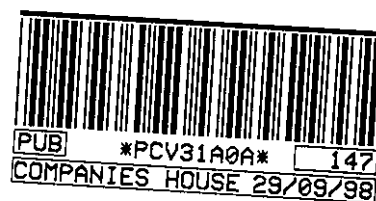


ROLLS-ROYCE POWER ENGINEERING plc

ANNUAL REPORT

AND

FINANCIAL STATEMENTS 1997



ROLLS-ROYCE POWER ENGINEERING plc

DIRECTORS AND OFFICERS

| | | |
|-----------|------------------------|------------------------|
| Directors | R H Maudslay BSc F.Eng | Resigned 17 July 1997 |
| | W Graham FCA | Resigned 28 March 1998 |
| | D R Bale LLB | |
| | P Heiden | Appointed 17 July 1997 |
| | M Townsend | Appointed 1 April 1998 |

| | | |
|-----------|----------|----------------------|
| Secretary | J Warren | Appointed 9 May 1997 |
| | H D Cone | Resigned 9 May 1997 |

Registered office NEI House
Regent Centre
Newcastle upon Tyne
NE3 3SB
Company registered in England, number 1305027

Registered office changed to:

Moor Lane
Derby
DE24 8BJ

with effect from 1 April 1998

| | |
|----------|--------------------|
| Auditors | KPMG Audit Plc |
| | 8 Salisbury Square |
| | London |
| | EC4Y 8BB |

ROLLS-ROYCE POWER ENGINEERING plc

| CONTENTS | PAGE |
|------------------------------------|------|
| Report of the Directors | 3 |
| Directors' responsibilities | 7 |
| Report of the Auditors | 8 |
| Accounting policies | 9 |
| Profit and Loss Account | 11 |
| Balance Sheet | 12 |
| Historical cost profits and losses | 13 |
| Notes to the Financial Statements | 14 |
| Principal Subsidiary Undertakings | 27 |

REPORT OF THE DIRECTORS

Principal activities

Rolls-Royce Power Engineering plc is an engineering company engaged in the design, manufacture, construction, commissioning and servicing of capital plant for the energy conversion and materials handling industries.

During the year ended 31 December 1997 the Company achieved a turnover of £554.4m (1996 £665.2m) and a profit on ordinary activities before taxation of £16.9m (1996 loss of £145.7m). The analysis of turnover and profits by business class and geographical area is given in Note 1 to the financial statements on page 14.

Dividend

No interim dividend for 1997 was paid (1996 - NIL). No final ordinary dividend is recommended. No dividends were paid for the three classes of preference shareholders for the half-year ended 31 December 1997.

Employees

The company recognises that its most valuable resource is its human resource and unlocking the potential of its employees so that they can contribute fully to its business success whilst enjoying maximum job satisfaction continues to have a high priority.

Employees are kept informed on matters affecting them as employees and on the various factors affecting the Company's general business situation through both formal and informal communication activities of various kinds, including regular briefing group meetings. Employee representatives at local and national level are consulted regularly on a wide range of matters affecting the Company's current and future situation.

The business systems and structures of the Company are under constant review to ensure through extensive teamwork initiatives, that the best contribution from each and every employee is available.

Employees are able to participate in the Rolls-Royce Sharesave Scheme.

The Company maintains Pension Schemes for the majority of employees in the UK and overseas. The assets of the Schemes are kept independent of the Company's finances and are administered by Trustees. The most recent actuarial valuations indicated that the assets of the principal schemes were sufficient to meet the cost of benefits as and when they fall due.

Applications for employment by disabled persons are always fully considered, bearing in mind the aptitudes and abilities of the respective applicant. In the event of members of staff becoming disabled, every effort is made to ensure that appropriate retraining is provided if necessary. The training, career development and promotion opportunities of disabled persons are, as far as possible, identical with those of other employees and the Company makes every effort to employ disabled persons. The Company also operates an Equal Opportunities Policy, details of which are available to all employees.

Education and training

The Company's commitment to education and training during 1997 has been reflected in continued investment in the field of employee development, with increased emphasis on individual competencies, team working, the setting of world class standard targets and greater customer/commercial awareness at all levels.

Employees are encouraged to take responsibility for their personal development and opportunities are available to extend their competency levels using a range of latest education and training techniques. The use of Appraisal Systems and Personal Development Planning is growing and opportunities for the Company to share best practice in these and other employee development and training activities is a high priority.

Disposals

During the year the company disposed of Kennicott Water Systems Limited, Parsons Power Generation Systems Limited (with the exception of some major turnkey contracts) and the service businesses of International Combustion Limited. On 19th February 1998 the company also disposed of its 51% holding in NEI Brantford International Limited, on the 2nd July 1998 disposed of its Valtek Valves business and on 21st September 1998 announced the disposal of its electrical transmission and distribution businesses.

Share capital

The authorised and issued share capital of the company is shown in Note 16 to the financial statements.

Following the sanction of an Order of the High Court of Justice dated 30th April 1997, the shareholders approved a reduction of capital and the three classes of preference shares were repaid in cash. The 3% cumulative redeemable preference shares, the 5.375% cumulative preference shares and the 11% cumulative preference shares were accordingly de-listed on 2 May 1997 from the London Stock Exchange Daily Official List.

