly number of Group employees during the year		
United Kingdom	**22,500**	21,300
Overseas	**14,800**	14,300
	37,300	35,600
Civil aerospace [1]	**21,800**	20,450
Defence aerospace	**5,400**	5,100
Marine	**7,400**	7 200
Energy [1]	**2,700**	2,850
	37,300	35,600

	£m	£m
Group employment costs [2]		
Wages and salaries	**1,456**	1,320
Social security costs	**158**	138
Share-based payments (note 26)	**36**	26
Pensions and other post-retirement benefits (note 22)	**145**	132
	1,795	1 616

[1] Financial services are now incorporated in civil aerospace and energy - see note 2
[2] Remuneration of key management personnel is shown in note 30

8 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Other £m	Total £m
Cost:						
At January 1, 2005 as previously reported	759	274	311	229	—	1,573
Reclassification of software from property plant and equipment [1]	—	—	—	—	28	28
At January 1, 2005 (restated)	759	274	311	229	28	1,601
Exchange adjustments	(8)	—	—	—	—	(8)
Additions	—	10	70	36	16	132
At January 1 2006 (restated)	**751**	**284**	**381**	**265**	**44**	**1,725**
Exchange adjustments	**(23)**	**—**	**—**	**—**	**—**	**(23)**
Additions	**—**	**91**	**41**	**64**	**29**	**225**
Acquisition of business	**7**	**—**	**—**	**—**	**3**	**10**
Disposals	**—**	**(1)**	**—**	**—**	**(6)**	**(7)**
At December 31 2006	**735**	**374**	**422**	**329**	**70**	**1,930**
Accumulated amortisation and impairment:						
At January 1, 2005 as previously reported	—	129	103	114	—	346
Reclassification of software from property, plant and equipment [1]	—	—	—	—	5	5
At January 1 2005 (restated)	—	129	103	114	5	351
Provided during the year (charged to cost of sales)	—	9	13	32	5	59
At January 1 2006 (restated)	**—**	**138**	**116**	**146**	**10**	**410**
Provided during the year (charged to cost of sales)	**—**	**5**	**16**	**30**	**9**	**60**
At December 31, 2006	**—**	**143**	**132**	**176**	**19**	**470**
Net book value at December 31, 2006	**735**	**231**	**290**	**153**	**51**	**1,460**
Net book value at December 31, 2005 (restated)	751	146	265	119	34	1,315
Net book value at January 1, 2005 (restated)	759	145	208	115	23	1,250
Net book value at January 1, 2005 as previously reported	759	145	208	115	—	1,227

[1] External software purchases were previously included within property, plant and equipment. Following a review in 2006 it was concluded that certain of these items should more properly in accordance with IAS 38 Intangible Assets, be classified as intangible assets. Accordingly, software with a net book value at December 31 2005 of £34 million (January 1 2005 £23 million) has been reclassified from property plant and equipment to intangible assets. There is no change to the amortisation policy in respect of these assets, being on a straight-line basis over a maximum of five years.

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	2006 £m	2005 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**186**	190
Commercial marine – arising from the acquisition of Vickers plc	Marine	**470**	482
Energy – arising from the acquisition of Cooper Energy Systems	Energy	**55**	61
Other	Various	**24**	18

Goodwill has been tested for impairment during 2006 on the following basis

- The carrying value of goodwill has been assessed by reference to value in use Values in use have been estimated using cash flows from the most recent forecasts prepared by management Given the long-term nature of the business in which the Group operates, these typically forecast the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate
- The key assumptions on which the cash flow projections for the most recent forecast are based are discount rates, growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs.
- The pre-tax cash flow projections have been discounted at 12 75 per cent, based on the Group's weighted average cost of capital

9 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, 2005 as previously reported	535	1,968	225	175	2,903
Reclassification of software to intangible assets [1]	—	(26)	—	(2)	(28)
At January 1, 2005 (restated)	535	1,942	225	173	2,875
Exchange adjustments	9	36	20	3	68
Additions	20	70	9	133	232
On disposals of businesses	—	(5)	—	—	(5)
Reclassifications	23	76	—	(99)	—
Disposals/write-offs	—	(166)	(42)	—	(208)
At January 1, 2006 (restated)	**587**	**1,953**	**212**	**210**	**2,962**
Exchange adjustments	**(16)**	**(51)**	**(17)**	**(4)**	**(88)**
Additions	**4**	**78**	**44**	**177**	**303**
On acquisitions of businesses	—	**2**	—	—	**2**
Reclassifications	**28**	**97**	—	**(125)**	—
Disposals/write-offs	**(16)**	**(83)**	**(84)**	**(1)**	**(184)**
At December 31, 2006	**587**	**1,996**	**155**	**257**	**2,995**
Accumulated depreciation and impairment					
At January 1 2005 as previously reported	115	1,024	92	—	1,231
Reclassification of software to intangible assets [1]	—	(5)	—	—	(5)
At January 1 2005 (restated)	115	1,019	92	—	1,226
Exchange adjustments	4	24	9	—	37
Provided during the year [2]	22	149	24	—	195
On disposals of businesses	—	(4)	—	—	(4)
Disposals/write-offs	—	(122)	(19)	—	(141)
At January 1, 2006 (restated)	**141**	**1,066**	**106**	—	**1,313**
Exchange adjustments	**(5)**	**(33)**	**(9)**	—	**(47)**
Impairment adjustment [3]	—	—	**(10)**	—	**(10)**
Provided during the year [2]	**22**	**139**	**10**	—	**171**
Disposals/write-offs	**(8)**	**(76)**	**(54)**	—	**(138)**
At December 31, 2006	**150**	**1,096**	**43**	—	**1,289**
Net book value at December 31, 2006	**437**	**900**	**112**	**257**	**1,706**
Net book value at December 31, 2005 (restated)	446	887	106	210	1,649
Net book value at January 1, 2005 (restated)	420	923	133	173	1,649
Net book value at January 1, 2005 as previously reported	420	944	133	175	1,672

[1] See note 8

[2] Includes impairment charge of **£nil** (2005 £11m) relating to the write-down of aircraft to values provided by independent aircraft appraisers.

[3] Impairment charge reversal of **£10m** (2005 nil) relating to aircraft referred to in footnote 2 as a result of improved lease terms and values provided by independent aircraft appraisers.

9 **Property, plant and equipment** continued

Property plant and equipment includes.

	2006 £m	2005 £m
Net book value of finance leased assets		
Land and buildings	**9**	10
Plant and equipment	**21**	28
Aircraft and engines	**—**	3
Assets held for use in operating leases		
Cost	**148**	196
Depreciation	**(42)**	(93)
Net book value	**106**	103
Non-depreciable land	**92**	96
Land and buildings at net book value comprise		
Freehold	**406**	416
Long leasehold	**15**	14
Short leasehold	**16**	16
	437	446
Capital expenditure commitments – contracted but not provided for	**91**	147
Net book value of assets held as security for liabilities	**48**	49
Cost of fully depreciated assets	**420**	399

10 Investments – joint ventures

	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m
At January 1, 2005	125	79	7	211
Exchange adjustments	4	5	—	9
Additions	2	—	11	13
Taxation paid by the Group	—	3	—	3
Share of retained profit	—	11	—	11
At January 1, 2006	**131**	**98**	**18**	**247**
Exchange adjustments	**(4)**	**(13)**	—	**(17)**
Additions	**8**	—	**3**	**11**
Taxation paid by the Group	—	**2**	—	**2**
Impairment	**(21)**	**17**	**(6)**	**(10)**[1]
Share of retained profit	—	**13**	—	**13**
Disposals	**(4)**	**(1)**	**(1)**	**(6)**[2]
At December 31, 2006	**110**	**116**	**14**	**240**

[1] Impairment charge of £10m recognised to reflect the write down of the Group's investment in Pembroke Group to its recoverable amount of £1m. In addition, previous impairment charges in respect of Pembroke Group, which were all charged against share of post acquisition reserves, have been reallocated

[2] Includes £5m for Data Systems & Solutions. The remaining 50 per cent of this joint venture was acquired during the year and as such it has been included in the consolidated results of the Group from the date of the transaction.

Investments in joint ventures are represented by

	2006 £m	2005 £m
Share of aggregate assets		
Non-current assets	**578**	671
Current assets	**645**	559
Share of aggregate liabilities [3]		
Non-current liabilities	**(551)**	(522)
Current liabilities	**(439)**	(465)
Goodwill	**7**	4
	240	247
[3] Liabilities include borrowings of	**(358)**	(480)

	2006 £m	2005 £m
Share of income	**82**	80
Share of interest	**(23)**	(24)
Share of taxation	**(12)**	(10)
	47	46
Dividend received	**(44)**	(35)
Share of retained profit	**3**	11

The tax charge on joint venture profits represents an effective tax rate of **20 per cent** (2005 18 per cent), an increase of two 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 89 and 90

11 Investments – other

	Unlisted investments at cost £m	Parent company shares held under trust £m	Total £m
At January 1, 2005	57	184	241
Additions	1	—	1
Fair value adjustments	—	121	121
Amortisation/disposals	(6)	(12)	(18)
At January 1 2006	**52**	**293**	**345**
Additions	**1**	**47**	**48**
Fair value adjustments	**—**	**2**	**2**
Amortisation/disposals	**(2)**	**(268)**	**(270)**
At December 31, 2006	**51** [1]	**74** [2]	**125**

[1] The fair values of these available for sale assets are not significantly different to cost.
[2] Held at fair value

12 Inventory

	2006 £m	2005 £m
Raw materials	**156**	151
Work in progress	**766**	487
Long-term contracts work in progress	**139**	137
Finished goods	**771**	808
Payments on account	**31**	47
	1,863	1,630
Progress payments received against:[1]		
Long-term contracts	**(18)**	(13)
Other inventory	**(398)**	(308)
	1,447	1,309

Inventories stated at net realisable value	**116**	112
Amount of inventory write-down	**46**	30
Reversal of inventory write-down	**7**	3
[1] Includes payments received from joint ventures	**16**	14

13 Trade and other receivables

	2006 £m	2005 £m
Trade receivables	**864**	738
Amounts recoverable on contracts	**820**	698
Amounts owed by joint ventures	**241**	215
Other receivables	**308**	226
Prepayments and accrued income	**232**	170
	2,465 [1]	2,047 [1]

