Rolls-Royce

Delivering today, investing for the future

Rolls-Royce Group plc

Annual report 2009

Contents

Business review

Corporate governance

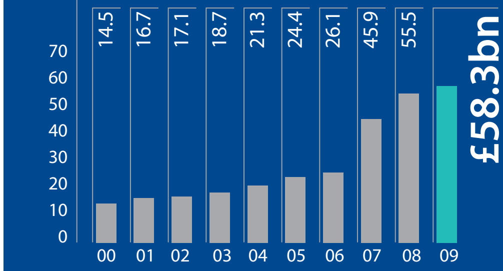
Financial statements

Directors' report

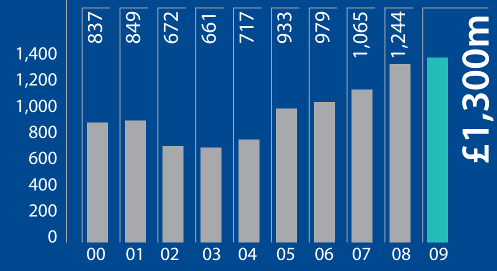
The Directors present the Annual report for the year ended December 31, 2009 which includes the business review, corporate governance and audited financial statements for the year. References to 'Rolls-Royce', the 'Group', the 'Company', 'we', or 'our' are to Rolls-Royce Group plc and/or its subsidiaries, or any of them as the context may require. Pages 01 to 90, inclusive, of this Annual report comprise a Directors' report that has been drawn up and presented in accordance with English company law and the liabilities of the Directors in connection with that report shall be subject to the limitations and restrictions provided by such law. Rolls-Royce Group plc is incorporated as a public limited company and is registered in England under the UK Companies Act 1985 with the registered number 4706930. Rolls-Royce Group plc's registered office is 65 Buckingham Gate, London, SW1E 6AT.

Financial highlights

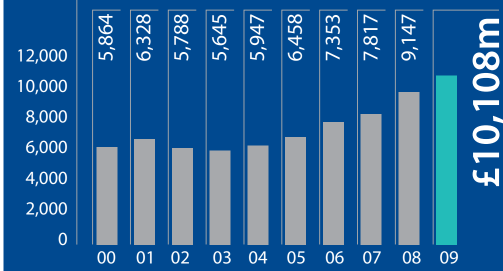
Order book – firm and announced (£bn)



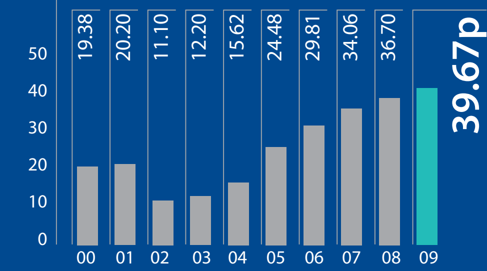
Underlying EBITDA (£m)



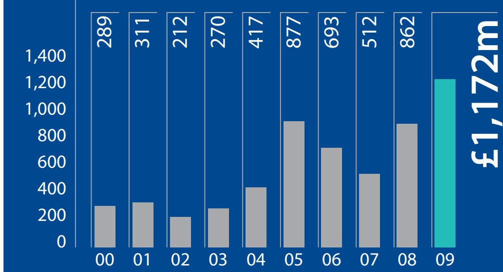
Underlying revenue (£m)



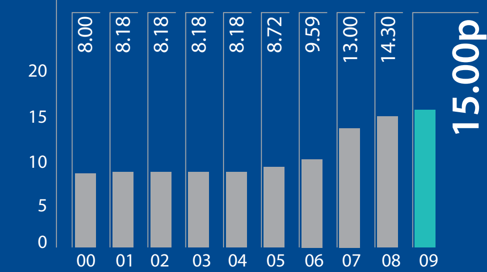
Underlying earnings per ordinary share (p)



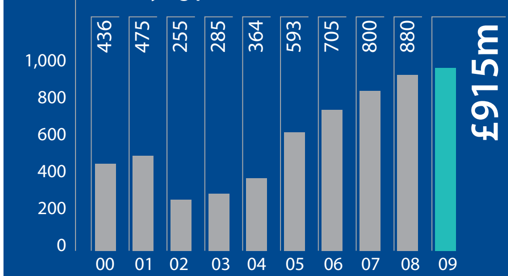
Profit before financing (£m)



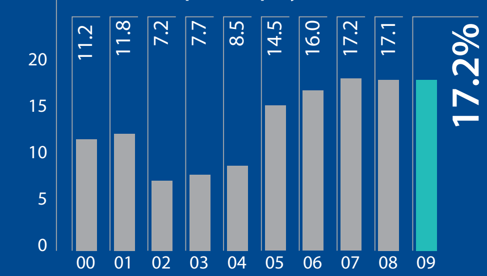
Payments to shareholders (p)



Underlying profit before tax (£m)



Return on capital employed (%)



Cautionary statement regarding forward-looking statements

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

Note: The reconciliation of underlying revenues and results is provided in notes 2 and 5 on pages 104 and 111 of the consolidated financial statements.

Introduction

We have followed a consistent strategy for 20 years and our investment in technology, together with our strong order book, positions us well for future growth.

Civil aerospace

Powering more than 30 civil aircraft types from small executive jets to the largest airliners.

£47.0bn
Order book

£4,481m
Underlying revenue

Marine

A world-class range of capabilities in ship design and in the supply and support of power and propulsion systems.

£3.5bn
Order book

£2,589m
Underlying revenue

Defence aerospace

An engine portfolio that covers all major sectors including transport, combat, trainers, helicopters, tactical and unmanned aircraft.

£6.5bn
Order book

£2,010m
Underlying revenue

Energy

An established and leading position in power for onshore and offshore oil and gas applications, together with a growing presence in power generation.

£1.3bn
Order book

£1,028m
Underlying revenue

Chairman's statement

Simon Robertson, Chairman

"Our balance sheet remains strong and the long-term nature of our business gives us exceptional visibility of revenues for many years to come."

At the end of an extremely challenging year for the world economy, I am pleased to report that Rolls-Royce has delivered another solid performance in 2009. This demonstrates both the resilience and the long-term nature of our business. Underlying profit before tax has increased by four per cent and despite intense competition, our order book has grown from £55.5 billion in 2008 to £58.3 billion in 2009.

We are proposing a final payment to shareholders of nine pence per share, bringing the full year payment to 15.00 pence. This is an increase of five per cent, and reflects the Board's continued confidence in the Group's business.

In the past year, the degree of uncertainty facing global markets has somewhat diminished. Sharp declines in output have been arrested and growth is returning to most of the world's major economies, albeit at considerably reduced levels. Overall the economic environment remains tough. Therefore we shall continue to focus on operational efficiency, while maintaining our commitment to research and development and to investment which supports our growing order book.

Our strategy of developing our business in new markets and geographies and increasing the revenues we earn through long-term service contracts, positions us well to take advantage of commercial opportunities as they arise and to deliver sustained growth. The power systems and services we sell employ complex technologies and demand advanced engineering skills, which together create high barriers to entry. Our balance sheet remains strong and the long-term nature of our business gives us exceptional visibility of revenues for many years to come.

Full year payment to shareholders

2008	2009
14.30p	**15.00p**

Business review
Corporate governance
Financial statements

It is particularly important in periods of economic uncertainty that a company's core values are defended and strengthened. Our commitment to acting with integrity is at the heart of the way we operate. In 2008, Rolls-Royce established an ethics committee, which reports to the Board. In 2009, we published a new Global Code of Business Ethics and distributed this, with face-to-face training, to all our employees worldwide. The Global Code establishes industry-leading standards and is supported by a rigorous process for reporting and monitoring to ensure compliance.

The Board is committed to improving the environmental performance of our products across all our business sectors. We have always recognised that technology and innovation are critical to achieving such improvements. As a consequence we commit two-thirds of our research and development expenditure to developing solutions to these challenges. Substantial progress has been made over many years. Our products are significantly more fuel efficient than they were a decade ago. We continue to look for further advances through the Environmentally Friendly Engine and other research programmes. In our marine business, we have extended our range of engines that run on liquefied natural gas, offering far better emission performance than conventional diesel powered engines. We also actively explore the opportunities presented by civil nuclear and other sustainable energy technologies.

Rolls-Royce is a long-term business operating in global markets and we have benefited again in the past year from the wise counsel of our International Advisory Board (IAB), which was established in 2006 to advise on emerging political, business and economic trends (membership of the IAB is shown on page 69). The IAB provides high-level strategic input to the Board and management. Its members bring a deep understanding of global issues affecting Rolls-Royce and of the markets and countries we operate in.

The life-blood of Rolls-Royce is its people. It is their pride in what Rolls-Royce has achieved and, even more important, their vision of what can be achieved in the future, that will secure our continued success. As I travel around the world, I am constantly impressed by the calibre of the men and women I encounter at every level of the Group. From our apprentices and recent graduates to the most experienced and knowledgeable of our engineers and scientists, it is their ideas, their insight and their motivation which give Rolls-Royce its competitive edge. The Board is committed to investing in the development of future generations who will, in time, ensure the success of the Company.

I am very proud of our employees. We remain committed to developing their skills through a range of world-class training programmes, as well as by encouraging a wider interest in science and engineering. A good example of this is our sponsorship of the Rolls-Royce Science Prize for schools which attracts greater interest every year. In 2009, 1,500 schools took part, with 2,000 schools expected to participate in 2010. Last year's top award of £20,000 went to Kells Lane Primary School, Gateshead, England for a really innovative wind turbine project.

Rolls-Royce supports a wide range of charitable causes, with much of that support directed towards educational programmes which promote engineering and scientific learning.

I would like to thank the management and all our employees for the commitment and the flexibility they have shown in the past challenging 12 months. I would also like to record my gratitude to my fellow directors for their continued hard work and support. There have been no changes to the Board during the past year, but I would like to take this opportunity to thank Charles Blundell for his contribution to Rolls-Royce and his services to the Board where he served as Company Secretary from 1995 to 2007. He retired this year from the position of Director of Public Affairs.

2010 will present significant challenges for Rolls-Royce. However the resilience of the Group's performance reflected in this report, the fundamental strength of its business model and the proven capabilities of the management team, give me confidence that Rolls-Royce will continue to find opportunities in the marketplace and deliver sustainable growth for the benefit of all our stakeholders.

Simon Robertson
Chairman
February 10, 2010

Chief Executive's review

Sir John Rose, Chief Executive

"Our resilience, coupled with the inherent strength of our business model, will enable us to manage short-term uncertainties and deliver future growth."

Delivering today, investing for the future

Group order book

£55.5bn	£58.3bn
2008	2009

In 2009, Rolls-Royce has delivered solid results despite the severity of the economic downturn, a performance which has again demonstrated the benefits of pursuing a consistent strategy over a long period. This approach has created a broadly-based business with deep customer knowledge, outstanding technology and world-class people.

Our financial results demonstrate the resilience of our business. The Group's order book increased to a record £58.3 billion, with underlying revenue growing 11 per cent to £10.1 billion and underlying profit before tax improving four per cent to £915 million.

The Group has a strong financial position with average cash balances increasing by £260 million to £635 million. The triennial valuation of the Group's largest pension scheme has just been completed and confirms that 2010's cash funding will be maintained at a level similar to that in 2009. This demonstrates the benefits of the early action taken to amend the terms of the scheme and to adopt an investment strategy that reduces volatility.

The economic environment remains challenging and it seems likely that world growth will be slower in the years ahead than it has been in the past decade. In these circumstances, we will benefit from our ability to access the world's faster growing markets where there continues to be demand for investment in transport and infrastructure.