Board of Directors

The Directors of the Company for the year to 31 December 1997 are listed on page 1.

Directors' Interests

None of the Directors had any interest in the shares of the Company.

The beneficial interests of the Directors holding office on 31 December 1997 in the share capital of the Company's ultimate holding company requiring disclosure in this report were as follows:

| | Rolls-Royce plc Ordinary Shares | | Options over Rolls-Royce plc Ordinary Shares | | | |
|----------|------------------------------------|----------|--|------------|--------------------|-------------------|
| | 1.1.97 | 31.12.97 | @1.1.97 | @ 31.12.97 | Exercise price (p) | Exercisable Dates |
| D R Bale | - | - | 44,500 | 44,500 | 176 | 1998-2005 |
| | | | 1,380 | 1,380 | 150 | 2003 |
| | | | 750 | 750 | 106 | 1998 |
| | | | ----- | ----- | | |
| | | | 46,630 | 46,630 | | |
| | | | ===== | ===== | | |
| W Graham | - | - | 46,549 | 46,549 | 125 | 1996-2002 |
| | | | 58,500 | 58,500 | 176 | 1998-2005 |
| | | | 10,552 | 10,552 | 106 | 2000 |
| | | | 6,136 | 6,136 | 150 | 2003 |
| | | | ----- | ----- | | |
| | | | 121,737 | 121,737 | | |
| | | | ===== | ===== | | |

Mr P Heiden and Mr M Townsend are members of the Rolls-Royce plc Board of Directors and their Director's interests and emoluments are disclosed in that Company's Annual Report and Financial Statements.

The market price of the ordinary shares of the company's ultimate parent company, Rolls-Royce plc, at 31 December 1997 was 235p and the range during 1997 was 190p to 272p.

At no time during the year has any Director had any interest in a contract with the Company, being a contract of significance in relation to the Company's business.

Tangible Fixed Assets

Valuations of the Company's properties were obtained as at 31 December 1996, excluding properties of businesses in the process of being sold and those under consideration for disposal. Details are given in note 7 to the financial statements.

Research and Development

The Company and its subsidiary undertakings devote a substantial amount of time and effort to research and development activities.

Payment to suppliers

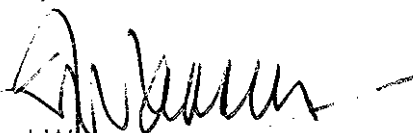
The Company seeks the best possible terms from suppliers and, in entering into binding purchasing contracts, gives consideration to quality, delivery, price and the terms of payment. Suppliers are, in this way, made aware of these terms. The Company complies whenever it is satisfied that suppliers have provided the goods and services in accordance with the agreed terms and conditions. In the event of disputes, efforts are made to resolve them quickly. The Company does not follow any code or standard on payment practice.

The Company had 82 days purchases outstanding at December 31, 1997 based on the average daily amount invoiced by suppliers during the year.

Ultimate Holding Company

The Company's ultimate holding company is Rolls-Royce plc, which is incorporated in England.

By order of the Board



J Warren
Secretary



1998

Directors' Responsibility for the financial statements

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the profit or loss for that period. In preparing those financial statements, the directors are required to:

1. Select suitable accounting policies and then apply them consistently
2. Make judgements and estimates that are reasonable and prudent
3. State whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements
4. Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

**Report of the Auditors KPMG Audit Plc
To the members of Rolls-Royce Power Engineering plc**

We have audited the financial statements on pages 9 to 27.

Respective responsibilities of Directors and Auditors

As described on page 7, the Company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

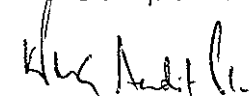
Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the 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 misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements give a true and fair view of the state of the Company's affairs as at 31st December 1997 and the profit of the Company for the year then ended and have been properly prepared in accordance with the Companies Act 1985.



KPMG Audit Plc
Chartered Accountants
Registered Auditor
London

28 September 1998

ACCOUNTING POLICIES

1. Accounting Convention

The accounts have been prepared under the historical cost convention adjusted for the revaluation of certain freehold and leasehold properties as disclosed in note 7 and have been prepared in accordance with applicable accounting standards. Adjustments have been made to comparative figures to put them on a consistent basis with the current year.

Consolidated accounts and a cash flow statement have not been prepared, as the Company is a wholly owned subsidiary of Rolls-Royce plc.

2. Turnover

Turnover excludes value added tax and with the exception of long term contracts represents the invoice value of goods despatched and services rendered. Long-term contracts are included in turnover on the basis of the sales value of work performed during the year by reference to the total sales value and stage of completion of these contracts.

3. Stocks and work in progress

Stocks and work in progress are generally valued at the lower of cost and net realisable value. The cost of work in progress includes an appropriate proportion of production and administration overheads, substantially all of which are related directly or indirectly to contracts. Full provision is made for estimated losses to completion.

Progress payments received and receivable where in excess of recorded turnover are deducted and, to the extent that such payments exceed the value of work in progress on any contract, the excess is included in current liabilities. 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.

4. Depreciation and Amortisation

Depreciation and amortisation are provided at various rates designed to write off the cost or the revalued amount of tangible fixed assets in equal annual amounts over their anticipated useful lives. No depreciation is provided in respect of freehold land or on assets under construction.