[1] Trade and other receivables expected to be recovered in more than one year

Trade receivables	**12**	5
Amounts recoverable on contracts	**624**	526
Amounts owed by joint ventures	**26**	27
Other receivables	**65**	58
Prepayments and accrued income	**99**	30
	826	646

14 Cash and cash equivalents

	2006 £m	2005 £m
Cash at bank and in hand	**756**	337
Short-term deposits	**1,428**	1 419
	2,184	1 756
Overdrafts (note 15)	**(14)**	(12)
Cash and cash equivalents per cash flow statement (page 22)	**2,170**	1,744
Cash held as collateral against third party obligations	**58**	63

15 Borrowings – amounts falling due within one year

	2006 £m	2005 £m
Overdrafts	**14**	12
Bank loans	**42**	55
Obligations under finance leases (note 28)	**7**	8
6 3/8% Notes 2007 €500m [1]	**337**	—
	400	75

[1] These notes are the subject of a currency swap agreement under which counterparties have undertaken to pay amounts at a fixed rate of interest and exchange in consideration for amounts payable by the Group at a variable rate of interest and at a fixed exchange rate

16 Trade and other payables – current

	2006 £m	2005 £m
Payments received on account [1]	**657**	362
Trade payables – current	**654**	537
Amounts owed to joint ventures	**167**	162
Amounts owed to parent undertaking	**554**	829
Other taxation and social security	**50**	62
Other payables	**731**	680
Accruals and deferred income	**1,031**	886
	3,844	3,518
[1] Includes payments received from joint ventures	**128**	115

17 Borrowings – amounts falling due after one year

	2006 £m	2005 £m
Unsecured		
Bank loans	3	4
6 ⅞% Notes 2007 €500m	—	354
7 ⅜% Notes 2016 £200m	200	200
5.84% Notes 2010 US$187m [1]	102	107
6.38% Notes 2013 US$230m [1]	121	134
6.55% Notes 2015 US$83m [1]	38	49
4 ½% Notes 2011 €750m [2]	494	524
Other loan 2008 (interest rate nil)	1	1
Secured		
Bank loans [3]	24	71
Obligations under finance leases payable [4] (note 28)		
Between one and two years	4	5
Between two and five years	2	8
After five years	1	1
	990	1,458
Repayable		
Between one and two years – by instalments	6	49
– otherwise	—	354
Between two and five years – by instalments	4	11
– otherwise	620	—
After five years – by instalments	1	29
– otherwise	359	1,015
	990	1,458

[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. Until October 5, 2005 the borrowing was included in a net investment hedging relationship. From October 6, 2005 the borrowing has been included in a fair value hedging relationship in respect of the foreign exchange risk.

[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.

18 Trade and other payables – non-current

	2006 £m	2005 £m
Payments received on account [1]	171	214
Amounts owed to joint ventures	31	30
Other payables	200	104
Accruals and deferred income	425	302
	827	650
[1] Includes payments received from joint ventures	62	13

19 Other financial assets and liabilities

Details of the Groups policies on the use of financial instruments are given in note 27 and in the accounting policies on pages 25 to 28

The carrying values of other financial assets and liabilities held by the Group are as follows

	Foreign exchange contracts £m	**Commodity contracts £m**	**Interest rate contracts £m**	**Financial RRSPs £m**	**Total £m**
					2006
Assets	**578**	**39**	**27**	**—**	**644**
Liabilities	**(24)**	**—**	**(12)**	**(324)**	**(360)**
	554	**39**	**15**	**(324)**	**284**

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
					2005
Assets	364	31	69	—	464
Liabilities	(136)	—	(7)	(423)	(566)
	228	31	62	(423)	(102)

Other financial liabilities are analysed as follows.

	2006 £m	2005 £m
Current liabilities	**(24)**	(227)
Non-current liabilities	**(336)**	(339)
	(360)	(566)

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$, the Group 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 financial instruments

	2006			2005		
	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	**228**	**538**		986	986[1]	
Fair value changes to derivative contracts not in accounting hedging relationships [2]	**696**	**—**	**696**	(399)	—	(399)
Fair value changes to fair value hedges [2]	**(26)**	**—**	**(26)**	5	—	5
Fair value of contracts settled	**(344)**	**—**	**—**	(364)	—	—
Transferred to revenue	**—**	**(284)**	**284**	—	(448)[1]	448
At December 31	**554**	**254**		228	538	

[1] Additionally £10m relating to derivatives settled prior to transition to IFRS was included in the transition hedging reserve and transferred to the income statement.
[2] Included in financing income/(costs)

19 Other financial assets and liabilities continued

Commodity financial instruments

	2006 Total £m	2006 Included in transition hedging reserve £m	2006 Included in income statement £m	2005 Total £m	2005 Included in transition hedging reserve £m	2005 Included in income statement £m
At January 1	**31**	**5**		9	9	
Fair value changes to derivative contracts not in accounting hedging relationships[1]	**34**	**—**	**34**	54	—	54
Fair value of contracts settled	**(26)**	**—**	**—**	(32)	—	—
Transferred to cost of sales	**—**	**(5)**	**5**	—	(4)	4
At December 31	**39**	**—**		31	5	

[1] Included in financing income/(costs)

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

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

Interest rate financial instruments

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

2005	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in cash flow hedging reserve £m	Included in income statement £m
At January 1	110	121	(11)	(3)	
Changes deemed effective for cash flow hedge accounting purposes	—	—	—	—	—
Changes deemed ineffective for cash flow hedge accounting purposes[1]	4	—	4	—	4
Other changes[1]	(52)	(52)	—	—	(52)
Transferred to interest payable	—	—	—	3	(3)
At December 31	62	69	(7)	—	

[1] Included in financing income/(costs)

19 Other financial assets and liabilities 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

	2006 £m	2005 £m
At January 1	**423**	468
Cash paid to partners	**(87)**	(58)
Financing charge [1]	**27**	43
Excluded from underlying profit:		
Exchange adjustments [1]	**(42)**	56
Restructuring of financial RRSP agreements and changes in forecast payments [1]	**3**	(86)
At December 31	**324**	423

[1] Included in financing income/(costs)

Total return swaps

The Group entered into forward contracts to purchase its own shares for the purposes of meeting obligations to issue shares under employee share schemes. Under IAS 32, these contracts were categorised as financial liabilities and accounted for on the amortised cost basis. These contracts were settled during 2005

	2005 £m
At January 1	142
On collapse of forward purchase contracts	(141)
Transferred to other financing charges	(1)
At December 31	—

20 Deferred taxation

	£m
At January 1, 2005	72
Amount charged to income statement (as restated, see note 5)	(70)
Amount credited to statement of recognised income and expense (as restated, see note 5)	186
Amount credited through equity	20
Exchange movements	5
At January 1, 2006	**213**
Amount charged to income statement	**(335)**
Amount charged to statement of recognised income and expense	**(43)**
Amount credited to equity	**58**
On acquisition of business	**1**
Exchange movements	**(5)**
At December 31 2006	**(111)**

The analysis of the deferred tax position is as follows

	2006 £m	2005 £m
Property plant and equipment	**(145)**	(138)
Other temporary differences	**(278)**	(267)
Pensions and other post-retirement benefits	**314**	505
Foreign exchange and commodity financial assets and liabilities	**(183)**	(77)
Losses	**117**	126
Advance corporation tax	**64**	64
	(111)	213
Analysed as		
Deferred tax assets	**141**	391
Deferred tax liabilities	**(252)**	(178)
	(111)	213
Deferred tax not recognised on unused tax losses and other items[1]	**154**	146

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

In addition there are temporary differences of **£593m** (2005 £467m) 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

21 Provisions

	At December 31 2005 £m	Exchange adjustments £m	Acquisition/ disposal of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2006 £m
Warranties and guarantees	162	(6)	—	(15)	36	(38)	139
Contract loss	43	(1)	—	—	13	(11)	44
Customer financing	90	1	—	—	14	(7)	98
Insurance	38	—	—	(1)	11	(11)	37
Restructuring	9	—	—	(3)	2	(5)	3
Other	19	(1)	3	(6)	3	(4)	14
	361	(7)	3	(25)	79[1]	(76)	335

[1] Includes £1m for amounts discounted

Analysed as

	2006 £m	2005 £m
Current liabilities	146	138
Non-current liabilities	189	223
	335	361

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 15 The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 29 Based on the assumptions used to estimate the customer finance provision, it is estimated that the provision will be utilised as follows

	2006 £m	2005 £m
Potential claims with specific claim dates		
In one year or less	—	—
In more than one year but less than five years	19	17
In more than five years	14	2
Potential claims that may arise at any time by date of expiry of the guarantee		
Up to one year	35	15
Up to five years	11	23
Thereafter	19	33
	98	90

22 Post-retirement benefits

Defined benefit schemes

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

Overseas defined benefit schemes are a mixture of funded and unfunded plans Additionally in the US and to a lesser extent in some other countries, the Group's employment practices include the provision of healthcare and life insurance benefits for retired employees These schemes are unfunded

The valuations of the schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2006 The most recent funding valuations of the main UK schemes were

Rolls-Royce Pension Fund – March 31, 2003
Rolls Royce Group Pension Scheme – April 5, 2004
Vickers Group Pension Scheme – March 31, 2004

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

	2006		2005	
	UK schemes %	**Overseas schemes %**	UK schemes %	Overseas schemes %
Rate of increase in salaries	**44**	**36**	44	34
Rate of increase of pensions in payment	**29**[1]	**0.2**	26	02
Discount rate	**51**	**56**	47	5.3
Expected rate of return on scheme assets	**66**	**70**	62	70
Inflation assumption	**29**	**24**	29	26

[1] Benefits accruing after April 5 2005 are assumed to increase in payment at a rate of 2.3 per cent.