We will maintain our focus on cost reduction and improving our operational efficiency. At the same time we will continue to invest in technology, in our product and service portfolio, in the capital assets required to deliver growth, in our international footprint and in our people.

A long-term business

It is important to recognise that ours is a long-term business. Typically, our product and service lifecycles span 40-50 years and we invest in technology programmes that look five, ten, 20 years and more into the future.

A good example of this is the Avon engine. In its latest version – modified to produce significant improvements in power and efficiency – it is meeting the demands of customers in the oil and gas sector. Yet the Avon first entered the industrial gas turbine market 40 years ago. That engine in turn was derived from the original aero version, which powered a Canberra aeroplane on the first non-stop, non-refuelling, jet flight across the Atlantic in 1951.

Examples like this show why it is so important to set our Group's progress into a broad context. This review will chart our progress over the past ten years, during which we more than doubled our revenues and our underlying profits. This has provided us with a platform from which we are confident we can grow our revenues by at least as much again in the decade ahead.

A very different company

We are now a very different company than we were ten years ago. This can be measured in terms of our scale and geography, in terms of the range of things we do and in terms of operational efficiency. All this has made us a more resilient business and has established a far broader foundation from which to build revenues in the future. A few facts and figures comparing the Rolls-Royce of 1999 with today's Group illustrate the point.

Today, at any one time around 200,000 people are flying in aircraft powered by Rolls-Royce engines. Our ability to keep those aircraft in the sky is a powerful illustration of the 'mission critical' nature of what we do. At peak times that figure can double, which means that the equivalent of the population of Bristol is being kept aloft by Rolls-Royce engines. That is considerably more than double the number of people we were flying a decade ago.

We have become much more than a civil aerospace company. The revenues from our marine, defence aerospace and energy businesses have grown from £2.1 billion in 1999 to £5.6 billion in 2009. In 2009, revenues from outside our civil aerospace business accounted for more than half of Group revenues.

Underlying earnings per ordinary share

2008	2009
36.70p	**39.67p**

We are becoming less dependent on our traditional markets of Europe and North America. These geographies, which accounted for around 70 per cent of our revenues in 1999, represent around 66 per cent of our revenues now and that trend is set to continue, as more than half our current order book comes from Asia, South America and the Middle East.

Around half our revenues come from services today compared to 40 per cent a decade ago. This represents an annual compound growth in services of ten per cent.

Throughout this period we have maintained our focus on costs and improving operational efficiency. Every year for the past ten years, revenue per employee has increased, showing a 16 per cent improvement in the year to £271,000 in 2009. We are now selling more than twice as much as we were ten years ago, with 2,000 fewer people.

Taken together, the pipeline of orders we have already signed, our increased market share, the growth and scale of our services business and our focus on costs, underpin our confidence that we will double our annual revenues in the decade ahead by organic growth alone.

Our shareholders have benefited from our success to date with payments increasing from 7.25 pence in 1999 to 15.00 pence in 2009.

A consistent strategy

The disciplined application of a consistent strategy over many years has delivered a strong, resilient company, which is well positioned for the long-term growth we expect.

Our strategy has five elements and 2009 saw us make progress against each of these.

1. Addressing four global markets

Rolls-Royce has become a truly global Group, providing 'mission critical' power and propulsion systems to a wide range of customers in over 120 countries. The scale of the progress that has been made is illustrated by the fact that the size of our order book in Asia and the Middle East today is around double the Group's entire order book in 1999.

During 2009 we won new customers in Asia, Africa, Europe, the Middle East and North and South America.

Our global reach, coupled with the fact that very few companies offer the highly sophisticated range of products and services that we do, positions us well to take advantage of opportunities in early recovering and emerging economies.

2. Investing in technology, infrastructure and capability

We have managed our balance sheet cautiously and for the long term so that we can continue to invest in manufacturing capability and technology. These investments are targeted specifically to support anticipated growth and meet our customers' future needs.

Technology is a critical differentiator in our four markets, all of which demand increased fuel efficiency, reduced environmental impact and higher levels of reliability and durability. We have invested £7 billion in R&D over the past ten years to maintain our technological advantage, with a particular emphasis on collaborative research involving a network of universities around the world.

This focus continued in 2009, as we championed the development of a network of Advanced Manufacturing Research Centres – four in the UK and one each in the US and Singapore – bringing business and academia together to undertake research relevant to industry.

In 2009, the Group announced a £300 million investment in four new factories in the UK: a casting facility for single crystal turbine blades; an advanced disc facility; a wide-chord fan blade facility for defence engines and; a civil nuclear facility to assemble and test components. This represents the latest phase in a programme of capital replacement which has seen Rolls-Royce invest £1.8 billion in UK infrastructure over the past decade, creating world-class manufacturing facilities in multiple locations and providing skilled jobs in state-of-the-art environments.

To address our global market opportunities, in 2009 we began work on a manufacturing and assembly facility at Crosspointe in the United States. We also confirmed a large engine assembly plant and announced a new wide-chord fan blade factory in Seletar, Singapore, our first outside the UK. This will bring the total investment in the Seletar campus to around £300 million by the time it is completed in 2012.

We now manufacture in 20 countries and have service centres in over 50.

3. Developing a competitive portfolio of products and services

We invest continually in developing proprietary technology which will meet our customers' present and future needs. We currently have 39 'live' major engineering programmes, compared to 25 a decade ago.

2009 was a remarkable year in which we celebrated the first flight of six of our customers' aircraft: the Boeing 787; Gulfstream G650; Airbus A400M; Embraer Legacy 650, the BAE Systems Mantis UAV and the AgustaWestland Lynx Wildcat helicopter. Early in 2010, the short take-off and vertical landing (STOVL) version of the F-35 Joint Strike Fighter deployed the unique Rolls-Royce LiftSystem® for the first time.

These are unprecedented achievements, with more entirely new aircraft taking to the skies in a period of three months than in the previous five years. The capability to meet these requirements is the direct consequence of a decade of investment and innovation.

In the marine market in 2009, we saw the US Navy's Littoral Combat Ship go on active duty, the first sailing of the Royal Navy's Astute class submarine and the commissioning of the Royal Navy's first Type 45 Destroyer, HMS Daring.

All these aircraft and vessels are powered by Rolls-Royce and will enter active service in the next two to three years. The lives of each of these programmes is expected to span 40 years or more, giving us exceptional clarity of future original equipment and service revenues.

4. Growing market share and our installed product base

We have successfully grown our market share in each of our businesses, generating revenues today and establishing a platform for future growth.

Our share of the civil aerospace market has expanded from 27 per cent in 1999 to 34 per cent today and our future order book will ensure that our market share continues to grow, driven by the strong position Rolls-Royce has established on the new generation of wide-bodied aircraft. On the new Boeing 787 and the Airbus A350 XWB families, Rolls-Royce has achieved a market share of 64 per cent.

In the defence aerospace sector we are the world's number two and Europe's number one producer of aero engines, with an extensive engine portfolio for all key sectors of the market.

Revenues in our marine business have more than doubled since 2005. We now design, supply and support power and propulsion systems for naval and commercial applications, with over 30,000 vessels worldwide using our equipment.

In 2009, our energy business recorded its highest ever underlying revenue and profit. We serve energy customers in over 120 countries. Our position in providing power for the oil and gas sector remains strong and the industrial Trent engine continues to establish its presence in the power generation market.

5. Adding value for customers through product-related services

We have unrivalled knowledge of the complex technologies within our products and a deep understanding of our customers' needs. We have used these to develop services that improve our customers' operations.

Our aerospace operations centres are a good illustration of this capability. In dedicated facilities serving airline, corporate and defence customers, these Rolls-Royce centres collect real-time data from our engines as they are operating around the world, 24 hours a day, 365 days a year. By analysing, sharing and acting upon this information we can optimise the performance of our engines in service. The centres are a focal point for service delivery, assessing the condition of the fleet and directing logistics and field maintenance.

We have transferred service best practice across all our businesses so that each now offers a through-life service capability. We continue to strengthen our global services network and in the past year opened, or expanded, marine services facilities in Niteroi in Brazil, Galveston and Seattle in the US and Newfoundland in Canada. We opened an On-Wing Care facility for corporate and regional aircraft in Indianapolis, in the US, and continue to invest in our civil aerospace overhaul bases in Hong Kong and Singapore.

Our people

To execute this strategy effectively and on a worldwide basis, the skills, diversity and dedication of our people are key. The global nature of our customers and our operations means that our people have to be capable of teamwork across geographies. They need to be flexible and open minded, to have world-class capabilities and shared values. Of the 38,500 people we employ, 45 per cent are now based outside the UK.

Today we run a civil aerospace business from the UK with emerging capabilities in Germany and the US. The Presidents of both our defence and energy businesses are based in North America. The US is our biggest defence market and in our energy business, gas turbines are produced in Canada and packaged in the US. We have transferred our marine headquarters to Singapore, reflecting the significance of the Asia region for shipbuilding.

Effective communication that enables the organisation to work well across time zones and borders is crucial. We invest time and effort in communication, using a combination of modern technology and traditional formats to help us to stay connected. In 2009, we shared our strategy storyboard with every employee. The programme was conducted in groups of around ten with a presenter and a record keeper. This amounts to more than 4,000 presentations over 6,000 hours, with a record of the conversation kept to make sure that we benefit from local insights.

In 2009, Rolls-Royce recruited more than 250 new apprentices and 334 graduates, more than ever before, young men and women of over 30 nationalities who have the potential to become leaders of the future.

We are able to attract exceptional people because of the range of world-class skills we require to deliver high value-added manufacturing and services. These range from expertise in marketing and law, through to specialist engineering and logistics, all of which need to be practised internationally and at the highest level.

While we have continued to invest, economic conditions have forced us to take some difficult decisions as well. We have had to reduce our staff in parts of the business where demand has been weak, leading to a net reduction in headcount across the Group of around 500 people in the past year.

Taking these difficult decisions early, investing where the business case is strong and continually looking for ways to improve, have enabled us to respond to the difficult economic environment. Our employees have again demonstrated their capability and commitment and I would like to thank them for playing an integral part in our Group's continuing success.

Prospects

I have described how Rolls-Royce has transformed itself in the past ten years and how, in doing so, it has established a platform for the doubling of revenues in the decade ahead.

In 1999, Rolls-Royce had an order book of £13.2 billion. Today our order book stands at £58.3 billion, with a record number of major global programmes balanced across our four business sectors. These include the Trent XWB, which is not due to enter service until 2013, yet has already achieved more than 1,000 orders – a powerful demonstration of the confidence our customers have in our ability to deliver.

The market share we have gained, the investments in new products we have made and the balance of the business we have achieved, affords us access to a global market for products and services we assess to be worth more than US$2 trillion over the next 20 years, made up of US$1,400 billion for civil aerospace, US$450 billion for defence aerospace, US$320 billion for marine and US$120 billion for energy.

In the short term, the Group expects the trading environment to remain difficult, with the implications of delayed airframe programmes and launch costs adding to demand and operational uncertainty. The Group expects underlying revenues and profits in the current year to be broadly similar to those achieved in 2009. We anticipate a modest cash outflow in 2010 with average cash balances remaining above £500 million.

Our resilience, coupled with the inherent strengths of our business model will enable us to manage these short-term difficulties and deliver future growth.

Sir John Rose
Chief Executive
February 10, 2010

Reliable power is *'mission critical'* for our customers

The power systems we deliver are critical to the operations of our customers.
On land, at sea and in the air we deploy the world's most advanced technologies for those who depend upon us.