5. Accounting for leases

Assets financed by leasing agreements which give rights approximating to ownership (finance leases) have been capitalised at amounts equal to the original cost of the assets to the lessors and depreciation provided on the basis of the depreciation policy set out above. The capital elements of future obligations under finance leases are included as liabilities in the balance sheet and the current year's interest element is charged to the profit and loss account. The annual payments under all other lease arrangements, known as operating leases, are charged to the profit and loss account on an accruals basis. Rental receivables as lessor under operating leases are included in turnover for the year on an accruals basis.

6. **Foreign Currencies**

Assets and liabilities denominated in foreign currencies are translated into sterling at the rate ruling at the year-end or, where applicable, at the estimated sterling equivalent, taking account of future foreign exchange and similar contracts. Exchange differences, including those arising from currency conversions in the usual course of trading, are taken into account in determining profit on ordinary activities before taxation.

7. **Deferred taxation**

Provision is made for deferred taxation arising from timing differences between taxation allowances and the related accounting treatment only to the extent that the Directors consider that a liability is likely to arise as a result of the reversal of such timing differences within the foreseeable future.

8. **Research and development**

Fixed assets used in research and development are depreciated on the basis described in (4) above. All other expenditure on research and development is written off in the year in which it is incurred.

ROLLS-ROYCE POWER ENGINEERING PLC

Profit and Loss Account

for the year ended 31st December 1997

| Notes | | Continuing Operations £m | Discontinued Operations £m | 1997 £m | 1996 £m |
|-------|--|--------------------------------|----------------------------------|---------------|------------------|
| 1 | Turnover | 437.6 | 116.8 | 554.4 | 665.2 |
| | Cost of sales | (384.2) | (152.1) | (536.3) | (695.7) |
| | Gross Profit/(Loss) | <u>53.4</u> | <u>(35.3)</u> | <u>18.1</u> | <u>(30.5)</u> |
| | Commercial, marketing and product support costs | (7.7) | (0.2) | (7.9) | (5.9) |
| | General & administrative costs | (12.5) | - | (12.5) | (19.7) |
| | Research & development (net) | (12.1) | (1.3) | (13.4) | (12.0) |
| | Provision for loss on sale/termination of business | - | 43.6 | 43.6 | - |
| | | <u>21.1</u> | <u>6.8</u> | <u>27.9</u> | <u>(68.1)</u> |
| 19 | Profit/(Loss) on sale of business | 0.7 | (5.1) | (4.4) | - |
| | Utilisation/(creation) of provision for Profit/(Loss) on sale/termination of business | - | 5.1 | 5.1 | (69.0) |
| | | <u>21.8</u> | <u>6.8</u> | <u>28.6</u> | <u>(137.1) *</u> |
| 3 | Net Interest and similar charges | | | <u>(11.7)</u> | <u>(8.6)</u> |
| 4 | Profit/(Loss) on ordinary activities before taxation | | | 16.9 | (145.7) |
| 5 | Taxation | | | <u>0.7</u> | <u>28.4</u> |
| | Profit/(Loss) on ordinary activities after taxation | | | 17.6 | (117.3) |
| 6 | Dividends - non-equity | | | - | (0.1) |
| 18 | Transferred to/(from) reserves | | | <u>17.6</u> | <u>(117.4)</u> |

There were no recognised gains or losses in the year other than the profit shown above (1996 - £nil).

*Profit/Loss on ordinary activities before interest in 1996, includes an exceptional loss of £147.2m (see note 4).

ROLLS-ROYCE POWER ENGINEERING PLC

Balance sheet 31st December 1997

| | | 1997 £m | 1996 £m |
|-------|---|----------------|----------------|
| Notes | | | |
| | Fixed assets | | |
| 7 | Tangible assets | 59.9 | 95.5 |
| 8 | Fixed asset investments | 175.8 | 176.5 |
| | | <u>235.7</u> | <u>272.0</u> |
| | Current assets | | |
| 9 | Stocks and contract work in progress | 57.9 | 62.8 |
| 10 | Debtors - amounts falling due within one year | 264.5 | 274.6 |
| 10 | Debtors - amounts falling after one year | 95.2 | 69.8 |
| 11 | Short term deposits | 2.8 | 5.6 |
| | Cash at bank and in hand | 22.1 | 18.7 |
| | | <u>442.5</u> | <u>431.5</u> |
| 12 | Creditors: Due within one year | <u>(401.3)</u> | <u>(380.4)</u> |
| | Net current assets | 41.2 | 51.1 |
| | Total assets less current liabilities | 276.9 | 323.1 |
| 13&14 | Creditors: due after more than 1 year | (151.5) | (148.9) |
| 15 | Provisions for liabilities and charges | <u>(48.5)</u> | <u>(115.0)</u> |
| | Net assets | <u>76.9</u> | <u>59.2</u> |
| | Capital and reserves | | |
| 16 | Called up share capital | 65.8 | 61.7 |
| 18 | Share premium account | 24.1 | 25.1 |
| 18 | Capital redemption reserve | 4.0 | 4.0 |
| 18 | Revaluation reserve | 11.0 | 16.3 |
| 18 | Profit and loss account | <u>(28.0)</u> | <u>(50.9)</u> |
| | Equity shareholders' funds | 76.9 | 56.2 |
| 16 | Non-equity shareholders' funds | <u>-</u> | <u>3.0</u> |
| | Total shareholders' funds | <u>76.9</u> | <u>59.2</u> |