The mortality assumptions adopted for the UK pension schemes are derived from the PA92 actuarial tables 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 22.0 years
Future pensioner	19.5 years to 23.9 years

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

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

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

22 Post-retirement benefits continued

Amounts recognised in the income statement

	2006 UK schemes £m	2006 Overseas schemes £m	2006 Total £m	2005 UK schemes £m	2005 Overseas schemes £m	2005 Total £m
Operating cost						
Current service cost	**102**	**28**	**130**	79	22	101
Past service cost	**—**	**2**	**2**	—	8	8
	102	**30**	**132**	79	30	109
Financing (income)/costs						
Expected return on assets	**(328)**	**(15)**	**(343)**	(298)	(14)	(312)
Interest on liabilities	**310**	**30**	**340**	295	26	321
	(18)	**15**	**(3)**	(3)	12	9
Total income statement charge	**84**	**45**	**129**	76	42	118

The operating cost is charged as follows

	2006 £m	2005 £m
Cost of sales	**93**	77
Commercial and administrative costs	**30**	25
Research and development	**9**	7

Actuarial gains of **£602m** (2005 £282m losses) have been reported in the statement of recognised income and expense Cumulative actuarial gains from January 1, 2004 reported in the statement of recognised income and expense are **£313m** (2005 £289m losses)

Amounts recognised in the balance sheet

	2006 UK schemes £m	2006 Overseas schemes £m	2006 Total £m	2005 UK schemes £m	2005 Overseas schemes £m	2005 Total £m
Present value of funded obligations	**(6,338)**	**(271)**	**(6,609)**	(6,661)	(296)	(6,957)
Fair value of scheme assets	**5,673**	**233**	**5,906**	5,343	220	5,563
	(665)	**(38)**	**(703)**	(1,318)	(76)	(1,394)
Present value of unfunded obligations	**—**	**(290)**	**(290)**	—	(263)	(263)
Irrecoverable surplus	**—**	**(2)**	**(2)**	—	(2)	(2)
Net liability recognised in the balance sheet	**(665)**	**(330)**	**(995)**	(1,318)	(341)	(1 659)

Changes in present value of defined benefit obligations

	2006 UK schemes £m	2006 Overseas schemes £m	2006 Total £m	2005 UK schemes £m	2005 Overseas schemes £m	2005 Total £m
At January 1	**(6,661)**	**(559)**	**(7,220)**	(5,688)	(419)	(6,107)
Exchange adjustments	**—**	**65**	**65**	—	(49)	(49)
Current service cost	**(102)**	**(28)**	**(130)**	(79)	(22)	(101)
Past service cost	**—**	**(2)**	**(2)**	—	(8)	(8)
Finance cost	**(310)**	**(30)**	**(340)**	(295)	(26)	(321)
Contributions by employees	**(39)**	**(2)**	**(41)**	(35)	(1)	(36)
Net benefits paid out	**279**	**18**	**297**	253	13	266
Actuarial gains/(losses)	**495**	**(25)**	**470**	(817)	(53)	(870)
Settlements/curtailment	**—**	**2**	**2**	—	6	6
At December 31	**(6,338)**	**(561)**	**(6,899)**	(6 661)	(559)	(7,220)

The defined benefit obligation relating to post retirement medical benefits would increase by £35m if the healthcare trend rate increases by one per cent, and reduce by £28m if it decreases by one per cent. The pension expense relating to post-retirement medical benefits, comprising service cost and interest cost, would increase by £4m if the healthcare trend increases by one per cent, and reduce by £3m, if it decreases by one per cent

22 Post-retirement benefits continued

Changes in fair value of scheme assets

	2006			2005		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
At January 1	**5,343**	**218**	**5,561**	4,527	171	4,698
Exchange adjustments	**—**	**(27)**	**(27)**	—	22	22
Expected return on assets	**328**	**15**	**343**	298	14	312
Contributions by employer	**122**	**31**	**153**	146	31	177
Contributions by employees	**39**	**2**	**41**	35	1	36
Benefits paid out	**(279)**	**(18)**	**(297)**	(253)	(13)	(266)
Actuarial gains/(losses)	**120**	**12**	**132**	590	(2)	588
Settlements/curtailment	**—**	**(2)**	**(2)**	—	(6)	(6)
At December 31	**5,673**	**231**	**5,904**	5,343	218	5,561
Actual return on scheme assets			**475**			900

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

	2006		2005	
UK schemes	**Expected rate of return %**	**Market value £m**	Expected rate of return %	Market value £m
Equities	**7.5**	**3,876**	7 1	3,654
Sovereign debt	**4.5**	**629**	4 1	565
Corporate bonds	**4 9**	**1,164**	4 5	978
Other	**5 0**	**4**	4 3	146
	6 6	**5,673**	6 2	5,343

	2006		2005	
Overseas schemes	**Expected rate of return %**	**Market value £m**	Expected rate of return %	Market value £m
Equities	**8.3**	**146**	8 6	131
Corporate bonds	**4 9**	**71**	4.5	72
Other	**5 1**	**16**	4 6	17
	7 0	**233**	7 0	220

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 on individual categories of scheme assets are determined by reference to gilt yields The expectation is that the return from equities and corporate bonds will exceed the return from gilts by three per cent per annum and 0 45 per cent per annum respectively The overall expected rate of return is calculated by weighting the individual returns expected from each asset class in accordance with the actual asset balance in the schemes' investment portfolios

22 Post-retirement benefits continued

History of plans
The history of the plans for the current and prior years is as follows

Balance sheet

	2006 £m	2005 £m	2004 £m
Present value of defined benefit obligations	**(6,899)**	(7,220)	(6,107)
Fair value of scheme assets	**5,904**	5,561	4,698
Deficit	**(995)**	(1,659)	(1,409)

Experience gains/losses

	2006 £m	2005 £m	2004 £m
Actuarial gain on scheme assets	**132**	588	126
Experience gains/(losses) on scheme liabilities	**470**	(870)	(133)
Total amount recognised in the statement of recognised income and expense	**602**	(282)	(7)

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

The Group expects to contribute approximately £185m to its defined benefit schemes in 2007, excluding any additional amounts contributed to address the deficit as discussed in the Chief Executive's review on page 4

Defined contribution schemes

The Group operates a number of defined contribution schemes.

The total expense recognised in the income statement was **£16m** (2005 £14m)

23 Share capital

	Equity ordinary shares of 20p each	Nominal value £m
Authorised		
At January 1, 2005 and December 31, 2006	**2,000,000,000**	**400**
Issued and fully paid		
At January 1 2005 at December 31, 2006	**1,630,996,508**	**326**

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

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

24 Reserves

					2006
	Share premium £m	Transition hedging reserve £m	Cash flow hedging reserve £m	Translation reserve £m	Retained earnings £m
At January 1, 2006	631	379	—	17	(432)
Exchange adjustments	—	—	—	(75)	—
Hedge reserve transfer to income statement	—	(289)	—	—	—
Profit for the year	—	—	—	—	1,144
Actuarial gains	—	—	—	—	602
Movement in fair value of available for sale assets	—	—	—	—	(126)
Share-based payments adjustment	—	—	—	—	40
Related tax movements	—	87	—	—	(54)
At December 31 2006	631	177	—	(58)	1,174

					2005
	Share premium £m	Transition hedging reserve £m	Cash flow hedging reserve £m	Translation reserve £m	Restated* Retained earnings £m
At January 1, 2005	631	703	(3)	(32)	(705)
Exchange adjustments	—	—	—	49	—
Hedge reserve transfer to income statement	—	(462)	3	—	—
Profit for the year	—	—	—	—	340
Actuarial losses	—	—	—	—	(282)
Movement in fair value of available for sale assets	—	—	—	—	121
Share-based payments adjustment	—	—	—	—	26
Related tax movements	—	138	—	—	68
At December 31, 2005	631	379	—	17	(432)

* See note 5

25 Minority interests

	£m
At January 1, 2005	4
Total recognised income and expense for the year	(3)
Sale of shares in subsidiary company to a minority interest	5
At January 1 2006	6
Total recognised income and expense for the year	(4)
Sale of shares in subsidiary company to a minority interest	5
At December 31 2006	7

26 Share-based payments

Share-based payment plans in operation during the year
The Group share-based payment plans relate to shares in the parent Company and the following plans were 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 – CPS) 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 28 countries participate in ShareSave plans through arrangements broadly comparable to the UK plan A small proportion of the ShareSave options are settled in cash

Executive Share Option Plan (ESOP)
This plan involves the grant of market value share options to participants The options are subject to a non-market based performance condition (growth in EPS) The options have a maximum contractual life of ten years There was no grant of executive share options in either 2005 or 2006 Following the introduction of the PSP, it is not intended to grant any further executive share options.

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

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

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

The Group recognised a total expense of **£36m** (2005 £26m)

26 Share-based payments continued

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

PSP	Number of shares awarded 2006 Millions	2005 Millions
Outstanding at January 1	11	6
Awarded during the year	5	5
Forfeited during the year	(1)	—
Vested during the year	—	—
Outstanding at December 31	15	11

	2006		2005	
ShareSave	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
Outstanding at January 1	65	157p	74	130p
Granted during the year	—	—	12	298p
Forfeited during the year	(1)	168p	(1)	139p
Exercised during the year	(9)	140p	(20)	140p
Outstanding at December 31	55	160p	65	157p
Exercisable at December 31	1	141p	—	—

	2006		2005	
ESOP	Number of share options Millions	Weighted average exercise price Pence	Number of share options Millions	Weighted average exercise price Pence
Outstanding at January 1	77	148p	80	149p
Granted during the year	—	—	—	—
Forfeited during the year	(1)	216p	(3)	169p
Exercised during the year	(57)	134p	—	—
Outstanding at December 31	19	188p	77	148p
Exercisable at December 31	6	124p	—	—

Deferred shares under APRA	Number of shares awarded 2006 Millions	2005 Millions
Outstanding at January 1	8	12
Awarded during the year	2	3
Forfeited during the year	—	—
Vested during the year	(5)	(7)
Outstanding at December 31	5	8

Free Shares under SIP	Number of shares awarded 2006 Millions	2005 Millions
Awarded during the year	1	1

Options were exercised on a regular basis during the year The average share price during the year was **439p** (2005 310p)

26 Share-based payments continued

Fair values

The weighted average fair values for PSP awards, ShareSave grants, APRA deferred share awards, and SIP Free Share awards made during the year are as follows

	2006 Pence	2005 Pence
PSP	**494p**	282p
ShareSave – 3 year	**—**	131p
ShareSave – 5 year	**—**	154p
APRA deferred share awards	**448p**	260p
SIP Free Share awards	**462p**	257p

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

PSP awards

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

	2006	2005
Weighted average share price	**444p**	262p
Expected dividends	**7 92p**	7 81p
Volatility	**32%**	34%
Correlation	**19%**	19%
Expected life	**3 years**	3 years
Risk free interest rate	**4.3%**	4 9%

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

ShareSave awards

The fair value of options granted under the ShareSave plan are calculated using a binomial pricing model with the following assumptions (no options were granted in 2006)

	2005
Weighted average share price	351p
Exercise price	298p
Volatility	40%
Expected dividends	7 86p
Expected life [1] – 3 year ShareSave	3 3-3 8 years
– 5 year ShareSave	5 3-5 8 years
Close periods	
From January 1	6 weeks
From July 1	1 month
Risk free interest rate	4 4%

[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

26 Share-based payments continued

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

Fair values of options granted in 2003 and 2004

The charge under IFRS 2 Share-based payments for the current period includes a charge for options granted under the PSP, ShareSave, ESOP and APRA plans during the years ended December 31, 2003 and 2004 with the following grant date fair values.