Civil aerospace

Airlines and their customers rely on Rolls-Royce. We recognise the responsibility that is placed on us to produce the most reliable engines with the highest engineering integrity.

1,000,000
Aircraft powered by Rolls-Royce fly one million miles every hour, keeping society and the global economy on the move.

67,000
Airlines look to us to deliver safe, reliable power on behalf of their customers – to ensure this, we monitor 67,000 hours of engine data every day, in real time.

650
650 airline, freight and lease customers are Rolls-Royce powered and they fly the equivalent of six million flights around the world each year.

Defence aerospace

Pilots of 160 armed forces need to know that they can depend on the power from Rolls-Royce engines instantly, whenever they call for it. Our engines are employed in all the key sectors of this market.

103
Rolls-Royce products provide the defence power systems for 103 countries.

85
Rolls-Royce powers 85 per cent of the UK MoD's aircraft in frontline operations. The UK military on average performs over 2,000 search and rescue missions annually, many are powered by Rolls-Royce.

15
Rolls-Royce is powering 15 different aircraft types in Afghanistan, supporting combat, transport, medical evacuation, tactical and surveillance operations.

Rolls-Royce is a global company producing *'mission critical'* power solutions for customers in aerospace, marine and energy markets.

3,000

Our design of specialist vessels can secure an offshore platform at depths of up to 3,000 metres with pinpoint accuracy – helping access the world's deep water oil and gas reserves.

40

The Littoral Combat Ship, USS Freedom, is one of the fastest warships afloat. Powered by two Rolls-Royce MT30 gas turbines it has a top speed of well over 40 knots.

The latest Rolls-Royce nuclear plant, that powers the Royal Navy's Astute class submarines, can circumnavigate the globe without surfacing and will never need to be refuelled in its life.

Marine

There are 30,000 commercial and naval vessels operating with Rolls-Royce equipment, ensuring that sea trade of all types keeps on the move and that coasts, national and international waters are safe for all. Rolls-Royce has a wider range of marine products than any other single supplier.

500

Over 500 of our gas turbines are operating in hostile weather environments, offshore of 25 countries, delivering the critical power needed on oil and gas platforms.

16

Our new Trent 60 gas turbine has been sold to 16 countries and the fleet can generate enough power for three million homes.

60

Over 60 major pipelines in 26 countries depend on Rolls-Royce gas turbines to transport oil and gas – essential arteries in the world's energy network.

Energy

Society's energy demands continue to grow. We are providing essential power for the oil and gas industries to meet these needs and increasingly our clean and efficient gas turbines are providing local electricity. Rolls-Royce is also at the forefront of low carbon and renewable energy products.

Our consistent strategy

Our consistent strategy is based on five key elements

Address four global markets
We are a leading producer of mission critical, integrated, power systems for the civil and defence aerospace, marine and energy markets.

Invest in technology, infrastructure and capability
Over the past five years, we have invested £4 billion in R&D. We invest substantially in employee development and invest around £300 million a year in capital projects.

Develop a competitive portfolio of products and services
We have 39 major engineering programmes and we are involved in many of the future projects in the markets we serve. These key projects will define the power systems market for many years.

Grow market share and installed product base
Across the Group, the installed base of engines in service is expected to generate attractive returns over many decades.

Add value for our customers through the provision of product-related services
We seek to add value for our customers with aftermarket services that will enhance the performance and reliability of our products.

Underpinned by core characteristics

Closeness to our customers
We recognise that our customers determine our strategy and organisation.

Domain knowledge
A deep understanding of our customers and the way in which our products and services are used.

Integrated systems
Integrating our products into systems that deliver increased value for our customers.

Technological superiority
Gaining competitive advantage through continuous investment in technology.

Operational excellence
Working constantly to meet and exceed customer expectations.

Organisational capability
Attracting and retaining the best people globally.

Brand
Recognised globally, our brand embodies qualities that create a common focus for all our people worldwide.

Across four key markets

Civil aerospace
Broadest engine range in the world

£4,481m
Underlying revenue 2009

Defence aerospace
Europe's biggest engine maker

£2,010m
Underlying revenue 2009

Marine
World-leading systems provider and integrator

£2,589m
Underlying revenue 2009

Energy
World leader in oil and gas and a growing power generation presence

£1,028m
Underlying revenue 2009

Expanding product portfolio

Astute class submarine
The Royal Navy's latest class of nuclear submarine went to sea in 2009, powered by a new Rolls-Royce designed long-life core.

Airbus A400M airborne
Rolls-Royce is a major partner in the engine consortium powering the new airlifter, which flew for the first time in 2009.

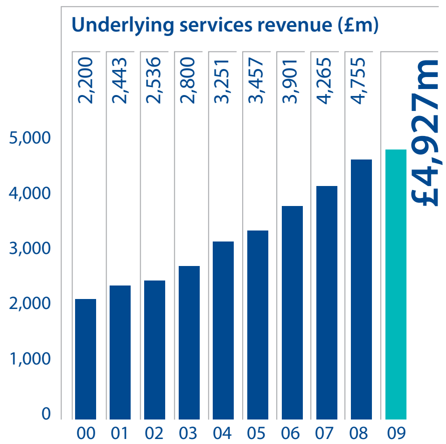
STOVL F-35 milestone
The F-35B Lightning engaged its Rolls-Royce designed STOVL propulsion LiftSystem™, in flight, for the first time.

An increasing contribution from services

The increasing contribution from services
We have grown our service revenues ten per cent compound over the past ten years. Services now account for around 50 per cent of total underlying revenue.

Underlying services revenue 2009

£4,927m

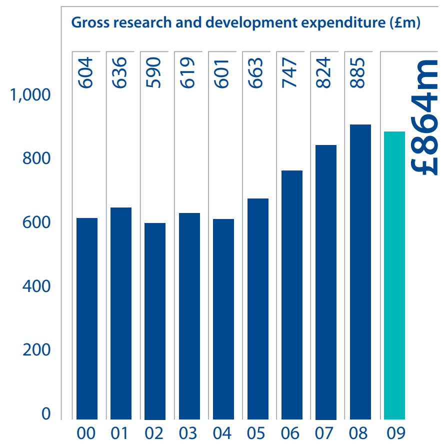


A commitment to R&D creating high barriers to entry

A strong record of investment in research and development
We invest in world-class, cost-effective technology in order to develop products that add value for our customers, improve efficiency and reduce environmental impact.

Investment in research and development during 2009

£864m



Delivering a 20-year track record of continued growth

Organic growth
Our broad product range and expanding service provision have delivered growth globally.

Partnerships
We increasingly develop products with risk and revenue sharing partners and through strategic long-term relationships.

Acquisition
Major acquisitions such as Allison and Vickers have enabled growth in key sectors.

Our growth during the past 20 years has been achieved organically and through partnerships and acquisitions.

Gulfstream G650 jet airborne

Powered by the new BR725 engine, this new long-range business jet took to the air for the first time on schedule during 2009.

Littoral Combat Ship completes sea trials

Lockheed Martin's USS Freedom, powered by Rolls-Royce MT30 marine gas turbines, completed its sea trials.

Boeing 787 airborne

Trent 1000 engines powered the new Boeing 787 Dreamliner on a successful first flight at the end of 2009.

Our strategy in action

Delivering today, investing for the future

Rolls-Royce is growing globally and at the same time meeting the challenges of managing the business today. Our consistent strategy has ensured that the Group is resilient in the current economic climate and is still able to plan and invest for future growth.

Addressing our four global markets

Serving a global customer base

We are a leading integrated power systems company, operating in civil and defence aerospace, marine and energy markets. We serve customers in over 120 countries and forecast a 20-year market opportunity of US$2 trillion.

Our gas turbine products are shipped to customers all over the world, by land, sea and air.

US$1,400bn
Civil aerospace market opportunity

US$450bn
Defence aerospace market opportunity

US$320bn
Marine market opportunity

US$120bn
Energy market opportunity

Our strategy in action

Investing in technology, infrastructure and capability

Future capacity

Rolls-Royce is investing in capital projects all over the world as the Group increases its operational capacity. We are growing as a result of our increased market share and substantial order book.

During 2009, building work began on the new US facility in Crosspointe, Virginia, where we will make discs for gas turbines.

£2.7 billion

The Group has invested £2.7 billion in capital projects over the past ten years.

Our strategy in action

Developing a competitive portfolio of products and services

Powering the F-35 Lightning
Rolls-Royce is a partner with General Electric in producing the F136 main propulsion engine for the F-35 and, in addition, Rolls-Royce has designed the LiftSystem which is employed in the F-35B, or STOVL, version of the aircraft. This is just one of the many major new programmes on which the Group is engaged.

The Rolls-Royce designed LiftFan™ is used in the F-35B as part of the overall LiftSystem. The F-35B LiftSystem was engaged in flight for the first time in early 2010.

39
39 major programmes in development.

Our strategy in action

Growing our market share and installed product base

World-leading offshore support and power

Rolls-Royce is a major partner of oil and gas companies all over the world, not just providing industrial gas turbines as power systems for the platforms but also providing the designs for, and much of the equipment on board, the specialist vessels that support the platforms.

The Group's UT-Design of offshore vessels is a world leader, incorporating significant amounts of Rolls-Royce technology and equipment.

2,000

2,000 marine customers.
Energy customers in 120 countries.

Our strategy in action

Adding value for our customers through product-related services

Data management for predictive maintenance

As the original equipment manufacturer, we have access to data on the Rolls-Royce fleet of gas turbines. We gather, analyse and act upon this data to ensure that we can maximise the value of the gas turbines in service with our customers.

We have expanded the capability of our operations centres. These centres manage data and help plan and drive the services offered by the businesses.

90

Ninety per cent of Trent fleet under TotalCare management.

Market outlook

The Group operates in four long-term global markets – civil and defence aerospace, marine and energy. These markets create a total opportunity worth in excess of US$2 trillion over the next 20 years and:

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

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

Civil aerospace

The Group publishes a 20-year global market outlook, which covers passenger and cargo jets, corporate and regional aircraft. We predict that over the next 20 years 141,000 engines, worth over US$800 billion, will be required for more than 65,000 commercial aircraft and business jets. The forecast predicts faster growth rates for long-haul markets and those markets to, from and within Asia. These markets will continue to benefit from more liberal air service agreements, which boost demand. Factors affecting demand include GDP growth, aircraft productivity, operating costs, environmental issues and the number of aircraft retirements. While the market can be temporarily disrupted by external events, such as war, acts of terrorism, or economic downturns, it has, in the past, always returned to its long-term growth trend. In addition to the demand for engines, the Group forecasts a market opportunity worth US$600 billion for the provision of product-related aftermarket services.

Defence aerospace

The Group forecasts that demand for military engines will be worth US$170 billion over the next 20 years. The largest single market is expected to be the US, followed by Europe and the Far East. Within Asia, demand will be dominated by Japan, South Korea and India. Trends are driven by the scale of defence budgets and geopolitical developments around the world.

As in the Group's other business sectors, programme lives are long and there is a significant opportunity to support equipment with aftermarket services estimated at US$280 billion over the same period. Customers' budget constraints and their need to increase the value they derive from their assets have accelerated the move in this direction.

Marine

The Group forecasts a demand for marine power and propulsion systems valued at more than US$200 billion over the next 20 years. Demand will be greatest in the commercial sector, where the shipping of raw materials, finished goods and people, in addition to oil and gas exploration and production activity, play crucial roles in the world economy. These activities require large fleets of specialised and increasingly sophisticated ships, which have to be continually renewed and supported to remain operationally efficient.