Approved by the Board of Directors on *28th September* 1998 and signed on its behalf by:

DR. BONE 
Director

ROLLS-ROYCE POWER ENGINEERING PLC

NOTE OF HISTORICAL COST PROFITS AND LOSSES

| | 1997 £m | 1996 £m |
|---|-------------|----------------|
| Reported profit/(loss) on ordinary activities before taxation | 16.9 | (145.7) |
| Realisation of revalued assets | 5.3 | 0.1 |
| Difference between a historical cost depreciation charge and the actual depreciation charge of the year calculated on the revalued amount | - | 0.1 |
| Historical cost profit/(loss) on ordinary activities before taxation | <u>22.2</u> | <u>(145.5)</u> |
| Historical cost profit/(loss) for the year after taxation and dividends | <u>22.9</u> | <u>(117.2)</u> |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts

| | Turnover | | Profit before Interest | | Net Assets | |
|-------------------------------|--------------|--------------|------------------------|----------------|--------------|--------------|
| | 1997 £m | 1996 £m | 1997 £m | 1996 £m | 1997 £m | 1996 £m |
| 1 Analysis of turnover | | | | | | |
| Profit and net assets | | | | | | |
| Analysis of business class | | | | | | |
| Power Engineering | 369.0 | 341.4 | 22.4 | 15.1 | 214.0 | 174.6 |
| General Engineering | 68.6 | 73.3 | (0.6) | 3.8 | 30.9 | 24.4 |
| | <u>437.6</u> | <u>414.7</u> | <u>21.8</u> | <u>18.9</u> | <u>244.9</u> | <u>199.0</u> |
| Operations to be discontinued | 116.8 | 250.5 | 6.8 | (156.0) | (8.1) | (36.2) |
| | <u>554.4</u> | <u>665.2</u> | <u>28.6</u> | <u>(137.1)</u> | <u>236.8</u> | <u>162.8</u> |

* Net assets exclude net borrowings of £159.9m (1996 - 103.6m)

Geographical analysis of turnover into specified markets

| | | |
|----------------|--------------|--------------|
| United Kingdom | 267.7 | 315.2 |
| Africa | 27.5 | 23.3 |
| North America | 27.8 | 24.1 |
| Australasia | 4.4 | 7.4 |
| Middle East | 111.6 | 123.2 |
| Western Europe | 35.9 | 32.4 |
| Asia | 70.9 | 136.4 |
| Others | 8.6 | 3.2 |
| | <u>554.4</u> | <u>665.2</u> |

All turnover, profit before interest and net assets originate from the United Kingdom.

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

| | 1997 Employees | 1996 Employees |
|--|-------------------|-------------------|
| 2 Staff numbers and costs | | |
| The average number of employees (including Directors) employed by the Company during the year was: | | |
| United Kingdom | 7,276 | 9,361 |
| Overseas | 109 | 139 |
| | <u>7,385</u> | <u>9,500</u> |
| Actual number of persons employed at 31st December | <u>6,081</u> | <u>8,619</u> |
| The aggregate payroll costs of these persons were as follows: | | |
| | 1997 £m | 1996 £m |
| Wages and salaries | 162.8 | 203.5 |
| Social security costs | 13.3 | 17.1 |
| Other pension costs/(credit) (Note 20) | (12.2) | (7.9) |
| Post retirement liabilities | 0.1 | 0.2 |
| | <u>164.0</u> | <u>212.9</u> |
| 3 Net interest and similar charges | | |
| Interest payable - | | |
| On borrowings wholly repayable within five years (including £11.1m payable to parent company, 1996 £8.6m) | (11.8) | (8.7) |
| On finance leases | - | (0.1) |
| | <u>(11.8)</u> | <u>(8.8)</u> |
| Other interest receivable | 0.1 | 0.2 |
| | <u>(11.7)</u> | <u>(8.6)</u> |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

| 4 | Profit on ordinary Activities before Taxation | 1997 £m | 1996 £m |
|---|---|------------|------------|
| | Profit (1996 - loss) on ordinary activities before taxation is arrived at after charging: | | |
| | Depreciation of owned tangible fixed assets | 5.8 | 8.6 |
| | Depreciation of tangible assets held under finance leases | 0.2 | 1.0 |
| | Hire of machinery and equipment (operating leases) | 1.3 | 2.1 |
| | Hire of other assets (operating leases) | 2.6 | 2.6 |
| | Directors emoluments (note 22) | 0.2 | 0.4 |
| | Auditors remuneration | 0.3 | 0.3 |
| | Other fees paid to Auditors | 0.2 | 0.1 |
| | Loss on disposal of businesses (note 19) | (4.4) | |

In July 1996 the Directors made the strategic decision to withdraw from large steam power generation. An exceptional loss of £147.2m was included within the total loss of £156.0m in respect of businesses to be discontinued in 1996.

| | |
|--|----------------|
| The Exceptional loss was | 1996 £m |
| Charged against operating profit | (78.2) |
| Provision for sale/termination of businesses | (69.0) |
| | <u>(147.2)</u> |