	2004	2003
PSP awards	249p	—
ShareSave – 3 year grants	—	61p
ShareSave – 5 year grants	—	71p
ESOP	—	22 7p
APRA	220p	—

These fair values were calculated using the following assumptions

	PSP	ShareSave	ESOP
Weighted average share price	233p	173p	79p
Weighted average exercise price		142p	78p
Volatility	35%	43%	43%
Expected dividends	7 61p	7 61p	7 61p
Expected life[1] – 3 year ShareSave		3 15-3 65 years	
– 5 year ShareSave		5 15-5 65 years	
– ESOP			4.5 years
– PSP	3 years		
Correlation	22%		
Close periods			
From January 1		6 weeks	6 weeks
From July 1		1 month	1 month
Risk free interest rate	5 2%	4 6%	4 1%

[1] For the ShareSave options, the binomial pricing model assumes that participants will exercise 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

27 Financial instruments

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.

Risk management policies and hedging activities

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

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

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

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

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

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

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

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

27 Financial instruments continued

Derivative financial instruments

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

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

2005	Nominal amount	Expected maturity: Within one year	Between one and two years	Between two and five years	After five years	Fair value: Assets	Liabilities
Foreign exchange contracts[1]							
Fair value hedges	(280)	—	—	(105)	(175)	5	—
Non-hedge accounted	6 158	2,055	1,883	2,220	—	359	(136)
Interest rate contracts							
Fair value hedges	1 104	—	313	109	682	69	—
Cash flow hedges	124	124	—	—	—	—	—
Non-hedge accounted	115	—	28	63	24	—	(7)
Commodity contracts							
Non-hedge accounted	102	46	33	23	—	31	—
	7,323	2,225	2,257	2,310	531	464	(143)

[1] Positive nominal amounts represent contracts to purchase sterling, negative nominal amounts represent contracts to sell sterling.

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

27 Financial instruments continued

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

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

	2005 Currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Currencies sold forward					
Sterling	—	522	—	17	539
US dollar	6,534	—	293	289	7,116
Euro	—	—	—	176	176
Other	7	25	31	8	71

Other derivative financial instruments are denominated in the following currencies

	2006 £m	2005 £m
Sterling	**22**	24
US dollar	**484**	558
Euro	**813**	813
Other	**—**	50

27 Financial instruments continued

Fair values of financial instruments

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 arms-length transaction Fair values have been determined with reference to available market information at the balance sheet date, using the methodologies discussed below

The carrying amounts and fair values of the Group's financial instruments are as follows.

	2006 Book value £m	**2006 Fair value £m**	2005 Book value £m	2005 Fair value £m
Assets.				
Unlisted non-current asset investments	**51**	**51**	52	52
Parent company shares held under trust	**74**	**74**	293	293
Cash at bank and in hand	**756**	**756**	337	337
Short term deposits and investments	**1,462**	**1462**	1,456	1,456
Trade receivables and similar items	**1,210**	**1,210**	963	963
Other financial assets				
Derivative financial assets	**644**	**644**	464	464
Other non-derivative financial assets	**300**	**300**	258	258
Liabilities				
Trade payables and similar items	**(1,735)**	**(1,735)**	(1,538)	(1,538)
Borrowings – current	**(400)**	**(402)**	(75)	(74)
– non-current	**(990)**	**(1,030)**	(1,458)	(1,530)
Other financial liabilities				
Derivative financial liabilities	**(36)**	**(36)**	(143)	(143)
Financial RRSPs	**(324)**	**(347)**	(423)	(454)
Other non-derivative financial liabilities	**(271)**	**(271)**	(246)	(246)

Unlisted non-current asset investments – These primarily comprise Floating Rate Convertible Loan Stock The conversion conditions are such that fair value approximates to the book value

Parent company shares – Fair value is determined using the market value bid price

Trade receivables, trade payables, short-term investments and cash and cash equivalents – 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

Borrowings, other financial assets and other financial liabilities – Where available, market values have been used to determine fair values. Where market values are not available, 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

27 **Financial instruments** continued

The currency profile of derivative financial instruments is analysed above The non-derivative financial instruments above are denominated in the following currencies

	Sterling £m	US dollar £m	Euro £m	Other £m	2006 Total £m
Assets					
Unlisted non-current investments	**46**	**1**	**2**	**2**	**51**
Parent company shares held under trust	**74**	**—**	**—**	**—**	**74**
Cash at bank and in hand	**104**	**255**	**335**	**62**	**756**
Short-term deposits and investments	**1,284**	**157**	**8**	**13**	**1,462**
Trade receivables and similar items	**270**	**728**	**114**	**98**	**1,210**
Other non-derivative financial assets	**113**	**90**	**44**	**53**	**300**
Liabilities					
Trade payables and similar items	**(890)**	**(512)**	**(236)**	**(97)**	**(1,735)**
Borrowings – current	**(7)**	**(41)**	**(341)**	**(11)**	**(400)**
– non-current	**(206)**	**(285)**	**(498)**	**(1)**	**(990)**
Other financial liabilities					
Financial RRSPs	**—**	**(255)**	**(69)**	**—**	**(324)**
Other non-derivative financial liabilities	**(147)**	**(63)**	**(5)**	**(56)**	**(271)**

	Sterling £m	US dollar £m	Euro £m	Other £m	2005 Total £m
Assets					
Unlisted non-current investments	46	—	2	4	52
Parent company shares held under trust	293	—	—	—	293
Cash at bank and in hand	110	67	87	73	337
Short-term deposits and investments	986	377	84	9	1,456
Trade receivables and similar items	194	633	74	62	963
Other non-derivative financial assets	84	122	19	33	258
Liabilities					
Trade payables and similar items	(731)	(550)	(130)	(127)	(1,538)
Borrowings – current	(8)	(11)	(1)	(55)	(75)
– non-current	(213)	(361)	(882)	(2)	(1,458)
Other financial liabilities					
Financial RRSPs	—	(325)	(98)	—	(423)
Other non-derivative financial liabilities	(178)	(36)	(10)	(22)	(246)

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

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

Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m	2005 Total £m
Sterling	—	(2)	1	2	1
US dollar	1	—	4	1	6
Euro	1	—	—	—	1
Other	2	6	5	13	26

27 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

							2006
			Period in which interest rate reprices				
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments[1]	4.8374%	34	15	5	—	8	6
Cash at bank and in hand[2]		756	756	—	—	—	—
Short-term deposits[3]		1,428	1,428	—	—	—	—
Unsecured bank loans							
€6m floating rate loan	EURIBOR +1 2	(4)	(4)	—	—	—	—
€5m fixed rate loan	4 1200%	(3)	—	(3)	—	—	—
Overdrafts[4]		(14)	(14)	—	—	—	—
Effect of other interest rate swaps	1 1392%	—	78	—	(21)	(35)	(22)
Other unsecured							
Other loan 2008 (interest rate nil)	0 0000%	(1)	—	—	(1)	—	—
Unsecured bond issues							
6 ⅜% Notes 2007 €500m	6.3750%	(337)	(337)	—	—	—	—
7 ⅜% Notes 2016 £200m	7.3750%	(200)	—	—	—	—	(200)
5 84% Notes 2010 US$187m	5.8400%	(102)	—	—	—	(102)	—
After effect of interest rate swaps	USD LIBOR + 1 159	—	(102)	—	—	102	—
6 38% Notes 2013 US$230m	6.3800%	(121)	—	—	—	—	(121)
After effect of interest rate swaps	USD LIBOR + 1.26	—	(121)	—	—	—	121
6 55% Notes 2015 US$83m	6.5500%	(38)	—	—	—	—	(38)
After effect of interest rate swaps	USD LIBOR + 1 24	—	(38)	—	—	—	38
4 ½% Notes 2011 €750m	4.5000%	(494)	—	—	—	(494)	—
After effect of interest rate swaps	GBP LIBOR + 0 911	—	(494)	—	—	494	—
Secured bank loans							
US$ floating rate loan	USD LIBOR + 0 97	(62)	(62)	—	—	—	—
Other secured							
Obligations under finance leases payable	9 9153%	(14)	(4)	(3)	(4)	(2)	(1)
		828	1,101	(1)	(26)	(29)	(217)

27 Financial instruments continued

Interest rate risk continued

	Effective interest rate %	Total £m	2005 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]	4.8700%	37	14	7	—	9	7
Cash at bank and in hand [2]		337	337	—	—	—	—
Short-term deposits [3]		1,419	1,419	—	—	—	—
Unsecured bank loans							
Canadian $100m floating rate loan	CAD LIBOR +0.55	(50)	(50)	—	—	—	—
€8m floating rate loan	EURIBOR +1.178	(6)	(6)	—	—	—	—
Overdrafts [4]		(12)	(12)	—	—	—	—
Effect of other interest rate swaps	2.0933%	—	115	—	(28)	(63)	(24)
Other unsecured							
Other loan 2008 (interest rate nil)	0.0000%	(1)	—	—	—	(1)	—
Unsecured bond issues							
6 ⅜% Notes 2007 €500m	6.3750%	(354)	—	—	(354)	—	—
After effect of interest rate swaps	GBP LIBOR + 0.866	—	(354)	—	354	—	—
7 ⅜% Notes 2016 £200m	7.3750%	(200)	—	—	—	—	(200)
5.84% Notes 2010 US$187m	5.8400%	(107)	—	—	—	(107)	—
After effect of interest rate swaps	USD LIBOR + 1.159	—	(107)	—	—	107	—
6.38% Notes 2013 US$230m	6.3800%	(134)	—	—	—	—	(134)
After effect of interest rate swaps	USD LIBOR + 1.26	—	(134)	—	—	—	134
6.55% Notes 2015 US$83m	6.5500%	(49)	—	—	—	—	(49)
After effect of interest rate swaps	USD LIBOR + 1.24	—	(49)	—	—	—	49
4 ½% Notes 2011 €750m	4.5000%	(524)	—	—	—	—	(524)
After effect of interest rate swaps	GBP LIBOR + 0.911	—	(524)	—	—	—	524
Secured bank loans							
US$ floating rate loan	USD LIBOR + 0.98	(74)	(74)	—	—	—	—
After effect of interest rate swaps	5.1540%	—	74	(74)	—	—	—
Other secured							
Obligations under finance leases payable	6.8603%	(22)	(4)	(4)	(5)	(8)	(1)
		260	645	(71)	(33)	(63)	(218)

[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.