Merchant and offshore markets are rarely at the same stage of the business cycle, which helps to reduce overall volatility. Whilst naval markets are driven by different considerations, customers are similarly seeking to get more from their budgets, leading to increasing demand for integrated systems and through-life support arrangements. As in the Group's other markets, marine aftermarket services are expected to generate significant opportunities, with demand forecasted at US$120 billion over the next 20 years.

Energy

The International Energy Agency has forecast that over the next 20 years, the worldwide demand for oil will grow by more than 20 per cent, for gas by 35 per cent and for power generation by more than 60 per cent. To satisfy this demand, there will be a growing requirement for aero derivative gas turbines.

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

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

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

Key performance indicators

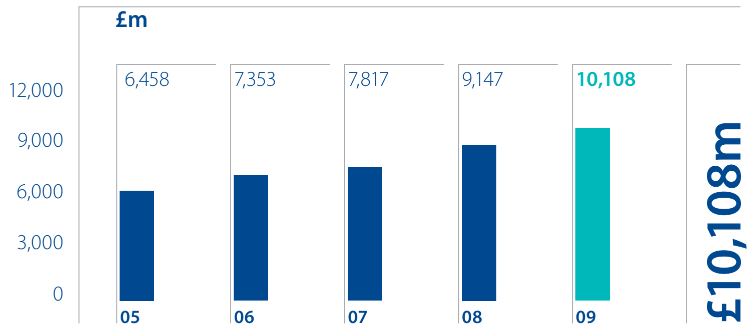
The Board uses a range of financial and non-financial indicators to monitor Group and segmental performance in line with the strategy described on pages 10-11. These indicators are chosen to monitor both current performance and the success of investments that will sustain and enhance future performance. Key performance indicators are included in the appropriate sections of the business review and are as follows:

Key performance indicators

- Underlying revenue
- Underlying profit before financing
- Cash flow
- Return on capital employed
- Net research and development charge
- Gross research and development expenditure
- Net research and development expenditure as a proportion of underlying revenue
- Capital expenditure
- Order book
- Training and development
- Employee engagement
- Underlying revenue per employee
- Product cost index
- Engine deliveries
- Installed thrust – civil aerospace
- Percentage of civil fleet under management
- Underlying services revenue
- Emissions

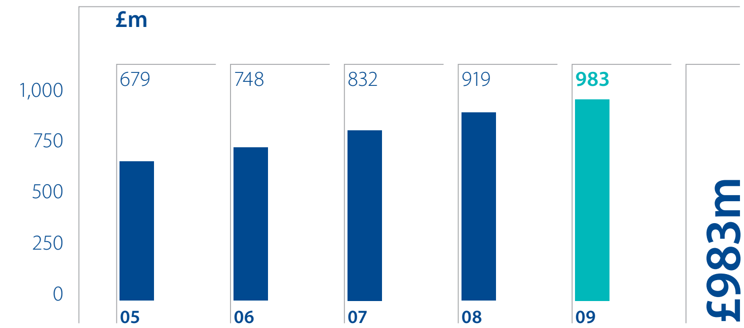
Underlying revenue

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



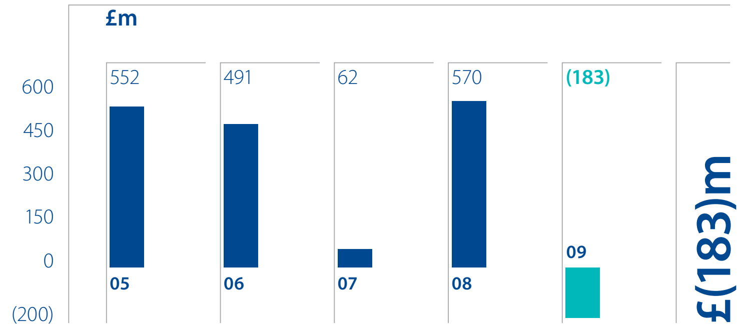
Underlying profit before financing

Underlying profit before financing is presented on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements. In particular: (a) revenues and costs denominated in US dollars and euros are presented on the basis of the exchange rates achieved during the year; (b) similar adjustments are made in respect of commodity derivatives; and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis. The derivation of underlying profit before financing is shown in note 2 on page 104 of the consolidated financial statements.



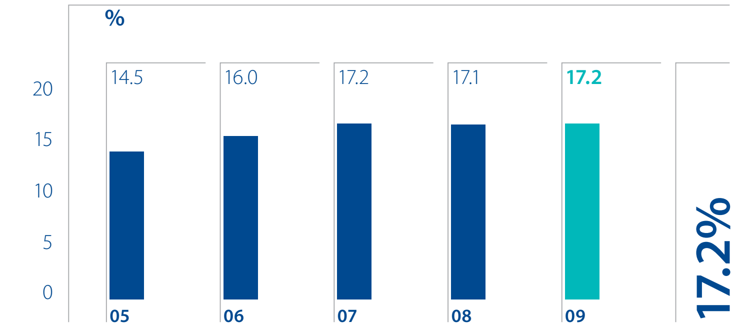
Cash flow

In a business requiring significant investment, the Board monitors cash flow to ensure that profitability is converted into cash generation, both for future investment and as a reward for shareholders. The Group measures cash flow as the movement in net funds/debt during the year, after taking into account the value of derivatives held to hedge the value of balances denominated in foreign currencies. The figure in 2007 includes a £500 million special contribution to the Group's UK pensions schemes, as part of the restructuring of its pension schemes.



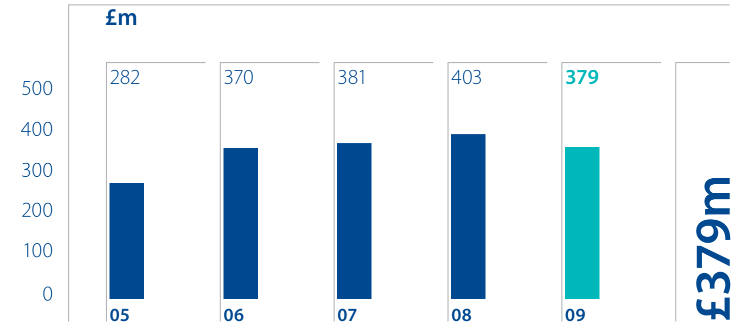
Return on capital employed

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



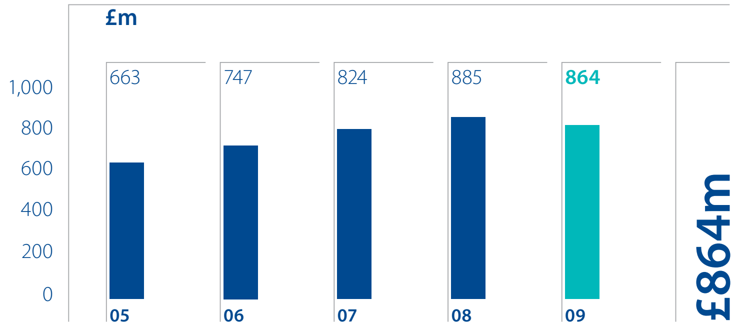
Net research and development charge

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



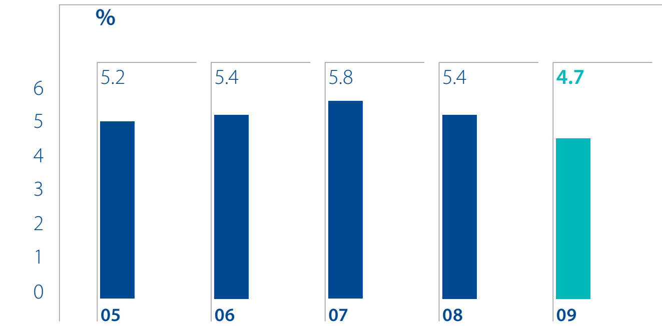
Gross research and development expenditure

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



Net research and development expenditure as a proportion of underlying revenue

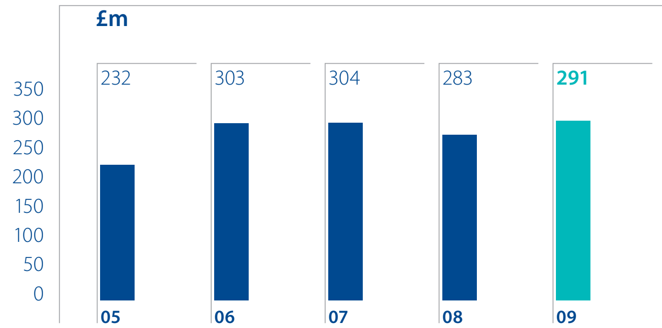
Research and development is measured as the self-funded expenditure before both amounts capitalised in the year and amortisation of previously capitalised balances. The Group expects to spend approximately five per cent of revenues on research and development although this proportion will fluctuate annually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



4.7%

Capital expenditure

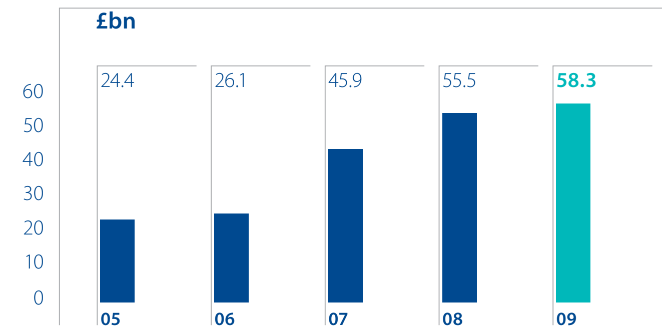
To deliver on its commitments to customers, the Group invests significant amounts in its infrastructure. All investments are subject to rigorous review to ensure that they are consistent with forecast activity and will provide value for money. Annual capital expenditure is measured as the cost of property,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



£291m

Order book

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



£58.3bn

Training and development

£24 million investment in 2009

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

£24m

Employee engagement

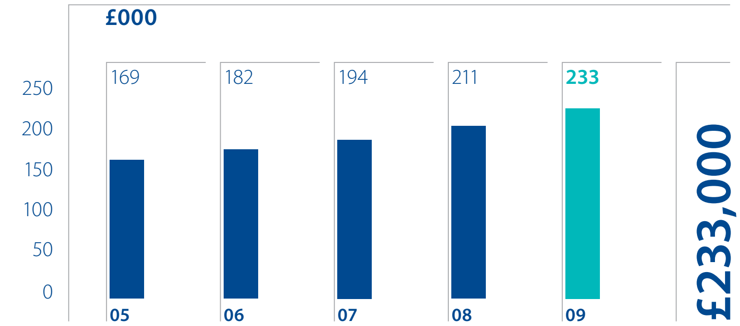
38,500 employees in 2009

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

38,500

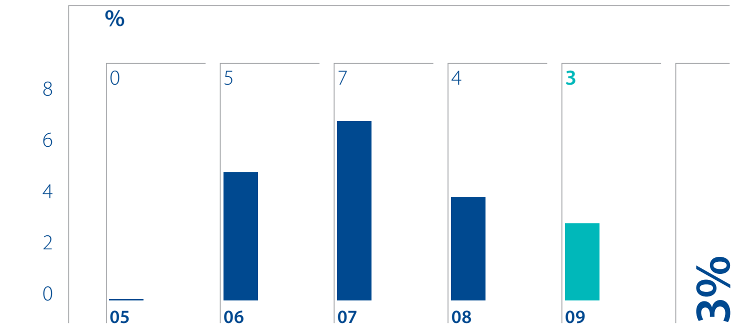
Underlying revenue per employee

A measure of personnel productivity, this indicator measures underlying revenue generated per employee on a three-year rolling basis. The basis of calculation has been amended to avoid short-term distortions caused by fluctuations in exchange rates.