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

| | Continuing Operations £m | Discontinued Operations £m | 1996 Total £m |
|--|--------------------------------|----------------------------------|---------------------|
| Turnover | 414.7 | 250.5 | 665.2 |
| Cost of sales | (374.9) | (320.8) | (695.7) |
| Gross profit/(loss) | 39.8 | (70.3) | (30.5) |
| Commercial, marketing and product support costs | (4.0) | (1.9) | (5.9) |
| General & administrative costs | (8.2) | (11.5) | (19.7) |
| Research & development (net) | (8.7) | (3.3) | (12.0) |
| Operating profit/(loss) | 18.9 | (87.0) | (68.1) |
| Loss on sale of business | - | (69.0) | (69.0) |
| (loss)/profit on ordinary activities before interest | <u>18.9</u> | <u>(156.0)</u> | <u>(137.1)</u> |
| Net interest payable | | | (8.6) |
| Loss on ordinary activities before tax | | | <u>(145.7)</u> |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

5 Taxation

The credit/(charge) is based on the loss for the year and comprises:

UK Corporation tax at 31.5% (1996 33%)
Group relief

Adjustments in respect of prior years

| 1997 £m | 1996 £m |
|------------|------------|
| 16.3 | 28.4 |
| (14.9) | - |
| 1.4 | 28.4 |
| (0.7) | - |
| 0.7 | 28.4 |

6 Dividends

Preference:

3% cumulative redeemable preference shares of £1 each

5.375% cumulative preference shares of £1 each

11% cumulative preference shares of £1 each

| | |
|---|-----|
| - | - |
| - | - |
| - | 0.1 |
| - | 0.1 |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

7 Tangible fixed assets

Land and Buildings

| | Freehold £m | Long Leasehold £m | Short Leasehold £m | Plant and Machinery £m | Total £m |
|--|----------------|-------------------------|--------------------------|------------------------------|-------------|
| Cost or valuation at 1 January 1997 | 31.2 | 9.4 | 1.7 | 171.2 | 213.5 |
| Additions | 0.8 | - | - | 6.4 | 7.2 |
| Disposals | (0.1) | (8.5) | - | (81.1) | (89.7) |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Balance carried fwd | 31.9 | 0.9 | 1.7 | 96.5 | 131.0 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Depreciation at 1st January 1997 | 1.0 | 1.7 | 1.5 | 113.8 | 118.0 |
| Disposals | | (1.7) | - | (51.2) | (52.9) |
| Charge for Year | 0.8 | - | - | 5.2 | 6.0 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Balance carried fwd | 1.8 | 0.0 | 1.5 | 67.8 | 71.1 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Net Book Value at 31 December 1997 | <u>30.1</u> | <u>0.9</u> | <u>0.2</u> | <u>28.7</u> | <u>59.9</u> |
| Net Book Value at 31 December 1996 | <u>30.2</u> | <u>7.7</u> | <u>0.2</u> | <u>57.4</u> | <u>95.5</u> |
| Anticipated useful lives | 40 years | period of leases | | 3 - 20 years | |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

| 7 | Tangible fixed assets continued | 1997 £m | 1996 £m |
|---|---|------------|-------------|
| | Included in plant and equipment are assets being acquired under finance leases as follows | | |
| | Capital cost | 6.1 | 24.8 |
| | Depreciation | 4.5 | 15.3 |
| | Net book value | <u>1.6</u> | <u>9.5</u> |
| | Depreciation charge for the year on assets being acquired under finance leases | <u>0.2</u> | <u>1.0</u> |
| | Net book value of assets not being depreciated | <u>9.2</u> | <u>11.5</u> |

The amounts of land and buildings included at 1996 open market valuation comprise:

| | Freehold £m | Long Leasehold £m |
|--------------------------------------|----------------|-------------------------|
| Gross book value at 31 December 1997 | <u>26.1</u> | <u>0.9</u> |
| Net book value at 31 December 1997 | <u>25.5</u> | <u>0.9</u> |
| Gross book value at 31 December 1996 | <u>26.1</u> | <u>8.3</u> |
| Net book value at 31 December 1996 | <u>26.1</u> | <u>6.7</u> |

On an historical cost basis the net book value of land and buildings would have been as follows

| | | |
|----------------|---------------|--------------|
| Cost | 24.3 | 2.7 |
| Depreciation | <u>(11.3)</u> | <u>(0.2)</u> |
| Net book value | <u>13.0</u> | <u>2.5</u> |

Properties were revalued at 31 December 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 basis.

The revaluation was carried out by Storey Sons & Parker, Chartered Surveyors, in accordance with the appraisal and valuation manual of the Royal Institution of Chartered Surveyors.

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

8 Fixed Asset investments

| | Shares in Subsidiary Undertakings £m | Loans to Subsidiary Undertakings £m | Other Investments £m | Total £m |
|--|---|--|----------------------------|-------------|
| Investment in subsidiary undertakings | | | | |
| Cost less amounts written off at 1st January 1997 | 143.3 | 32.8 | 0.4 | 176.5 |
| Provision raised during year | - | (0.8) | - | (0.8) |
| Loans repaid | - | - | (0.2) | (0.2) |
| Loans made in year | - | 0.2 | 0.1 | 0.3 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Cost less amounts written off at 31st December 1997 | 143.3 | 32.2 | 0.3 | 175.8 |
| | <hr/> | <hr/> | <hr/> | <hr/> |