27 Financial instruments continued

Maturity analysis

The maturity analysis of the Group's interest bearing financial liabilities is as follows

	2006 £m	2005 £m
In one year or less or on demand	400	75
In more than one year but not more than two years	6	403
In more than two years but not more than five years	624	11
In more than five years	360	1,044
	1,390	1 533

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

	2006 £m	2005 £m
Expiring within one year	—	—
Expiring in one to two years	—	—
Expiring thereafter [1]	450	250
	450	250

[1] A new £200m facility was agreed in 2006 with the European Investment Bank

28 Operating and finance leases

Operating leases

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

	2006 £m	2005 £m
Within one year	78	82
Between one and five years	213	270
After five years	106	134
	397	486

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

	2006 £m	2005 £m
Within one year	8	14
Between one and five years	13	23
After five years	4	7
	25	44

The Group acts as lessee and lessor for both land and buildings and gas turbine engines, and acts as lessee for some plant and machinery

- Sublease payments of **£23m** (2005 £16m) and sublease receipts of **£11m** (2005 £15m) were recognised in the income statement in the period
- Purchase options exist on aero engines with the period to the purchase option date varying between 4-8 years
- Escalation clauses exist on some leases and are linked to LIBOR
- The total future minimum sublease payments expected to be made is **£23m** (2005 £16m) and sublease receipts expected to be received is **£5m** (2005 £2m)

Finance leases

Finance lease liabilities are payable as follows

	2006			2005		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Within one year	9	2	7	10	2	8
Between one and five years	8	2	6	17	4	13
After five years	1	—	1	1	—	1
	18	4	14	28	6	22

There were no contingent rents recognised as an expense in the period (2005 £nil)

Future minimum sublease receipts of **£nil** (2005 £nil) are expected under non-cancellable subleases.

29 Contingent liabilities

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

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

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions, at December 31 2006 amounted to **$1,109m, £566m** (2005 $1 097m, £638m) Taking into account the net realisable value of the relevant security including unrestricted cash collateral of **$114m, £58m** (2005 $108m, £63m), the discounted value of the net contingent liabilities in respect of financing arrangements on all delivered aircraft amounted to **$243m, £124m** (2005 $259m, £150m) Sensitivity calculations are complex, but for example, if the value of the relevant security was reduced by 20 per cent, a net contingent liability with a discounted value of approximately **$361m, £184m** (2005 $363m, £211m) would result There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time

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

30 Related party transactions

	2006 £m	2005 £m
Sales of goods and services to joint ventures	**1,252**	986
Purchases of goods and services from joint ventures	**(830)**	(643)
Operating lease payments to joint ventures	**(43)**	(38)
Guarantees provided to joint ventures	**—**	2
Dividends received from joint ventures	**44**	35
RRSP receipts from joint ventures	**7**	3
Other income received from joint ventures	**12**	14

The aggregated balances with joint ventures are shown in notes 12, 13, 16 and 18

Transactions with Group pension schemes are shown in note 22

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

	2006 £m	2005 £m
Salaries and short-term benefits	**10**	10
Post-retirement schemes	**2**	2
Share-based payments	**5**	3
	17	15

31 Acquisitions and disposals

During the year the Group acquired Data Systems & Solutions (previously a joint venture) as summarised below

	Total £m
Intangible assets	10
Property, plant and equipment	2
Deferred tax assets	1
Inventory	2
Trade and other receivables	18
Cash and cash equivalents	5
Trade and other payables	(21)
Borrowings – current liabilities	(1)
Provisions	(3)
Borrowings – non current liabilities	(3)
Net assets	**10**
Financed by	
Share of net assets transferred from joint venture	5
Net cash outflow per cash flow statement	5
	10

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

During the year the Group received £1m of deferred consideration in respect of a disposal recognised in prior years.

Company

Financial statements

December 31, 2006

Company balance sheet

At December 31, 2006

	Notes	2006 £m	Restated[1] 2005 £m
Fixed assets			
Intangible assets	3	**270**	174
Tangible assets	4	**990**	900
Investments – subsidiary undertakings	5	**1,713**	1,766
Investments – joint ventures	6	**74**	65
Investments – other	7	**120**	340
		3,167	3,245
Current assets			
Stocks	8	**920**	797
Debtors – amounts falling due within one year	9	**1,073**	997
Debtors – amounts falling due after one year	10	**387**	356
Other financial assets	16	**654**	478
Short-term deposits and investments	11	**1,249**	1,125
Cash at bank and in hand		**724**	107
		5,007	3,860
Creditors – amounts falling due within one year			
Borrowings	12	**(947)**	(351)
Other financial liabilities	16	**(92)**	(285)
Other creditors	13	**(3,640)**	(3,262)
Net current assets/(liabilities)		**328**	(38)
Total assets less current liabilities		**3,495**	3,207
Creditors – amounts falling due after one year			
Borrowings	14	**(961)**	(1,381)
Other financial liabilities	16	**(353)**	(391)
Other creditors	15	**(356)**	(226)
Provisions for liabilities and charges	17	**(150)**	(113)
Net pensions liability	19	**(479)**	(905)
		1,196	191
Capital and reserves			
Called-up share capital	20	**326**	326
Share premium account	21	**631**	631
Revaluation reserve	21	**73**	81
Transition hedging reserve	21	**178**	339
Other reserves	21	**167**	167
Profit and loss account	21	**(179)**	(1,353)
		1,196	191

[1] See notes 3 and 19

The financial statements on pages 68 to 87 were approved by the Board on February 7, 2007 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, 2006

	2006 £m	Restated[1,2] 2005 £m
Profit/(loss) attributable to the shareholders of Rolls-Royce plc	**749**	(233)
Actuarial gains/(losses) net of deferred tax	**414**	(170)
Movement in fair value of available for sale assets	**(126)**	121
Related tax movements	**48**	(36)
Total recognised gains/(losses) relating to the year	**1,085**	(318)
Prior year adjustment	**(8)**	
Total gains and losses recognised since last Report of the directors and financial statements	**1,077**	

[1] In 2005 fair value adjustments relating to parent company shares held under trust were recognised in the profit and loss account. Following amendments to FRS 26 effective in 2006, changes in fair value of financial assets classified as assets held for sale are recognised in reserves until the shares are disposed of, when amounts previously recorded in reserves are recognised in the profit and loss account. Accordingly £121m recognised in the profit and loss account in 2005 has been reclassified to the statement of total recognised gains and losses. The related deferred tax balance of £36m has also been transferred to the statement of total recognised gains and losses. There is no net effect on the balance sheet.

[2] Amendments to FRS 17 have been adopted – see note 19

Reconciliation of movements in shareholders' funds

For the year ended December 31, 2006

	2006 £m	Restated 2005 £m
At January 1 (as previously reported)	**191**	734
Adoption of amendments to FRS 17 – see note 19	**—**	(6)
At January 1 (restated)	**191**	728
Total recognised gains/(losses) for the year	**1,085**	(318)
Transfer from transition hedging reserve	**(230)**	(367)
Transfer from cash flow hedging reserve	**—**	3
Share-based payments adjustment	**34**	16
Related tax movements	**116**	129
At December 31	**1,196**	191

Notes to the Company financial statements

1 Accounting policies

Basis of accounting

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

The Company has adopted the amendments to FRS 17 Retirement Benefits published in December 2006 This is described further in note 19

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

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

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

Revenue recognition

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

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

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

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

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

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

Risk and revenue sharing partnerships (RRSPs)

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

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

Research and development

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

Interest

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

Taxation

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

Foreign currency translation

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

Financial instruments

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

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

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

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

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

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

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

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

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

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

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

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

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

Certification costs and participation fees
Costs incurred in respect of meeting regulatory certification requirements for new civil 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 Amounts previously included within tangible fixed assets have been transferred to intangible assets (see notes 3 and 4)

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

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

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

Accounting for leases
i) As Lessee

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

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

ii) As Lessor

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

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

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

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

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

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

Share-based payments
The Company applied the requirements of FRS 20 Share-based payments from January 1, 2004 In accordance with the transition provisions, FRS 20 has been applied to all grants made after November 7, 2002 that were unvested as of January 1, 2005 The Company, on behalf of its parent company, provides share-based payments arrangements to certain employees. These are predominantly equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant The fair value is expensed on a straight-line basis over the vesting period, based on the Company's estimate of shares or options that will eventually vest

Fair value is measured using the binomial pricing model for the ShareSave and the Executive Share Option Plan (ESOP) The fair value of awards made under the Performance Share Plan (PSP) is based on the market value of shares at the date of grant adjusted to reflect non-entitlement to dividends and the Total Shareholder Return market-based performance condition

See note 23 for further description of the share-based payment plans

2 Emoluments of directors

	2006 Highest paid director[1] £000	2006 Other directors £000	2005 Highest paid director[1] £000	2005 Other directors £000
Aggregate emoluments excluding deferred share plans	**1,151**	**3,463**	1,085	3,721
Aggregate amounts relating to deferred share plans	**211**	**397**	191	415
Aggregate value of Company contributions to Company defined contribution pensions schemes		**396**		499
Accrued pension of highest paid director	**493**		436	
Gains realised on exercise of share options[2]	**5,603**	**9,782**	213	150