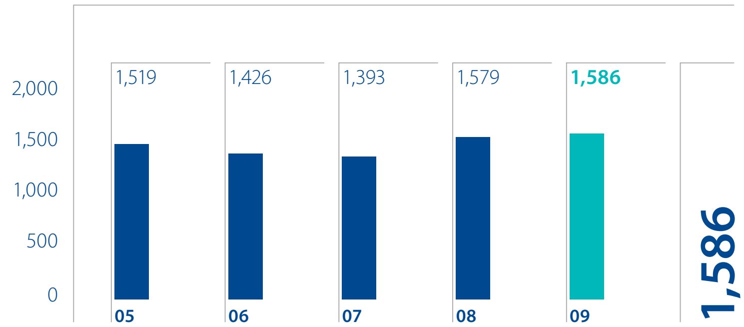
Product cost index

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



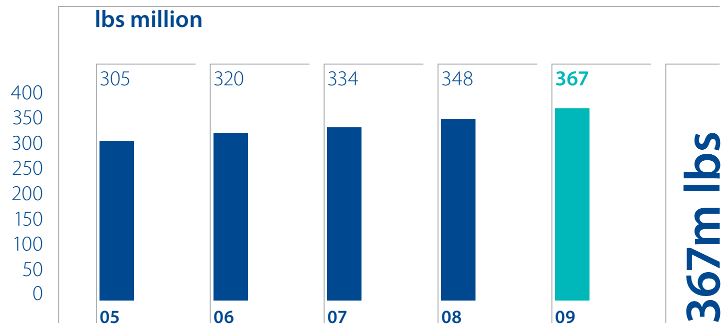
Engine deliveries

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



Installed thrust – civil aerospace

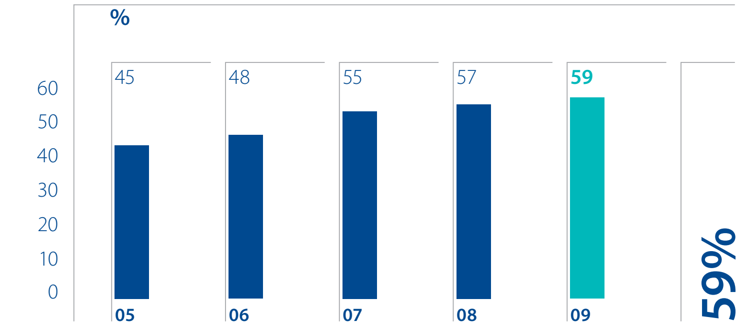
Installed thrust is the indicator of the amount of product in use by our customers and therefore the scale of opportunity this presents for our services business.



Percentage of civil fleet under management

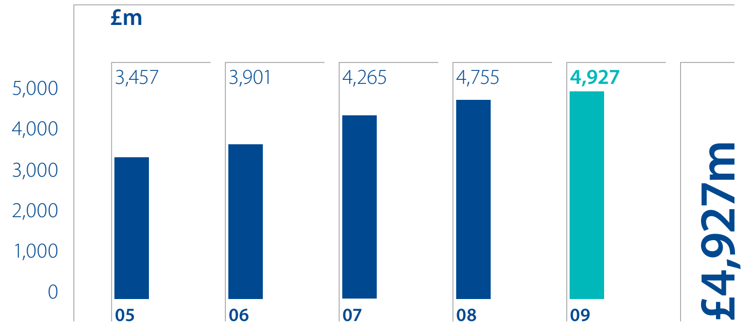
Long-term contracts are an important way of generating value for customers. The percentage of fleet under management gives a measure of the proportion of the installed base where the future aftermarket arrangements are agreed under long-term contracts.

The corresponding indicators for the other segments are shown in the respective sections of the business review of operations.



Underlying services revenue

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



Emissions

Much of the research and development expenditure is focused on reducing emissions of the Group's products. The Group measures both the emissions of its products and the emissions of its manufacturing operations. These measures are described in detail in the environment report, 'Powering a better world', which is available on the Group's website at www.rolls-royce.com/cr/reports.

Principal risks and uncertainties

The Group continues to be exposed to a number of risks and has an established, structured approach to identifying, assessing and managing these.

The risk committee has accountability for the system of risk management and reports regularly to the Board on the key risks facing the business and the mitigating actions taken in order to manage them. The Group's consistent strategy and long-term programmes require that key sources of risk are identified and are kept under continuous review.

Risk profile

Over the past year the risk profile of the Group, in common with many other large companies, has changed to reflect the underlying global economic uncertainties. The Group continues to experience the negative effects of the recent economic downturn through a decline in the civil aviation sector, shipbuilding and other capital-intensive industries, which are prime markets for its products and services.

In the absence of a sustained and general return to growth, uncertainty remains across financial and industrial markets. This is reflected in the Group's risk profile.

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

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

Business environment risks

Cyclical downturn – global recession

The Group's largest market, civil aerospace, is cyclical by nature, although services activity and revenue, which now represents 59 per cent of annual revenue, have historically been less volatile in economic slowdowns and are considered more predictable and robust than the sales of engines for new aircraft.

The willingness of passengers to travel by air is influenced by a range of factors, including economic conditions, as well as health and security issues. Any prolonged reduction in air travel would impact airlines' revenues and cash flows and potentially reduce their need for new engines, spare parts or aftermarket support services.

The strategy of growing revenues in other sectors with steady and substantial long-term growth, will help offset this risk. Access to global markets with greater diversification by sector, customer and geography and an improved balance between original equipment and services revenue, are expected to help mitigate the effects of the slowing global economy in any one sector.

Tight control of the underlying cost base, the cost of managing operations and the unit cost of products, is essential to protect margins and maintain profitability. Even as the economy begins to recover, there will be continued pressure to reduce costs and improve the use of resources. The Group is focusing on identifying the principal drivers of unit costs and identifying actions to achieve sustainable cost reductions.

Environmental impact of products and operations

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

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

Strategic risks

Competitive pressures

The markets in which Rolls-Royce operates are highly competitive and this competitiveness is increasing as a result of the global economic uncertainties. The majority of product programmes are long term in nature and access to key customer platforms is critical to the success of the business. This requires sustained investment in technology, capability and infrastructure by the Group, all creating high barriers to entry. However, these factors alone do not protect the Group from competition such as pricing and technical advances made by competitors.

The Group has developed a balanced business portfolio and continues to maintain a steady focus on improvement in operational performance, for example through the modernisation of its facilities and an increased focus on managing the costs of operations and products. Sustained investment in technology acquisition and robust protection of intellectual property, together with the establishment of long-term customer relationships, allow the Group to differentiate its products and services and protect margins in the face of competitive pressures.

Export controls

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

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

Financial risks

Principal risks are:

- movements in foreign currency exchange rates;
- interest rates;
- commodity prices;
- counterparty credit risk; and
- regulatory developments.

A description of these risks and details of the Group's risk mitigation actions in this area are provided in the Finance Director's review.

Operational risks

Performance of supply chain

The Group's products and services are delivered through the effective operation of its facilities and key capabilities, including its supply chain. The Group's success in strengthening its market position and its presence on a number of high profile civil and defence aerospace programmes places increased demands on the performance of the supply chain. The Group manufactures approximately 30 per cent by value of its gas turbine products, the remainder being provided through external suppliers, including risk and revenue sharing partners. Meeting delivery commitments on schedule, cost and quality are critical to the achievement of business goals. Investment in developing world-class manufacturing processes is continuing in Asia, North America and Europe.

Global supply chains are complex with multiple inter-relationships across a wide network of organisations. While the Group's strategy is to improve integration and simplify the internal and external elements of its supply chain by building long-term strategic links with fewer, stronger suppliers, it remains at risk of disruption from financial or physical causes such as bankruptcy, natural disaster, armed conflict or pandemic. A significant disruption in any of these elements could adversely affect the Group's ability to deliver its operational commitments and would have the potential to affect financial returns.

The planning for, and management of, any such interruption is addressed through the Group's business continuity management process, which is well established and focused on critical facilities, activities, processes, skills and suppliers. The Group's crisis management plan and framework were significantly revised and exercised in 2009. In addition to the Group's comprehensive programme of business interruption insurance, significant investment is being undertaken to establish, where possible, dual sourcing of key components or processes. Increased focus is also being applied to understanding and addressing sources of risk arising in the external supply chain, particularly those associated with financial instability. Procedures are in place to monitor, assess and respond to such risks.

IT security

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

Ethics

The Group recognises the benefit that is derived from conducting business in an ethical and socially responsible manner. This approach extends from the sourcing of raw materials and components to the manufacture and delivery of products and services in all of its global locations and markets. It applies to the provision of a safe and healthy place of work and investment in technologies to reduce the environmental impact of the Group's products and operations. Shortcomings in any of these areas could damage the Group's reputation, expose it to financial penalties and disrupt its business.

The Group is committed to maintaining high ethical standards. A Global Code of Business Ethics, available in 16 languages, has been issued to all employees supported by a training and engagement programme to improve awareness of the Group's values. A programme of technical training for specialist roles is underway. The Group's ethical standards are also communicated to the Group's first-tier supply base through a supplier code of conduct. Concerns regarding potentially unethical behaviours can be reported in confidence via dedicated global telephone and internet channels. All such reports are followed up and are monitored by the ethics committee.

Programme risk

The Group manages complex product programmes with demanding technical requirements against stringent, and sometimes fluctuating, customer schedules. This requires co-ordination of the engineering function, manufacturing operations, the external supply chain and other partners. Failure to achieve programme goals would have significant financial and reputational implications for the Group. These implications include the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation. Impairment is discussed further in the Finance Director's review on page 58.

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

Review of operations
Overview

Rolls-Royce is a technology leader with a global customer base. We are developing our presence across the world to meet increasing demand for the advanced products and services that we take to market.

As well as introducing new technologies we also place emphasis on continuously developing the through-life performance of our products for the benefit of customers.

New facilities

We are expanding our operations facilities around the world.

Building our global operations

Civil aerospace

The civil aerospace business powers over 30 types of commercial aircraft and has a strong position in all sectors of the market: wide-body, narrow-body and corporate and regional aircraft. Over 13,000 engines are currently in service with 650 airlines, freight operators and lessors and 4,000 corporate operators.

"A strong portfolio of products and services combined with a global customer base has provided strength during uncertain times."
Mark King President – Civil Aerospace

£4,481m
Underlying revenue

US$1,400bn
Market opportunity over 20 years

Despite a decline in air traffic, the market is beginning to recover, albeit slowly. 2010 traffic will see a return to growth but from suppressed levels. We remain cautious but optimistic of seeing the historic traffic growth level of approximately five per cent per annum achieved over a 20-year period.

The economic situation also saw the retirement across the industry of some 500 aircraft, notably older models. The Rolls-Royce powered fleet is, by contrast, relatively young and more fuel efficient. The better performance and increased aftermarket potential in this younger fleet underlined the value of our balanced services and products business model. The corporate and regional aircraft market has been sensitive in the downturn but the twin-aisle, large airliner market, has been more robust.

Order intake was reduced due to the poor market conditions but there were some significant orders, notably from AirAsia X, Air China and United Airlines. New orders also included first-time customers for the Trent family: Turkish Airlines; Ethiopian Airlines and, the US lessor Aviation Capital Group. Trent engines continue to win business across the range of wide-body aircraft and now hold a 50 per cent market share.