9 Stocks and contract work in progress

| | 1997 £m | 1996 £m |
|--|------------|------------|
| Long term contract work in progress | 26.7 | 13.5 |
| Other work in progress | 36.4 | 56.1 |
| | <hr/> | <hr/> |
| | 63.1 | 69.6 |
| Payments on account received and receivable | 44.7 | 57.9 |
| | <hr/> | <hr/> |
| | 18.4 | 11.7 |
| Payment on account in excess of work in progress transferred to current liabilities | 20.9 | 31.0 |
| | <hr/> | <hr/> |
| | 39.3 | 42.7 |
| Finished goods and goods for resale | 6.8 | 6.5 |
| Raw materials and consumables | 11.8 | 13.6 |
| | <hr/> | <hr/> |
| | 57.9 | 62.8 |
| | <hr/> | <hr/> |
| Payments on account included in long term contract work in progress | - | 0.1 |
| | <hr/> | <hr/> |

Payments on account received and receivable attributable to long term contract work in progress amount to £31.7m (1996 - £34.6m). Payments on account in excess of work in progress attributable to long term contract work in progress amount to £17.9m (1996 - £27.0m).

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

| 10 | Debtors | 1997 £m | 1996 £m |
|----|---|--------------|--------------|
| | Amounts falling due within one year - | | |
| | Trade debtors | 84.6 | 104.3 |
| | Amounts recoverable on contracts | 99.9 | 102.5 |
| | Amounts owed by parent company and fellow subsidiary undertakings | 35.4 | 11.1 |
| | Amounts owed by associated undertakings | - | 0.2 |
| | Corporate taxation recoverable | 30.0 | 31.5 |
| | Other debtors | 9.7 | 16.8 |
| | Prepayments and accrued income | 4.9 | 8.2 |
| | | <u>264.5</u> | <u>274.6</u> |
| | Amounts falling due after more than one year - | | |
| | Trade debtors | 2.1 | 5.9 |
| | Amounts recoverable on contracts | 1.7 | - |
| | Amounts owed by parent company and fellow subsidiaries | 26.7 | 11.2 |
| | Pension prepayment | 64.7 | 52.7 |
| | | <u>95.2</u> | <u>69.8</u> |
| | | <u>359.7</u> | <u>344.4</u> |
| 11 | Investments and short term deposits | | |
| | The short term deposits are stated at cost and include call, short notice and term deposits with finance house and other negotiable instruments. Includes £0.1m due from fellow subsidiaries (1996 - £0.1m) and £2.7m (1996 - £5.5m) due from subsidiaries. | | |
| 12 | Creditors: amounts falling due within one year | 1997 £m | 1996 £m |
| | Bank loans and overdrafts | 14.1 | 8.2 |
| | Amounts owed to parent company and fellow subsidiary companies | 170.7 | 118.5 |
| | Net rentals due under finance leases | - | 1.0 |
| | Borrowings | <u>184.8</u> | <u>127.7</u> |
| | Payments on account in excess of work in progress | 20.9 | 31.0 |
| | Trade creditors | 109.7 | 126.9 |
| | Amounts owed to parent company and fellow subsidiary undertakings | 7.6 | 11.1 |
| | Corporate taxation | - | 0.3 |
| | Other taxation and social security | 7.8 | 11.6 |
| | Other creditors | 50.5 | 67.3 |
| | Accruals and deferred income | 20.0 | 4.5 |
| | | <u>216.5</u> | <u>252.7</u> |
| | | <u>401.3</u> | <u>380.4</u> |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

13

Creditors: amounts falling due after more than one year

| | 1997 £m | 1996 £m |
|---|------------|------------|
| Net rentals due under finance leases | - | 0.2 |
| Long term borrowings (note 14) | - | 0.2 |
| Amounts owed to subsidiary undertakings | 145.4 | 143.4 |
| Amounts owed to parent company | 5.9 | 5.1 |
| Accruals and deferred income | 0.2 | 0.2 |
| Other creditors | 151.5 | 148.7 |
| | 151.5 | 148.9 |

14

Long term borrowings

| | 1997 £m | 1996 £m |
|--------------------------------------|------------|------------|
| Net rentals due under finance leases | | |
| Payable between two and five years | - | 0.1 |
| Payable between one and two years | - | 0.1 |
| | - | 0.2 |

15

Provisions for liabilities and charges

| | Balance at 1.1.97 £m | Utilised during the year £m | Charge for the year in the profit and loss account £m | Balance at 31.12.97 £m |
|--|----------------------------|--------------------------------------|--|------------------------------|
| Provisions for warranty, maintenance and other future contract costs | 43.3 | (33.5) | 15.5 | 25.3 |
| Provision for pension costs | 2.7 | - | 0.2 | 2.9 |
| Provision for restructuring | 69.0 | (41.9) | (6.8) | 20.3 |
| | 115.0 | (75.4) | 8.9 | 48.5 |