	2006 Number	2005 Number
Number of directors with accruing retirement benefits		
Defined contribution schemes[3]	**2**	2
Defined benefit schemes	**5**	6
Number of directors exercising share options	**5**	5
Number of directors receiving shares as part of long-term incentives schemes	**6**	6

[1] Member of defined benefit scheme.
[2] Includes gains under the ShareSave plan
[3] Two directors were members of both defined contribution and defined benefit schemes (2005 two directors)

3 Intangible assets

	Certification costs and participation fees £m	Other £m	Total £m
Cost			
At January 1, 2006	**276**	**—**	**276**
Reclassification of software to intangible assets[1]	**—**	**38**	**38**
At January 1, 2006 (restated)	**276**	**38**	**314**
Additions	**87**	**19**	**106**
At December 31 2006	**363**	**57**	**420**
Accumulated amortisation			
At January 1 2006	**131**	**—**	**131**
Reclassification of software to intangible assets[1]	**—**	**9**	**9**
At January 1, 2006 (restated)	**131**	**9**	**140**
Provided during the year	**3**	**7**	**10**
At December 31 2006	**134**	**16**	**150**
Net book value at December 31, 2006	**229**	**41**	**270**
Net book value at January 1, 2006 (restated)	145	29	174
Net book value at December 31, 2005 as previously reported	145	—	145

[1] External software purchases were previously included within tangible fixed assets. Following a review in 2006 it was concluded that certain of these items should more properly be classified as intangible assets. Accordingly software with a net book value at December 31 2005 of £29 million has been reclassified from tangible fixed assets to intangible assets. There is no change to the amortisation policy in respect of these assets, being on a straight line basis over a maximum of five years.

4 Tangible fixed assets

	Land and buildings £m	Plant and equipment £m	In course of construction £m	Total £m
Cost or valuation				
At January 1, 2006	322	1,178	167	1,667
Reclassification of software to intangible assets[1]	—	(31)	(7)	(38)
At January 1, 2006 (restated)	322	1,147	160	1,629
Additions	2	42	156	200
Reclassifications	27	72	(99)	—
Disposals/write-offs	(10)	(69)	—	(79)
At December 31, 2006	341	1,192	217	1,750
Accumulated depreciation				
At January 1, 2006	88	650	—	738
Reclassification of software to intangible assets[1]	—	(9)	—	(9)
At January 1, 2006 (restated)	88	641	—	729
Provided during the year	13	86	—	99
Disposals/write-offs	(5)	(63)	—	(68)
At December 31 2006	96	664	—	760
Net book value at December 31, 2006	**245**	**528**	**217**	**990**
Net book value at January 1, 2006 (restated)	234	506	160	900
Net book value at December 31, 2005 as previously reported	234	528	167	929

Tangibles fixed assets include	2006 £m	2005 £m
Net book value of finance leased assets	29	37
Non-depreciable land	57	58
Land and buildings at cost or valuation comprise		
Cost	159	130
Valuation at December 31, 1996	182	192
	341	322
Land and buildings at net book value comprise		
Freehold	236	227
Long leasehold	7	6
Short leasehold	2	1
	245	234
On an historical cost basis the net book value of land and buildings would have been as follows		
Cost	323	304
Depreciation	(151)	(151)
	172	153
Capital expenditure commitments – contracted but not provided for	87	142

[1] See note 3

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

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

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

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

5 Investments – subsidiary undertakings

	Shares £m
Cost	
At January 1, 2006	1,766
Additions	30
Disposals/write-offs	(83)
At December 31, 2006	1,713

The principal subsidiary undertakings are listed on page 88.

The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited, one of its subsidiaries At December 31, 2006, this guarantee was **£12m** (2005 £12m)

6 Investments – joint ventures

	Shares at cost £m	Loans £m	Total £m
At January 1, 2006	55	10	65
Additions	6	3	9
At December 31, 2006	61	13	74

The principal joint ventures are listed on pages 89 and 90

7 Investments – other

	Unlisted investments at cost £m	Parent company shares held under trust [1] £m	Total £m
At January 1 2006	47	293	340
Additions	—	47	47
Fair value adjustments	—	2	2
Amortisation/disposals	(1)	(268)	(269)
At December 31, 2006	46	74	120

[1] Shares in the parent company are held at fair value in a trust At December 31 2006 **16,654,181 shares** with a fair value of **£74m** (2005 68,536,712 shares with a fair value of £293m) were held

8 Stocks

	2006 £m	2005 £m
Raw materials	26	18
Work in progress	470	242
Long-term contracts work in progress	46	57
Finished goods	572	597
Payments on account	8	27
	1,122	941
Progress payments received against [1]		
Long-term contracts	(8)	(7)
Other stocks	(194)	(137)
	920	797
[1] Includes payments received from joint ventures	16	14

9 Debtors – amounts falling due within one year

	2006 £m	2005 £m
Trade debtors	**254**	231
Amounts recoverable on contracts	**55**	34
Amounts owed by – subsidiary undertakings	**333**	375
Amounts owed by – joint ventures	**201**	179
Other debtors	**136**	59
Prepayments and accrued income	**94**	119
	1,073	997

10 Debtors – amounts falling due after one year

	2006 £m	2005 £m
Trade debtors	**11**	4
Amounts recoverable on contracts	**233**	267
Amounts owed by – subsidiary undertakings	**—**	13
Amounts owed by – joint ventures	**10**	10
Deferred tax assets (note 18)	**—**	5
Other debtors	**34**	27
Prepayments and accrued income	**99**	30
	387	356

11 Short-term deposits and investments

	2006 £m	2005 £m
Short-term deposits	**1,249**	1,125

12 Borrowings – amounts falling due within one year

	2006 £m	2005 £m
Overdrafts	**603**	343
Obligations under finance leases	**7**	8
6 ⅞% Notes 2007 [1]	**337**	—
	947	351

[1] These notes are the subject of a currency swap agreement under which the counterparties have undertaken to pay an amount at a fixed rate of interest and exchange in consideration for an amount payable by the Company at a variable rate of interest and at a fixed exchange rate

13 Other creditors – amounts falling due within one year

	2006 £m	2005 £m
Payments received on account [1]	**295**	214
Trade creditors	**324**	245
Amounts owed to – subsidiary undertakings	**1,037**	697
Amounts owed to – joint ventures	**164**	159
Amounts owed to – parent and its subsidiaries	**554**	829
Corporate taxation	**128**	120
Other taxation and social security	**25**	34
Other creditors	**626**	610
Accruals and deferred income	**487**	354
	3,640	3,262

[1] Includes payments received from joint ventures	**128**	115

14 Borrowings – amounts falling due after one year

	2006 £m	2005 £m
Unsecured		
6 ⅜% Notes 2007 €500m	—	354
7 ⅜% Notes 2016 £200m	**200**	200
5.84% Notes 2010 US$187m [1]	**102**	107
6 38% Notes 2013 US$230m [1]	**121**	134
6.55% Notes 2015 US$83m [1]	**38**	49
4 ½% Notes 2011 €750m [2]	**494**	524
Secured		
Obligations under finance leases payable [3]		
Between one and two years	**4**	5
Between two and five years	**2**	8
After five years	—	—
	961	1 381
Repayable		
Between one and two years – by instalments	**4**	5
– otherwise	—	354
Between two and five years – by instalments	**2**	8
– otherwise	**596**	—
After five years – by instalments	—	—
– otherwise	**359**	1 014
	961	1,381

[1] These notes are the subject of interest rate swap agreements under which the Company has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge Until October 5 2005 the borrowing was included in a net investment hedging relationship From October 6, 2005 the borrowing has been included in a fair value hedging relationship in respect of the foreign exchange risk.

[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

15 Other creditors – amounts falling due after one year

	2006 £m	2005 £m
Payments received on account [1]	**161**	130
Amounts owed to joint ventures	**4**	—
Other creditors	**191**	86
Accruals and deferred income	—	10
	356	226
[1] Includes payments received from joint ventures	**62**	13

16 Other financial assets and liabilities

Details of the Company's policies on the use of financial instruments are given in the accounting policies on pages 70 and 71
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.

	2006				
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
Assets	588	39	27	—	654
Liabilities	(80)	—	(11)	(354)	(445)
	508	39	16	(354)	209

	2005				
	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
Assets	376	31	71	—	478
Liabilities	(183)	—	(7)	(486)	(676)
	193	31	64	(486)	(198)

Other financial liabilities are analysed as follows

	2006 £m	2005 £m
Current liabilities	(92)	(285)
Non-current liabilities	(353)	(391)
	(445)	(676)

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$, the Company has currency derivatives designated as part of a fair value hedge

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

Foreign exchange financial instruments

	2006			2005		
	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	193	479		832	832 [1]	
Fair value changes to derivative contracts not in accounting hedging relationships	595	—	595	(327)	—	(327)
Fair value changes to fair value hedges	(26)	—	(26)	5	—	5
Fair value of contracts settled	(254)	—	—	(317)	—	—
Transferred to turnover	—	(227)	227	—	(353)[1]	353
At December 31	508	252		193	479	

[1] Additionally £10m relating to derivatives settled prior to adoption of FRS 25 and FRS 26 was included in the transition hedging reserve and transferred to the profit and loss account in 2005

16 Other financial assets and liabilities continued

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

Commodity financial instruments

	2006			2005		
	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	31	5		9	9	
Fair value changes to derivative contracts not in accounting hedging relationships	34	—	34	54	—	54
Fair value of contracts settled	(26)	—	—	(32)	—	—
Transferred to cost of sales	—	(5)	5	—	(4)	4
At December 31	39	—		31	5	

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

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

Interest rate financial instruments

	2006				
	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in cash flow hedging reserve £m	Included in profit and loss account £m
At January 1	64	69	(5)	—	
Changes during the year	(48)	(51)	3	—	(48)
At December 31	16	18	(2)	—	

	2005				
	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in cash flow hedging reserve £m	Included in profit and loss account £m
At January 1, on adoption of FRS 26	112	121	(9)	—	
Changes during the year	(48)	(52)	4	—	(48)
At December 31	64	69	(5)	—	

16 Other financial assets and liabilities continued

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

	2006 £m	2005 £m
At January 1	**486**	544
Cash paid to partners	**(96)**	(65)
Financing charge	**31**	45
Excluded from underlying profit		
Exchange adjustments	**(50)**	64
Restructuring of financial RRSP agreements and changes in forecast payments	**(17)**	(102)
At December 31	**354**	486