The first flight of the Boeing 787 in December 2009, powered by Rolls-Royce Trent 1000 engines, was a significant and important milestone for this programme. The majority of the Boeing 787 flight test and certification programme planned to be completed in 2010 will use Trent 1000 engines.

The Trent family philosophy continues to demonstrate significant advantages with the introduction of new technology for established engines. Upgrades for the Trent 700 have enhanced its performance and

Trent engine

The Trent family of large aero engines continues to command a strong market position on the new generation of wide-bodied aircraft.

fuel efficiency and a similar package is planned for the Trent 900. Technology being developed for new engines such as the Trent 1000 and Trent XWB will continue to provide operational, performance and environmental advantages across our product range. Orders for the Trent 700 and the Trent XWB now exceed 1,000 engines for each programme. For the Trent XWB this marks a significant demonstration of customer confidence as the programme is still three years away from entry into service.

In the narrow-body market the V2500 engine, produced by International Aero Engines (IAE) in which Rolls-Royce is a major partner, continues to win orders. IAE delivered 347 engines in 2009. IAE also gained significant contract awards from Air China, Qatar Airlines and Dubai Aerospace. There are now more than 4,000 V2500 engines flying with 190 customers worldwide.

In the corporate and regional market, the latest addition to the Group's corporate engine family is the BR725 engine. It flew for the first time on the Gulfstream G650 ultra-long-range business jet in November 2009, and remains on schedule for entry into service in 2012. In September 2009, the first flight of an Embraer Legacy 650, powered by the new AE 3007A2 engine, took place. The AE 3007A2 will deliver significant performance and reliability improvements over previous engine marks. It is currently undergoing flight testing ahead of certification and entry into service in the second half of 2010.

The majority of orders in the civil aerospace business are now contracted under TotalCare® or CorporateCare® long-term support contracts. These overarching service contracts provide an important and sustainable revenue stream for the business. They also allow our customers to plan their business more effectively both financially and in the use of engine assets. Services revenue has been affected by the current economic environment with fewer flying hours and airlines deferring non-essential maintenance. As more engines enter service in line with order commitments we expect to see flying hours increase. The TotalCare service structure has been particularly robust and the model we have in place is designed to be responsive to this change and match the market and customer demand. Hours flown under TotalCare agreements continue to grow.

50

Trent engines now hold a 50 per cent market share in wide-bodied aircraft.

Corporate jets

Rolls-Royce holds a strong position in this market sector, where there were notable programme achievements in 2009.

Highlights

- Record year for Trent delivery with 224 engines shipped
- Trent 700 and Trent XWB each exceeded orders for 1,000 engines
- Trent 1000 powered the Boeing 787 Dreamliner first flight
- BR725 powered the Gulfstream G650 long range business jet first flight

Key financial data

	2005	2006	2007	2008	**2009**
Underlying revenue £m	3,406 +11%	3,907 +15%	4,038 +3%	4,502 +11%	**4,481** **0%**
Underlying profit before financing £m	454 +118%	519 +14%	564 +9%	566 0%	**493** **-13%**
Net assets £m	1,617	2,165	2,468	330	**2,694**

Other key performance indicators

	2005	2006	2007	2008	**2009**
Order book £bn	19.0 +17%	20.0 +5%	35.9 +80%	43.5 +21%	**47.0** **+8%**
Engine deliveries	881	856	851	987	**844**
Underlying services revenues £m	2,016	2,310	2,554	2,726	**2,626**
Underlying services revenues %	59	59	63	61	**59**
Percentage of fleet under management	45	48	55	57	**59**

Defence aerospace

Rolls-Royce is a global provider of defence aero-engine products and services, with 18,000 engines in service for 160 customers in 103 countries. Our engines power aircraft in all key defence market sectors: transport; combat; reconnaissance; training; helicopters and unmanned aerial vehicles.

"Public spending is under pressure but we have strong positions in new and established programmes."
Dan Korte President – Defence Aerospace

£2,010m
Underlying revenue

US$450bn
Market opportunity over 20 years

Eurofighter Typhoon

As a major partner in the Eurojet engine consortium, Rolls-Royce benefited from the latest tranche of Eurofighter aircraft being ordered.

The downturn in the global economy has put pressure on public spending in our key markets in Europe and the US. However, our position on new and established programmes continues to provide growth opportunities in these markets. In addition, we are well positioned to secure growth from emerging economies in Asia, the Middle East and South America.

During 2009, key orders were secured in both the combat and transport sectors and we saw new programmes emerge in the helicopter and unmanned aerial vehicles (UAVs) sectors.

The US Government approved 2010 funding for development of the F136 engine for the F-35 Joint Strike Fighter. This engine, being developed jointly by Rolls-Royce and General Electric, is designed to power all variants of the F-35 aircraft.

We also received the second contract, worth US$171 million, for the production of the LiftSystem for the short take-off and vertical landing (STOVL) or 'B' version of the F-35 Joint Strike Fighter. This programme reached a significant milestone in early 2010, when the Rolls-Royce designed LiftSystem was engaged successfully in flight for the first time.

Tranche three of the Eurofighter Typhoon aircraft was ordered, which provided Rolls-Royce with a 37 per cent production share of 241 Eurojet engines. The EJ200's reliability and support effectiveness was highlighted during the year, with a Royal Air Force engine reaching 1,200 flying hours with no requirement for unscheduled maintenance.

At the end of the year the Airbus A400M airlifter, powered by the TP400 turboprop engine, flew for the first time. Rolls-Royce is a major partner in the European consortium producing the TP400. There is continuing uncertainty about the A400M programme. However, the TP400 engine has made good progress, with engine flight testing to date being encouraging. We believe that our estimated costs to completion adequately consider the remaining testing and delivery phases.

There were four additional successful Rolls-Royce powered first flights during 2009 in the defence sector: the AgustaWestland Lynx AH Mk.9A; the AgustaWestland AW159 Wildcat; and the AgustaWestland T129 Attack Helicopter, all powered by the CTS800 engine. The BAE Systems Mantis UAV powered by the Model 250 engine, also flew and demonstrated our capability to design and deliver an integrated power system.

Conversion work began on the first Airbus A330 aircraft for the Future Strategic Tanker Aircraft programme. The A330M multi-role tanker is powered by the Trent 700 engine and is expected to enter service in 2012.

Service business under long-term contract programmes, such as MissionCare™, continues to be attractive to defence customers. The US Department of Defense awarded us a US$90 million contract to support the engines for the US Navy's T-45 trainer aircraft. We agreed a US$200 million production contract and a US$500 million service contract, through to 2014, with the US Marine Corps to provide support for the AE 1107C Liberty engine in the Bell-Boeing V-22 Osprey vertical lift aircraft.

An £865 million contract to service the EJ200 engines for the UK Eurofighter Typhoon fleet through to 2019 was also secured. Rolls-Royce is a major partner in the Eurojet consortium which produces the EJ200.

Over £1 billion worth of orders for services were signed in 2009, presenting significant opportunities for Rolls-Royce to leverage its innovative service solutions.

The defence sector has continued to invest successfully in new technology as demonstrated by the Phase 2 award of the US Air Force ADVENT technology programme. Phase 2 will include the integration of a variety of advanced technologies, component testing and culminates with the development of a new technology demonstrator engine. The demonstrator is designed to reduce fuel consumption significantly, enabling extended mission ranges and loiter times. This advanced engine is targeted for future US military aerospace platforms. In the UK, we signed a jointly funded research and technology contract for ENTAPS (Engine Technologies for Aircraft Persistence and Survivability) with the UK Ministry of Defence.

BAE Systems Mantis

Mantis is an unmanned advanced technology demonstrator powered by Rolls-Royce.

AW159 Wildcat

The AW159 Wildcat programme will deliver a fleet of 62 new light helicopters for the Army and Royal Navy from 2014 and 2015, respectively.

90

US$90 million contract to support the engines for the US Navy's T-45 trainer aircraft.

Market strength

We signed a US$500 million contract to support the engines for the V-22 Osprey, in service with the US Marine Corps.

Highlights

- £325 million contract secured for EJ200 engine production
- US$200 million production contract for AE 1107C V-22 engines
- F136 engine development funded for 2010
- US$184 million worth of US Army helicopter contracts secured for the Model 250 fleet
- £865 million contract secured for long-term EJ200 engine support
- US$500 million MissionCare contract signed for AE 1107C fleet

Key financial data

	2005	2006	2007	2008	**2009**
Underlying revenue £m	1,420	1,601	1,673	1,686	**2,010**
	+3%	+13%	+4%	+1%	**+19%**
Underlying profit before financing £m	180	193	199	223	**253**
	+1%	+7%	+3%	+12%	**+13%**
Net assets £m	55	20	(172)	(197)	**(345)**

Other key performance indicators

	2005	2006	2007	2008	**2009**
Order book £bn	3.3	3.2	4.4	5.5	**6.5**
	0%	-3%	+38%	+25%	**+18%**
Engine deliveries	565	514	495	517	**662**
Underlying services revenues £m	787	853	877	947	**1,046**
Underlying services revenues %	55	53	52	56	**52**
Percentage of fleet under management	8	11	11	12	**16**

Marine

Rolls-Royce has a world-class range of capabilities and expertise in the design, supply and support of power and propulsion systems for offshore oil and gas, merchant and naval vessels. Our marine business has more than 2,000 customers and equipment installed on over 30,000 vessels worldwide, including those of 70 navies.

"Our business has grown significantly during the past year and we are seeing the increasing importance of support services in our revenue mix."
John Paterson President – Marine

£2,589m
Underlying revenue

US$320bn
Market opportunity over 20 years

Far Samson

This is the world's most powerful offshore vessel, designed primarily for laying pipelines and cables.

33

We acquired a 33 per cent holding in ODIM ASA, a leading provider of specialist marine handling systems.

The marine business has enjoyed another year of strong growth, despite macroeconomic challenges and a slowdown in orders. Although the demand for original equipment has reduced, service opportunities have increased as a result of the large number of ships introduced to the market in recent years. As a systems integrator, Rolls-Royce has an advantage in being able to provide a wide range of services for the sophisticated vessels that utilise our systems.

Since 2005, our revenues have more than doubled and increased by 17 per cent on 2008, driven primarily by the continued growth in our offshore business. Marine profit increased 44 per cent in 2009 as a result of strong revenue growth, the increasing importance of support services and improved operational performance.

The offshore sector has been central to our continued strong performance, based on the success of our specialist UT-Design and integrated systems capability. 2009 saw the launch of the Rolls-Royce designed Far Samson, the world's most powerful offshore vessel, and the introduction of an innovative wave-piercing design that improves stability and crew safety while minimising environmental impact.

During 2009, we acquired a 33 per cent holding in ODIM ASA, a leading provider of specialist marine handling systems. This investment increases our already strong presence in the offshore oil and gas sector.

Our naval business had a good year, with significant activity in the UK, the US, France, India and Korea. We began delivering power and propulsion equipment for the UK's new, Queen Elizabeth class, aircraft carriers. Stabilisers have already been delivered for the first carrier and our MT30 gas turbine has successfully completed trials. MT30 gas turbines installed in the US Navy Littoral Combat Ship, USS Freedom, also completed sea trials during the year.

As our installed base of equipment continues to grow, we are actively expanding our support capacity and capability to realise the significant opportunity that this represents. Six marine service centres across North America, South America, Europe and the Middle East were opened in 2009. Marine customers seek to have their ships serviced close to where they primarily operate and we are continuing to develop our extensive, global network to meet customer requirements.