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

| 16 | Share capital | 1997 £m | 1996 £m |
|----|--|------------|------------|
| | <u>Authorised -</u> | | |
| | Equity - | | |
| | 332 million ordinary shares of 25p per share | 83.0 | 83.0 |
| | Non equity - | | |
| | 1,460,000 3% cumulative redeemable preference shares of £1 each | - | 1.5 |
| | 709,600 5.375% cumulative preference shares of £1 each | - | 0.7 |
| | 764,614 11% cumulative preference shares of £1 each | - | 0.8 |
| | | - | 3.0 |
| | <u>Allotted, issued and fully paid -</u> | | |
| | Equity - | | |
| | 263,382,058 (1996: 247,134,492) ordinary shares of 25p per share | 65.8 | 61.7 |
| | Non equity - | | |
| | 1,460,000 3% cumulative redeemable preference shares of £1 each | - | 1.5 |
| | 709,600 5.375% cumulative preference shares of £1 each | - | 0.7 |
| | 764,614 11% cumulative preference shares of £1 each | - | 0.8 |
| | | - | 3.0 |

The Company announced on 19th December 1996 that, following its decision to withdraw from large steam power generation and the impact upon the company's distributable reserves arising out of the resulting provisions made by the Company, the dividends which would otherwise have been payable on the preference shares in respect of the period to 31 December 1996 would not be paid. The Company further announced that active consideration was being given to proposals for acquiring or repaying all the preference shares.

On 14th February 1997, the Company served notice to holders of all classes of preference shares of its intention to reduce its capital by offering to purchase all the issued preference share capital. Class meetings and an Extraordinary General Meeting were held on 11th March 1997. A Court hearing on 30 April sanctioned the reduction of capital and on 2nd May 1997 all classes of preference shares were repaid in cash and delisted from the London Stock Exchange Daily Official List. Redemption prices were 107.5p for each 3% cumulative redeemable preference share of £1, 116.5p for each 5.375% cumulative preference share of £1 and 193.0p for each 11% cumulative preference share of £1.

| 17 | Deferred taxation | 1997 £m | 1996 £m |
|----|--|------------|------------|
| | No provision for deferred tax has been made. | | |
| | Full potential liability/(asset) - | | |
| | Fixed asset timing differences | 7.3 | 12.3 |
| | Other timing differences | (7.3) | (13.3) |

At 31st December 1997 advance corporation tax of £19.3m (1996 - £19.3m) is available to carry forward against future corporation tax liabilities.

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

18 Reserves

| | Share Equity £m | Capital Non Equity £m | Share Premium £m | Capital redemption reserve £m | Revaluation reserve £m | Profit and loss account £m | Total £m |
|---|-----------------------|-----------------------------|------------------------|--|------------------------------|-------------------------------------|-------------|
| Balance at 1st January 1997 | 61.7 | 3.0 | 25.1 | 4.0 | 16.3 | (50.9) | 59.2 |
| Profit retained for the financial year | - | - | - | - | - | 17.6 | 17.6 |
| Redemption of shares | - | (3.0) | - | - | - | - | (3.0) |
| Premium on redemption of shares | - | - | (1.0) | - | - | - | (1.0) |
| Issue of shares | 4.1 | - | - | - | - | - | 4.1 |
| Depreciation and disposals of revalued assets | - | - | - | - | (5.3) | 5.3 | - |
| Balance at 31st December 1997 | <u>65.8</u> | <u>0.0</u> | <u>24.1</u> | <u>4.0</u> | <u>11.0</u> | <u>(28.0)</u> | <u>76.9</u> |

19 Disposal of businesses

During the year the company has disposed of Kennicott Water Systems, Parsons (excepting some major turnkey contracts) and International Combustion's service businesses.

| | Continuing Operations £m | Discontinued Operations £m | Total £m |
|----------------------------|--------------------------------|----------------------------------|-------------|
| Tangible fixed assets | - | 31.6 | 31.6 |
| Stocks | 0.1 | 8.0 | 8.1 |
| Debtors | 5.5 | 20.1 | 25.6 |
| Creditors | (4.1) | (12.8) | (16.9) |
| Provisions | (0.1) | (7.0) | (7.1) |
| | <u>1.4</u> | <u>39.9</u> | <u>41.3</u> |
| Profit/(loss) on disposals | 0.7 | (5.1) | (4.4) |
| | <u>2.1</u> | <u>34.8</u> | <u>36.9</u> |

20 Pensions

The Company's principal Pension Scheme is of the defined benefit type and covers some 5,500 employees in the UK. The scheme is set up under trust and the assets of the scheme are, therefore, held separately from those of the participating companies. The pension cost of this scheme charged to the Profit and Loss Account is assessed in accordance with the advice of a qualified actuary using the Projected Unit Method. The pension cost is calculated so as to spread the cost of pensions over the employees' expected working service lives with the Company. It is based on an actuarial valuation of the Scheme as at 5 April 1995. The principal assumptions used in that valuation were that in the long term the average total annual return on investments would be between 2% and 2.5% higher than the average annual increase in pay and 5.5% higher than the average annual increase in pensions in excess of members' Guaranteed Minimum Pensions. Assets have been valued using the Discounted Income Method assuming that the rate at which equity dividends increase is 4.75% less per annum than the return on investments. The pension credit to the Profit and Loss Account for the year was £12.0m (1996 - £8.8m). This included a credit of £16.0m (1996 - £14.9m) in respect of the amortisation of past over-funding. This amortisation is over a period of 9 years, the average expected working service life of the pensioned employees. There is an additional credit of £5.6m (1996 - £4.6m) for calculated interest on the debtor due.

The actuarial valuation as at 5 April 1995 showed that the market value of the Scheme assets was £562m and the actuarial value of those assets represented 131% of the liability for benefits in respect of service to the valuation date, based on salaries projected to retirement or earlier exit.