Total return swaps

The Company entered into forward contracts to purchase its parent's shares for the purposes of meeting obligations to issue shares under employee share schemes. Under FRS 25, these contracts were categorised as financial liabilities and accounted for on the amortised cost basis, with the shares included at fair value These contracts were settled during 2005

	2005 £m
At January 1	142
On settlement of forward purchase contracts	(141)
Transferred to finance charges	(1)
At December 31	—

17 Provisions for liabilities and charges

	At December 31, 2005 £m	Exchange adjustments £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At December 31, 2006 £m
Deferred taxation (note 18)	—	—	—	47	—	47
Warranties and guarantees	39	(1)	(8)	7	(15)	22
Contract loss	2	—	—	—	(2)	—
Customer financing	70	—	—	18	(7)	81
Restructuring	2	—	—	—	(2)	—
	113	(1)	(8)	72	(26)	150

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.
Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 24 Timing of utilisation is uncertain.
Insurance provisions relate to the Company's captive insurance business with the timing of utilisation being uncertain

18 Deferred taxation

	£m
At January 1, 2006	5
Amount charged to profit and loss account	(216)
Amount credited to statement of total recognised gains and losses	48
Amount credited to equity	116
At December 31, 2006	(47)

There are other deferred tax assets totalling **£102m** (2005 £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

	2006 £m	2005 £m
Fixed asset timing differences	(115)	(111)
Other timing differences	74	5
Foreign exchange and commodity financial assets and liabilities	(182)	(77)
Losses	115	127
Advance corporation tax	61	61
	(47)	5
Included in		
Debtors – amounts falling due after one year	—	5
Provisions	(47)	—
	(47)	5

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

19 Post-retirement benefits

Defined benefit schemes

The Company operates a number of defined benefit schemes, for which the assets are held in separate trustee administered funds and employees are entitled to retirement benefits based on their final salaries and length of service

The valuations of the schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2006 The most recent funding valuations of the main schemes were

Rolls-Royce Pension Fund – March 31 2003
Rolls-Royce Group Pension Scheme – April 5 2004

In 2006, the Company has adopted the amendments to FRS 17 published in November 2006 These amendments bring the disclosures into line with International Accounting Standard 19 and change the valuation of scheme assets to a bid price basis (previously valued on a mid market price basis) The corresponding amounts have been restated accordingly The net result of these amendments is the recognition of additional actuarial losses of £8m, of which £2m relates to 2005 and £6m to prior years

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

	2006 %	2005 %
Rate of increase in salaries	**4.4**	4.4
Rate of increase of pensions in payment[1]	**2.9**	2.6
Discount rate	**5.1**	4.7
Expected rate of return on scheme assets	**6.6**	6.2
Inflation assumption	**2.9**	2.9

[1] Benefits accruing after April 5 2005 are assumed to increase in payment at a rate of 2.3 per cent

The mortality assumptions adopted for the pension schemes are derived from the PA92 actuarial tables published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant schemes actual experience The resulting ranges of life expectancies in the main schemes are as follows

Life expectancy from age 65	
Current pensioner	17.5 years to 22.0 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

Actuarial gains of **£591m** (2005 £242m loss) have been reported in the statement of total recognised gains and losses. Cumulative actuarial losses from January 1, 2002 reported in the statement of recognised income and expense are **£748m** (2005 £1,339m)

Amounts recognised in the balance sheet

	2006 £m	2005 £m
Present value of funded obligations	**(5,785)**	(6,102)
Fair value of scheme assets	**5,101**	4,809
Deficit	**(684)**	(1,293)
Related deferred tax asset	**205**	388
Net liability	**(479)**	(905)

Changes in present value of defined benefit obligations

	2006 £m	2005 £m
At January 1	**(6,102)**	(4,321)
Transfer from subsidiary company	**—**	(904)
Current service cost	**(97)**	(67)
Finance cost	**(284)**	(246)
Contributions by employees	**(38)**	(31)
Net benefits paid out	**259**	212
Actuarial gains/(losses)	**477**	(745)
At December 31	**(5,785)**	(6,102)

19 Post-retirement benefits continued

Changes in fair value of scheme assets

	2006 £m	2005 £m
At January 1 (as previously reported)		3,291
Adoption of amendments to FRS 17		(8)
At January 1 (restated)	**4,809**	3,283
Transfer from subsidiary company	**—**	837
Expected return on assets	**296**	244
Contributions by employer	**103**	123
Contributions by employees	**38**	31
Benefits paid out	**(259)**	(212)
Actuarial gains/(losses)	**114**	503
At December 31	**5,101**	4,809
Actual return on plan assets	**410**	747

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

	2006		2005	
	Expected rate of return %	**Market value £m**	Expected rate of return %	Market value £m
Equities	**7.5**	**3,526**	7 1	3,328
Sovereign debt	**4.5**	**537**	4 1	493
Corporate bonds	**4 9**	**1,009**	4 5	856
Other	**5.0**	**29**	4.3	132
	6.6	**5,101**	6 2	4,809

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 on individual categories of scheme assets are determined by reference to gilt yields. The expectation is that the return from equities and corporate bonds will exceed the return from gilts by three per cent per annum and 0 45 per cent per annum respectively The overall expected rate of return is calculated by weighting the individual returns expected from each asset class in accordance with the actual asset balance in the schemes' investment portfolios

History of plans

The history of the plans for the current and prior years is as follows.

	2006 £m	2005 £m	2004 £m	2003 £m	2002 £m
Present value of defined benefit obligation	**(5,785)**	(6,102)	(4,321)	(4,105)	(4,127)
Fair value of scheme assets	**5,101**	4,809	3,283	3,049	2,694
Deficit	**(684)**	(1 293)	(1 038)	(1,056)	(1 433)
Actuarial gains/(losses) on scheme assets	**114**	503	92	253	(656)
Experience losses on scheme liabilities	**477**	(745)	(113)	(436)	(237)
Total amount recognised in the statement of total recognised gains and losses	**591**	(242)	(21)	(183)	(893)

The Company has adopted the amendment to FRS 17 published in December 2006 In accordance with the transitional provisions of these amendments, the corresponding amounts for 2002 and 2003 above have not been amended to reflect the change in valuation of scheme assets from mid-market to bid prices

The Company expects to contribute approximately £132m to its defined benefit schemes in 2007 excluding any additional amounts contributed to address the deficit as discussed in the Chief Executive's review on page 4

Defined contribution schemes

The Company operates a number of defined contribution schemes.

The total expense recognised in the income statement was **£2m** (2005 £2m)

20 Share capital

	Equity ordinary shares of 20p each	Nominal value £m
Authorised		
At January 1, and December 31, 2006	2,000,000,000	400
Issued and fully paid		
At January 1, and December 31 2006	1,630,996,508	326

21 Reserves

	Non-distributable				
	Share premium £m	Revaluation reserve £m	Transition hedging reserve £m	Other reserves £m	Profit and loss account £m
At January 1, 2006 (as previously reported)	631	81	339	167	(1,345)
Adoption of amendments to FRS 17 (see note 19)	—	—	—	—	(8)
At January 1, 2006 (restated)	631	81	339	167	(1,353)
Transfers between reserves	—	(8)	—	—	8
Transfer from transition hedging reserve	—	—	(230)	—	—
Share-based payments adjustment	—	—	—	—	34
Total recognised gains relating to the year	—	—	—	—	1,085
Related tax movements	—	—	69	—	47
At December 31, 2006	631	73	178	167	(179)

The cumulative amount of goodwill, arising on the acquisition of undertakings still in the Company at December 31, 2006, written off against other reserves amounts to **£370m** (2005 £370m) The continuance of this basis, in respect of pre-1998 acquisitions, is permitted under the transitional arrangements of FRS 10

22 Operating lease annual commitments

	2006 £m	2005 £m
Leases of land and buildings which expire		
Within one year	—	—
Between one and five years	2	—
After five years	4	6
Other leases which expire		
Within one year	1	1
Between one and five years	1	1
After five years	—	—

23 Share-based payments

Share-based payment schemes in operation during the period
The Company participated in the following share-based payment schemes 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 – CPS) and a market based performance condition (Total Shareholder Return – TSR)

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

Executive Share Option Plan (ESOP)
This plan involves the grant of market value share options to participants The options are subject to a non-market based performance condition (growth in EPS) The options have a maximum contractual life of ten years There was no grant of executive share options in 2005 or 2006 Following the introduction of the PSP it is not intended to grant any further executive share options

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

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

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

The Company recognised a total expense of **£22m** in 2006 (£16m in 2005)

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

PSP	Number of shares awarded 2006 Millions	2005 Millions
Outstanding at January 1	7	4
Awarded during the year	3	3
Forfeited during the year	—	—
Vested during the year	—	—
Outstanding at December 31	10	7

ShareSave	2006 Number of share options Millions	2006 Weighted average exercise price Pence	2005 Number of share options Millions	2005 Weighted average exercise price Pence
Outstanding at January 1	52	158p	60	130p
Granted during the year	—	—	9	298p
Forfeited during the year	(1)	168p	(1)	138p
Exercised during the year	(9)	140p	(16)	140p
Outstanding at December 31	42	153p	52	158p
Exercisable at December 31	1	141p	—	—

23 **Share-based payments** continued

ESOP	2006 Number of share options Millions	2006 Weighted average exercise price Pence	2005 Number of share options Millions	2005 Weighted average exercise price Pence
Outstanding at January 1	**43**	**149p**	44	149p
Granted during the year	**—**	**—**	—	—
Forfeited during the year	**(1)**	**216p**	(1)	170p
Exercised during the year	**(30)**	**131p**	—	—
Outstanding at December 31	**12**	**191p**	43	149p
Exercisable at December 31	**3**	**118p**	—	—

Deferred shares under APRA	Number of shares awarded 2006 Millions	2005 Millions
Outstanding at January 1	**5**	7
Awarded during the year	**1**	2
Forfeited during the year	**—**	—
Vested during the year	**(3)**	(4)
Outstanding at December 31	**3**	5

Free shares under SIP	Number of shares awarded 2006 Millions	2005 Millions
Awarded during the year	**1**	1

Options were exercised on a regular basis during the year The average share price during the year was **439p** (2005 310p)

Fair values

The weighted average fair values for PSP awards, ShareSave grants, APRA deferred share awards, and SIP Free Share awards made during the year are as follows

	2006 Pence	2005 Pence
PSP	**494p**	282p
ShareSave – 3 year	**—**	131p
ShareSave – 5 year	**—**	154p
APRA deferred share awards	**448p**	260p
SIP Free Share awards	**462p**	257p

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

PSP awards

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

	2006	2005
Weighted average share price	**444p**	262p
Expected dividends	**7 92p**	7.81p
Volatility	**32%**	34%
Correlation	**19%**	19%
Expected life	**3 years**	3 years
Risk free interest rate	**4 3%**	4 9%

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.