A significant and growing proportion of our customers, manufacturing capability and supply chain are based in the Asia region. As a result, and recognising the importance of being closer to where more of our activity is located, we established the global headquarters of our marine business in Singapore.

We continue to invest in technology that can address the need for more efficient and environmentally sustainable power and propulsion systems. This is primarily through the reduction of exhaust gas emissions and improvements in ship design. Our Bergen gas engines already surpass International Maritime Organization limits for NO_x emissions, while research in propulsor/hull interactions deliver improvements in fuel consumption, stability and general performance, as demonstrated by our Promas integrated rudder/propeller system.

Rolls-Royce and Royal Caribbean Cruises have settled the lawsuit regarding the Mermaid podded-propulsion system, which experienced technical issues that have now been resolved. By working together, Rolls-Royce and Royal Caribbean have been successful in improving the reliability of the design.

As anticipated, there were some order cancellations in 2009 as customers reviewed their requirements given the economic downturn. However, our strong market-leading position in the offshore sector and demand for high-specification vessels in support of oil and gas exploration, provide good visibility of revenues in 2010.

Marine services

Six new marine service centres were opened during the course of last year as we seek to build a global network for our customers.

Littoral Combat Ship

The Littoral Combat Ship, USS Freedom, is powered by two MT30 gas turbines.

Highlights

- Continued strong growth despite challenging market environment
- Far Samson, the world's most powerful offshore vessel, entered service
- Service capabilities expanded across North America, South America, Europe and Middle East
- Queen Elizabeth class aircraft carrier equipment deliveries commenced

Key financial data

	2005	2006	2007	2008	**2009**
Underlying revenue £m	1,097 +14%	1,299 +18%	1,548 +19%	2,204 +42%	**2,589** **+17%**
Underlying profit before financing £m	89 +14%	101 +13%	113 +12%	183 +62%	**263** **+44%**
Net assets £m	674	619	563	488	**641**

Other key performance indicators

	2005	2006	2007	2008	**2009**
Order book £bn	1.7 +21%	2.4 +41%	4.7 +96%	5.2 +11%	**3.5** **-33%**
Underlying services revenues £m	435	487	545	712	**785**
Underlying services revenues %	40	37	35	32	**30**
Percentage of fleet under management	3	3	33	35	**26**

Energy

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

"Our order book was maintained and market confidence in oil and gas has begun to return."
John Cheffins Acting President – Energy

£1,028m
Underlying revenue

US$120bn
Market opportunity over 20 years

Energy had a strong performance in 2009, with revenues up by 36 per cent to over £1 billion for the first time and profits growing by £26 million.

The number of orders secured by the business reduced by 16 per cent compared to the previous year. Despite the challenging market conditions, the size of the order book was broadly maintained in 2009. The year also saw high original equipment volume deliveries. The modest profit increase in the year was achieved as a result of the continued growth in demand for aftermarket products and services.

In the main, oil and gas customers took a long-term view from the outset of the global recession and continued to invest, albeit at a reduced level. Market confidence has begun to return as a result of the strengthening in oil prices, with both offshore and pipeline customers now persisting with previous expansion plans.

Pipeline bid activity continued in the year, with a total of 24 gas turbine units ordered, comprising 11 units for Kazakhstan, nine for China and four for India. In other oil and gas markets, orders for five gas turbine units were received for installation offshore of Azerbaijan and Malaysia.

The power generation market remained depressed due to the high cost and restricted availability of finance, coupled with reduced demand for electricity. However, market interest in the Trent 60 continued to grow and contracted projects proceeded as planned. Sales growth continued to advance on the back of high order levels in recent years and the increasing aftermarket business. In the power generation market, successful commercial operation of the Trent 60 began in the US, Israel, Germany, China and Australia. Orders for 15 Trent 60 packages were secured in 2009.

Industrial RB211 gas turbine

Used in gas compression, oil pumping and electrical generation applications, the RB211 is a highly reliable and robust unit.

Business review
Corporate governance
Financial statements

Demand for aftermarket products and services grew strongly with another record year resulting in revenues of £470 million, an increase of 27 per cent. The growth of the installed fleet has resulted in an increase in demand for services and product upgrades which incorporate the latest gas turbine technology. Operators are benefiting from the additional power and efficiency that these upgrades provide. Units under long-term service agreements increased to approximately 300 units from 250 units the previous year.

The energy business strategy to consolidate its gas turbine packaging operations into the Mount Vernon, Ohio, US facility progressed with the latest site improvements becoming fully operational in the middle of 2009. While the energy business currently centres its product portfolio on the gas turbine, the skills and technical knowledge within the Group allow the business to identify and explore new growth opportunities in the energy market.

During 2009, good progress was made on the establishment of the new Rolls-Royce civil nuclear business unit. The business announced plans to build a new factory in the UK to assemble and test systems and components for nuclear power stations. This facility will have strong links with the UK Government-funded Nuclear Advanced Manufacturing Research Centre, in which Rolls-Royce is a lead partner. The Rolls-Royce position in the nuclear market was further strengthened with the signing of a memorandum of understanding in 2009 with EDF Energy to support the UK facility.

Rolls-Royce is already a global leader in the supply of digital instrumentation and control systems for nuclear power plants, with products installed in over 184 nuclear reactors worldwide.

Investment in fuel cell development technology continued, although at a reduced cost to the Group as planned. Other energy research included tidal power, where preparations for sea trials got underway during the year, following the Group taking full ownership of Tidal Generation Limited.

15

Orders for 15 Trent 60 packages were secured in 2009.

Pipeline power

A total of 24 gas turbine units were ordered during the year for pipelines around the world.

Highlights

- Order book maintained despite difficult market conditions
- Revenues increased to over £1 billion for the first time
- Service business growth of 27 per cent to £470 million sales
- Civil nuclear business memorandum of understanding with EDF Energy

Key financial data

	2005	2006	2007	2008	**2009**
Underlying revenue £m	535 -1%	546 +2%	558 +2%	755 +35%	**1,028** **+36%**
Underlying profit before financing £m	1 +114%	(18) -1900%	5 +128%	(2) -140%	**24** **+1300%**
Net assets £m	390	387	370	392	**533**

Other key performance indicators

	2005	2006	2007	2008	**2009**
Order book £bn	0.4 0%	0.5 +25%	0.9 +80%	1.3 +44%	**1.3** **0%**
Engine deliveries	61	44	32	64	**73**
Underlying service revenues £m	219	251	289	370	**470**
Underlying service revenues %	41	46	52	49	**46**
Percentage of fleet under management	5	6	7	9	**10**

Business review Corporate governance Financial statements

Engineering and technology

In 2009, Rolls-Royce invested a total of £864 million in research and development, of which £471 million was funded from Group resources.

"An ongoing commitment to research and development is fundamental to the Group's future success."
Colin Smith Director – Engineering and Technology

£864m
Investment

440
Patent applications

The Group believes that its ongoing commitment to research and development is fundamental to its future success, providing technologies and intellectual property that allow us to compete on a global basis in highly competitive markets.

During 2009, we created a new advanced research centre in Singapore to develop manufacturing, electrical systems and high-power computing capabilities. Our new Mechanical Test Operations Centre in Dahlewitz, Germany, neared completion during the year. This centre will provide mechanical testing capability for all areas of the Group.

Building on the success of our membership of the Advanced Manufacturing Research Centre, we have increased our focus on advanced manufacturing. In the UK, we announced our partnership in the new National Composites Centre, the Advanced Fabrication Research Centre, the Advanced Nuclear Research Centre and became the inaugural industrial partner in the Manufacturing Technology Centre. Additionally, we became a partner of the US Commonwealth of Virginia in two new centres studying advanced aerospace propulsion systems and advanced manufacturing.

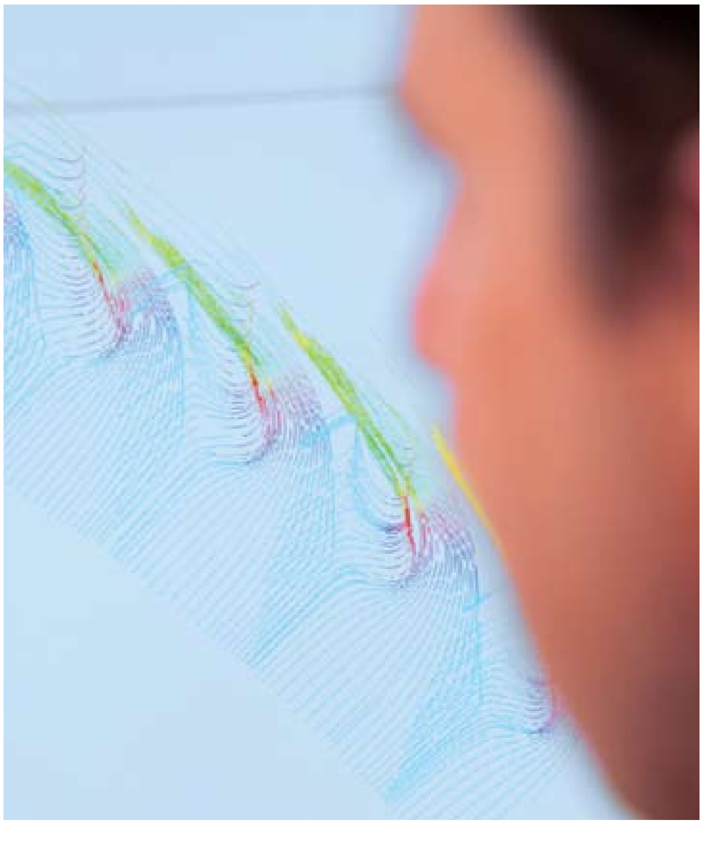
We continue to invest in our worldwide network of 27 Rolls-Royce University Technology Centres, which undertake advanced research for the Group across a range of specialist subject areas such as materials, noise, vibration and combustion. During the year we filed 440 patent applications.

Improving the environmental performance of our products and operations continues to be a key driver for research and development in Rolls-Royce. We have completed the first build of the Environmentally Friendly Engine and the second build of our mid-size technology demonstrator engine. These will begin testing in early 2010, delivering technology for the next generation of civil gas turbine engines. We also continue to invest in several other large-scale demonstrator programmes to reduce carbon emissions, which focus both on future gas turbine technology and advanced manufacturing.

We completed wind tunnel testing of our open rotor aero-engine concept. This concept uses large unducted fan blades to secure a significant reduction in fuel burn when compared with modern turbofans. Our results demonstrated efficient performance and low-noise characteristics in line with our expectations.

Next generation technology

The Group has a global network of University Technology Centres undertaking advanced research in specialist subject areas.



Turbine blade

The design, use of materials and the manufacturing processes that go towards the production of our high-pressure turbine blades exemplify the Group's engineering capability.

Our work for the US Air Force on the Adaptive Versatile Engine Technology (ADVENT) programme has led to us being awarded the second phase of funding, which will include the incorporation of Phase 1 technologies in a demonstrator engine. ADVENT focuses on the variable cycle and geometry to meet demanding US defence requirements for the next generation of military engines.

We achieved notable engineering successes in each of our key business sectors.

In the civil aerospace business, the Trent 1000 successfully completed its Extended Twin Operations (ETOPS) testing and, at the end of the year, powered the Boeing 787 on its first flight. The BR725 engine was certified and delivered on time and powered the new Gulfstream G650 corporate jet on its maiden flight. The AE 3007A2 engine for the Embraer Legacy 650 completed the majority of its certification testing and started flight testing.