The costs charged in respect of other pension schemes throughout the Company have also been assessed with the advice of a qualified actuary using methods appropriate to the circumstances of these schemes to spread the costs over the expected working lifetime of the employees concerned. The total costs charged for the year in respect of these other schemes was £0.2m (1996 - £0.9m).

A provision of £2.9m (1996 - £2.8m) and a debtor of £64.7m (1996 - £52.7m) are included in the balance sheet, being the difference between the accumulated amounts paid into the pension funds and the accumulated pension costs.

21 Contingent liabilities

The Company has in the normal course of business, entered into guarantees in respect of export finance, bills discounted, performance bonds etc.

The Company has guaranteed bank borrowings and term loans of certain subsidiary undertakings and fellow subsidiary undertakings which at 31st December 1997 amounted to £1.0m (1996 - £0.4m).

There are claims outstanding which arise under contracts carried out by the Company. It is not possible to predict with certainty the results of these claims but the Directors believe, in the light of advice received and taking into account counter claims, claims against third parties and provisions in the accounts, that the outcome will not have a material affect on the Company's financial position.

ROLLS-ROYCE POWER ENGINEERING PLC

Notes to the accounts continued

22 Directors Emoluments

| | 1997 £'000 | 1996 £'000 |
|---|---------------|---------------|
| The aggregate emoluments of the Directors including performance related bonuses of £nil - (1996 - £nil) | 213.9 | 272.0 |
| Compensation for loss of office | - | 175.0 |

The emoluments of the Chairmen are disclosed in the financial statements of the Company's ultimate holding company.

The emoluments of the Highest Paid Director were £122,663 (1996: £121,000). At the end of the year this director had an accrued pension entitlement of £29,136 per annum and an accrued lump sum of £35,217.

All of the Directors are members of defined benefit pension schemes.

Details of Directors' share interests are disclosed in the Directors' Report.

23 Commitments under operating leases

At 31st December, future annual commitments under non-cancellable operating leases were as follows -

| | 1997 £'000 | 1996 £'000 |
|---|---------------|---------------|
| Land and buildings - leases expiring: | | |
| within one year | 0.1 | - |
| in two to five years | 0.1 | 0.1 |
| after five years | 0.1 | 0.1 |
| Other operating leases - leases expiring: | | |
| within one year | 1.3 | 1.1 |
| in two to five years | 1.3 | 2.7 |
| | <u>2.9</u> | <u>4.0</u> |

The majority of leases of land and buildings are subject to rent reviews.

24 Ultimate Holding Company

The Company's ultimate holding company and controlling party as defined by FRS 8 is Rolls-Royce plc, a company which is registered in England and Wales.

Copies of Rolls-Royce plc's Directors' Report and Financial Statements can be obtained from Rolls-Royce plc, 65 Buckingham Gate, London SW1E 6AT.

Under Financial Report Standard 8 the Company is exempt from the requirement to disclose related party transactions with the Rolls-Royce Group and its associates on the grounds that it is a wholly owned subsidiary undertaking of Rolls-Royce plc.

PRINCIPAL SUBSIDIARY UNDERTAKINGS

The following were the principal undertakings of Rolls-Royce Power Engineering plc during the year ended 31st December 1997. Effective group interest is 100% unless otherwise stated.

The principal wholly owned UK subsidiary undertakings trade as agents of the Company.

| | United Kingdom | Overseas* | Country of incorporation and/or operation |
|------------------------------------|---|---|--|
| Subsidiary undertakings | Allen Power Engineering Ltd | Rolls-Royce Industrial Power (Pacific) Ltd | Australia |
| | Clarke Chapman Ltd | Rolls-Royce Industrial Power (New Zealand) Ltd | New Zealand |
| | Cochran Boilers Ltd | Rolls-Royce Industrial Power (Malaysia) Ltd | Malaysia |
| | Derby Specialist Fabrications Ltd | Rolls-Royce Industrial Power (Hong Kong) Ltd | Hong Kong |
| | International Research & Development Ltd | NEI Africa Holdings Ltd (60%) | South Africa |
| | NEI Overseas Holdings Ltd | Northern Engineering Industries Africa Ltd (56%) | South Africa |
| | Heaton Power Ltd | NEI Zambia Ltd | Zambia |
| | Peebles Electric Ltd | Cutler Hammer Zambia Ltd | Zambia |
| | Reyrolle Ltd | NEI Holdings Zimbabwe (Private) Ltd | Zimbabwe |
| | Reyrolle Projects Ltd | Fushun & Reyrolle Bushing Co Ltd (50%) | China |
| | R-R Industrial Controls Ltd | Caillard S. A. | France |
| | Rolls-Royce Nuclear Engineering Services Ltd | Ferranti Packard de Mexico SA de CV (63%) | Mexico |
| | Rolls-Royce Industrial Power (India) Ltd + | | |
| | Rolls-Royce Industrial Power (Overseas Projects) Ltd | | |
| | NEI Brantford International Ltd (51%) ** | | |

* The shares in overseas subsidiary undertakings are held by subsidiary undertakings. The percentage of shares held refers to the ordinary share capital, none of which is held by the parent company.

+ Financial year ends 31st March

** 51% sold on 19 February 1998