23 Share-based payments continued

ShareSave awards

The fair value of options granted under the ShareSave plan are calculated using a binomial pricing model with the following assumptions (no options were granted in 2006)

	2005
Weighted average share price	351p
Exercise price	298p
Volatility	40%
Expected dividends	7 86p
Expected life[1] – 3 year ShareSave	3 3-3 8 years
– 5 year ShareSave	5 3-5.8 years
Close periods	
From January 1	6 weeks
From July 1	1 month
Risk free interest rate	4 4%

[1] The binomial pricing model assumes that participants will exercise 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 award

Fair values of options granted in 2003 and 2004

The charge under FRS 20 for the current period includes a charge for options granted under the PSP, APRA, ESOP and ShareSave plans during the years ended December 31, 2003 and 2004 with the following grant date fair values

	2004	2003
PSP	249p	—
ShareSave – 3 year	—	61p
ShareSave – 5 year	—	71p
ESOP	—	22 7p
APRA	220p	—

These fair values were calculated using the models described above with the following assumptions

	PSP	ShareSave	ESOP
Weighted average share price	233p	173p	79p
Weighted average exercise price		142p	78p
Volatility	35%	43%	43%
Expected dividends	7 61p	7 61p	7 61p
Expected life[1] – 3 year ShareSave		3 15-3 65 years	
– 5 year ShareSave		5 15-5 65 years	
– ESOP			4 5 years
– PSP	3 years		
Correlation	22%		
Close periods			
From January 1		6 weeks	6 weeks
From July 1		1 month	1 month
Risk free interest rate	5 2%	4 6%	4 1%

[1] For the ShareSave options, the binomial pricing model assumes that participants will exercise 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

24 Contingent liabilities

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

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

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions, at December 31 2006 amounted to **$1,109m, £566m** (2005 $1,097m, £638m) Taking into account the net realisable value of the relevant security including unrestricted cash collateral of **$114m, £58m** (2005 $108m £63m), the discounted value of the net contingent liabilities in respect of financing arrangements on all delivered aircraft amounted to **$243m, £124m** (2005 $259m, £150m) Sensitivity calculations are complex, but for example, if the value of the relevant security was reduced by 20 per cent, a net contingent liability with a discounted value of approximately **$361m, £184m** (2005 $363m, £211m) would result There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time

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

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its Group, the Company considers these to be insurance arrangements, and accounts for them as such In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee At December 31, 2006, there were Company guarantees in respect of financial obligations of subsidiary undertakings amounting to **£nil** (2005 £50m), and in respect of joint ventures amounting to **£12m** (2005 £33m)

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 2006 these guarantees amounted to **£40m** (2005 £117m)

25 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 not to disclose related party transactions with its parent company and other group companies

The aggregated balances with joint ventures are shown in notes 8, 9, 10, 13 and 15

26 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, 2006

Incorporated within the UK – directly held unless marked*

Civil aerospace	
Data Systems & Solutions Limited*	*Advanced controls and predictive data management*
Rolls Royce Aircraft Management Limited	*Sales finance and other financial services*
Rolls-Royce Leasing Limited	*Engine leasing*
Rolls-Royce Total Care Services Limited	*Aftermarket support services*
Marine	
Rolls-Royce Marine Electrical Systems Limited*	*Marine electrical systems*
Rolls-Royce Marine Power Operations Limited	*Nuclear submarine propulsion systems*
Energy	
Rolls-Royce Fuel Cell Systems Limited	*Development of fuel cell systems*
Rolls-Royce Power Ventures Limited	*Provision of project development capabilities*
Corporate	
Rolls-Royce International Limited	*International support and commercial information services*
Rolls-Royce Power Engineering plc	*Power generation and marine systems*

The above companies operate principally in the UK and the effective Group interest is 100 per cent, other than Rolls-Royce Fuel Cell Systems Limited which is 75 per cent

Incorporated overseas – indirectly held

Civil aerospace		
Brazil	Rolls-Royce Brasil Limitada	*Repair and overhaul*
France	Rolls-Royce Technical Support SARL*	*Project support*
Germany	Rolls-Royce Deutschland Ltd & Co KG*	*Design, development and manufacture of aero engines*
Italy	Europea Microfusioni Aerospaziali S p.A	*Manufacture of castings*
US	Data Systems & Solutions LLC*	*Advanced controls and predictive data management*
US	Rolls-Royce Corporation*	*Design, development and manufacture of gas turbine engines*
US	Rolls-Royce Engine Services – Oakland Inc.*	*Repair and overhaul*
Defence aerospace		
US	Rolls-Royce Defense Services Inc	*Repair and overhaul*
Marine		
China	Rolls-Royce Marine (Shanghai) Limited*	*Manufacture and supply of marine equipment*
Finland	Rolls-Royce OY AB*	*Manufacture of winches and propeller systems*
India	Rolls-Royce Energy Systems India Private Limited*	*Project management and customer support*
Norway	Rolls Royce Marine AS*	*Design and manufacture of ship equipment/holding company*
Norway	Ulstein Holding AS*	*Holding company*
Sweden	Rolls-Royce AB*	*Manufacture of propeller systems*
US	Rolls Royce Commercial Marine Inc*	*Aftermarket support services*
US	Rolls-Royce Naval Marine Inc.*	*Design and manufacture of ship propellers*
Energy		
Canada	Rolls-Royce Canada Limited*	*Industrial gas turbines and aero-engine sales, service and overhaul*
Singapore	Rolls-Royce Pte Limited*	*Engine and turbine compression systems, spares*
US	Rolls Royce Energy Systems Inc*	*Turbine generator packages*
Corporate		
Guernsey	Nightingale Insurance Limited*	*Insurance services*
India	Rolls-Royce Operations (India) Private Limited*	*Provision of support services*
US	Rolls-Royce North America Holdings Inc.*	*Holding company*

The above companies operate principally in the country of their incorporation
The effective Group interest is 100 per cent, other than Europea Microfusioni Aerospaziali S p.A. which is 51 per cent.

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

Principal joint ventures
At December 31, 2006

Incorporated within the UK – directly held unless marked*

	Class	% of class held	% of total equity held
Civil aerospace			
Alpha Partners Leasing Limited	A Ordinary	100	50
Engine leasing	B Ordinary	—	
TRT Limited	A Ordinary	—	49.5
Turbine blade repair services	B Ordinary	100	
Turbine Surface Technologies Limited	A Ordinary	—	50
Turbine surface coatings	B Ordinary	100	
Defence aerospace			
Airtanker Holdings Limited	Ordinary	20	20
Strategic tanker aircraft PFI project			
Rolls-Royce Snecma Limited (UK & France)	A Shares	—	50
Engine collaboration	B Shares	100	
Rolls-Royce Turbomeca Limited (UK & France)	A Shares	—	50
Adour and RTM322 engines collaboration	B Shares	100	
Turbo-Union Limited (UK, Germany & Italy)	Ordinary	40	40
RB199 engine collaboration	A Shares	37.5	
Energy			
Genistics Holdings Limited	A Ordinary	100	50
Trailer mounted field mobile generator sets	B Ordinary	—	
Rolls Wood Group (Repair and Overhauls) Limited	A Ordinary	100	50
Repair and overhaul	B Ordinary	—	

Incorporated overseas – directly held unless marked*

		Class	% of class held	% of total equity held
Civil aerospace				
China	Xian XR Aero Components Co Limited *Manufacturing facility for aero-engine parts*	Ordinary	49	49
Germany	N3 Engine Overhaul Services Verwaltungsgesellschaft mbh* *Repair and overhaul*	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited* *Repair and overhaul*	Ordinary	45	45
Israel	TechJet Aerofoils Limited* *Manufacture of compressor aerofoils*	A Ordinary B Ordinary	50 50	50
Saudi Arabia	Middle East Propulsion Company Limited* *Repair and overhaul*	Ordinary	167	167
Singapore	International Engine Component Overhaul Pte Limited* *Repair and overhaul*	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited* (effective interest 39%) *Repair and overhaul*	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA *Manufacture and maintenance of aero engines*	Ordinary	469	469
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & US) *V2500 engine collaboration*	A Shares B Shares C Shares D Shares	100 — — —	325
US	Alpha Leasing (US) LLC*, Alpha Leasing (US) (No 2) LLC*, Alpha Leasing (US) (No 4) LLC* *Engine leasing*	Partnerships	50	—
US	Rolls-Royce & Partners Finance (US) LLC* *Engine leasing*	Partnership	50	—
US	Texas Aero Engine Services, LLC* *Repair and overhaul*	Partnership	50	—
US	Williams-Rolls Inc.* (UK & North America) *Small engine collaboration*	Common	15	15
Defence aerospace				
Germany	EPI Europrop International GmbH (Germany) (effective interest 35.5%) *A400M engine collaboration*	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) *EJ200 engine collaboration*	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) *MTR390 engine collaboration*	Ordinary	33.3	33.3
US	GE Rolls-Royce Fighter Engine Team LLC* *F136 development engine for the Joint Strike Fighter (JSF) Programme*	Partnership	40	40
Corporate				
US	Exostar LLC* *Business to business internet exchange*	Partnership	17.6	—

Unincorporated overseas – held by subsidiary undertakings

Defence aerospace	
US	Light Helicopter Turbine Engine Company* (LHTEC) *Rolls-Royce Corporation has a 50% interest in this unincorporated partnership which was formed to develop and market jointly the T800 engine*

The countries of principal operations are stated in brackets after the name of the company, if not the country of incorporation.

Rolls-Royce

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