Our marine business has designed a radical wave-piercing hull concept for applications in the offshore marine market. For the second year running Rolls-Royce won the coveted 'Ship of the year award', this time for the 'Far Samson' – the most powerful offshore vessel ever built. The Littoral Combat Ship, USS Freedom, completed US Navy acceptance trials in preparation for entering service. The first Type 45 Destroyer, HMS Daring, has entered service with the Royal Navy powered by the WR-21 and work on her sister ships is progressing well. The first Astute class nuclear-powered attack submarine with the Rolls-Royce designed, full-life, PWR2 power system has sailed for initial trials.

In defence aerospace, the Airbus A400M powered by the Europrop TP400 turboprop engine made a successful first flight in 2009 and the BAE Systems Mantis unmanned aerial vehicle, powered by Rolls-Royce, also operated flawlessly during its flight trials. In the F-35 Joint Strike Fighter programme, the first development F136 engine was delivered one month ahead of schedule. The Rolls-Royce LiftSystem, for the short take-off and vertical landing variant, completed ground testing and aircraft taxi trials ahead of its first engagement in-flight, which was achieved early in 2010.

In energy, the latest industrial Trent combustion system entered service during the year and the design of the high efficiency RB211-H63 has progressed significantly. We continue our work on low carbon energy solutions. During 2009, we began installation of a 500kW tidal power generator in the waters off the coast of Scotland and the Group continues to invest in engineering capability to support its move into the civil nuclear energy market.

Highlights

- Award of the second phase of the ADVENT programme
- First flight of the Trent 1000-powered Boeing 787
- First flight of the BR725-powered Gulfstream G650
- First flight of the TP400-powered Airbus A400M
- First in-flight engagement of the F-35 LiftSystem
- Initial trials of the first Astute class submarine

Key performance indicators

	2005	2006	2007	2008	**2009**
Gross research and development expenditure £m	663	747	824	885	**864**
Net research and development expenditure £m	339	395	454	490	**471**
Net research and development charge £m	282	370	381	403	**379**
Net research and development expenditure % of underlying revenue	5.2	5.4	5.8	5.4	**4.7**

Operations

2009 proved to be a challenging year but also one of notable achievement for our operations. We improved our revenue per employee significantly from £211,000 in 2008 to £233,000 in 2009.

"Our focus continues to be on operational excellence, strong partnerships and technological superiority."
Mike Terrett Chief Operating Officer

£291m
Capital expenditure

Business review
Corporate governance
Financial statements

The Group managed the disruptive effects of the recession and changes to programmes, we reduced our inventory levels and, although gas turbine product costs increased slightly, these were held at a level of three per cent above those of 2008.

Our operational activity in 2009 centred around two prime objectives: managing our own activities and those of the supply chain in a weak global economic climate, while at the same time continuing with our programme of investment for the future.

The Group's operations and its supply chain faced the challenges of uncertain market conditions, depressed financing markets and volatility in major programmes such as the Boeing 787 Dreamliner, Airbus A380 airliner and the A400M military airlifter.

Weaker demand in the corporate and regional jet market and for civil engine overhauls and spare parts in the large engine market, reduced levels of activity and impacted on productivity and unit costs.

Our marine business had a record year, placing additional demand on operations. Although certain product areas saw a slowdown in production, we also introduced an unprecedented number of new products in this sector. Nevertheless, the supply chain coped well by using our production planning and management tools and we were able to successfully match capacity to demand.

Across the Group we sought to ensure that we maintained the correct balance of employees to meet current and anticipated demand. This did involve some difficult decisions and, regrettably, some redundancies. Our employees remain understanding, loyal and co-operative, working with us to help mitigate the effects wherever possible and I would like to thank them for their support.

New facilities
The Group is investing substantially in new facilities in the UK, US and Asia.

Our process excellence and improvement journeys continued throughout 2009. Our joint venture engine overhaul facilities, Hong Kong Aero Engine Services Limited (HAESL) and Singapore Aero Engine Services Limited (SAESL), were the latest to benefit from the rollout of the enterprise resource planning and SAP process systems.

Around 500 engineers based at our engineering support services business in India, also became connected to our design network, Product Life-cycle Management, and are now able to work concurrently on design models with colleagues around the world.

Continuing with our investment plan is important, as the Group must increase its operational capability in order to deliver the inevitable growth over the next decade that we will experience. This growth is as a result of the Group's improved market position and current order book commitments.

We announced further new investments in facilities in 2009 and work commenced on facilities that had already been announced. Construction of our new US-based disc manufacturing centre in Crosspointe, Virginia, began during the year.

Our plans progressed on the building of the new assembly and test facility for Trent engines at the Seletar Aerospace Park, Singapore. We also announced that we will build an additional wide-chord fan blade facility on an adjacent site at Seletar, bringing the total investment on the site to £300 million and creating 500 jobs over the next few years.

A further £300 million of significant capital investment in the UK was also announced, creating or securing 800 jobs. The Group is to build a new single crystal turbine blade facility at a location yet to be determined and in Sunderland we are to build a new discs facility. We are also extending our wide-chord fan blade facility at Barnoldswick to support our defence business. These gas turbine facilities are addressing the planned increase in the manufacturing of components that the Group sees as necessary over the next five years and they will help provide improved productivity benefits on our current product range.

In addition, we announced in 2009 our intention to create a new facility in the UK to support our emerging civil nuclear business.

Despite the planned increases in our own capability, the proportion of parts that the Group buys, including through our partnerships, will also continue to increase as we move towards having fewer, larger and more capable suppliers to support our global operations.

The increasing globalisation of our own operations and of our supply chain will, over time, bring together world-class capabilities while also helping to reduce the Group's US dollar exposure.

Our focus continues to be on operational excellence, strong partnerships and technological superiority, as we manage the current economic situation alongside continuing with our investments to provide the increased operational capacity we require for future growth.

While we expect 2010 to be no less volatile, it is pleasing to reflect on a year of strong progress. Our operations have proven to be robust and adaptable, giving us confidence in our ability to cope well with challenges and changes as we move ahead.

Singapore

We opened an extension to our joint venture repair and overhaul business in Singapore. Plans for our wholly-owned new facilities there also progressed.

Highlights

- Recession and delays to major programmes managed successfully
- Announced investment in Singapore facilities now at £300 million
- £300 million investment in UK facilities announced in 2009
- Building of new US facility commenced
- Global integration of people and systems continues

Key performance indicators

	2005	2006	2007	2008	**2009**
Capital expenditure £m	232	303	304	283	**291**
Product cost index – year-on-year (increase)/decrease %	–	(5)	(7)	(4)	**(3)**
Underlying revenue per employee £000 [1]	169	182	194	211	**233**

[1] Calculated on a three-year rolling basis

Services

Services activities provide around one half of the Group's revenues, having increased ten per cent compound over the past ten years. As the original equipment manufacturer, Rolls-Royce is best placed to provide 'mission critical' support, long-term product care and well planned maintenance on behalf of customers in each of the markets we serve.

"We work closely with customers to align service packages to their operational needs."
Tony Wood President – Services

£4,927m
Underlying revenue

US$1,050bn
Market opportunity over 20 years

The Group's service business capabilities include field services, the sale of spare parts, equipment overhaul services, component repair, data management, field support, equipment leasing and inventory management. These are typically sold as packages such as our TotalCare suite. We work closely with customers to align these service packages to their operational needs, helping to maximise the efficient operation of the equipment on their behalf.

In civil aerospace, over 65 per cent of the total large-engine fleet and nearly 90 per cent of the in-service Trent fleet is now managed under TotalCare. We also have over 900 corporate and business jet aircraft enrolled in CorporateCare, the equivalent offering for this market sector. This year, significant TotalCare contracts were signed with airlines in Asia, the Middle East and the US.

Defence continued to develop its MissionCare provision worldwide and its service presence on military bases. A number of long-term engine service agreements were signed with customers of the C-130J airlifter worldwide and contracts were signed with the UK Ministry of Defence in support of frontline fighter aircraft engines. The US Department of Defense also signed major agreements for support of Rolls-Royce engines in service.

Energy secured 12 long-term service agreements which, together with the additional 35 new gas turbine units that will become operational during 2010, will take the number of gas turbines under long-term service agreement to over 300. In support of the Rolls-Royce fleet in China, a 22-year maintenance, repair and overhaul agreement was signed with PetroChina for the West to East Gas Pipeline Project. New service operations serving energy customers were opened in Angola, India, Israel, Kazakhstan and Qatar.

MissionCare in defence

Defence continued to develop its MissionCare service worldwide and service provision on military bases.

In the marine market our investment in capability and capacity continued to deliver benefits, with ten per cent services revenue growth in 2009. Marine customers require their service centres to be close to their operational base and therefore the expansion of our network to serve their needs continued. Six new centres were opened during the year in North America, South America, Europe and the Middle East. We have also developed underwater intervention capability, enabling Rolls-Royce to complete major propulsion overhauls without the need for time-consuming dry dockings.

The Group invested over £10 million this year in developing and restructuring our gas turbine repair and overhaul network, which will deliver significant improvements in performance and customer satisfaction. We also upgraded our service processes and continued to make progress in standardising our IT systems for global services.

Our SAESL joint venture celebrated its 1,000th Trent engine overhaul and a £25 million facility extension was opened. A similar investment in our HAESL joint venture is planned to open in 2010. N3, our Germany-based repair and overhaul joint venture with Lufthansa marked its 100th Trent engine overhaul this year and is now fully capable for Trent 500 and 700 overhaul, with Trent 900 capability development underway. 2009 also saw the celebration of 50 years of repair and overhaul operations in Brazil.

During 2009, we opened our sixth On-Wing Care facility in Indianapolis, US and our field service capability supported over 4,000 aero engines globally. Good progress has been made in applying this capability across all sectors. Our focus on asset optimisation was further reinforced by the Optimized Systems and Solutions Inc. (OSyS) business, created in 2009. OSyS has further expanded our in-service diagnostic and predictive capabilities and signed contracts this year with Qatar Airways and easyJet for its fuel management system, enabling them both to realise substantial fuel savings. OSyS also expanded the health monitoring services and capabilities already applied successfully to aircraft engines and energy systems.

We expanded component repair coverage and capability across all sectors and delivered savings to Rolls-Royce of £120 million during 2009. Our International Engine Component Overhaul Limited (IECO) joint venture in Singapore completed its 11th year of operation and the repair of its one millionth component. Both SAESL and IECO were recognised with several prestigious awards, highlighting their contribution to the Asia Pacific region, process innovation, new technology introduction and service delivery.

Predictive capabilities

Our operations centres specialise in acquiring and analysing data on the Rolls-Royce engine fleet in operation.

Highlights

- Service revenues increased by four per cent to £4.9 billion
- 65 per cent of the civil large engine fleet now under TotalCare support
- OSyS expands service diagnostic and predictive capabilities
- Major defence contracts secured for Typhoon and C-130J airlifter engines
- New marine service centres opened around the world
- Over 300 long-term service contracts now signed by energy

Key performance indicators

	2005	2006	2007	2008	**2009**
Underlying services revenue £m	3,457	3,901	4,265	4,755	**4,927**
Underlying services as percentage of Group revenue	54	53	55	52	**49**

TotalCare agreement

As the original equipment manufacturer, Rolls-Royce is best placed to offer long-term support.

90

90 per cent of the in-service Trent fleet is now managed under TotalCare.

Corporate responsibility
The business case for corporate responsibility

Corporate responsibility is a fundamental part of the Group's business strategy. It is not conducted as a separate and self-contained activity, but is integral to the business.

Promoting science and engineering

Rolls-Royce supports the UK Cub Scout Scientist badge – encouraging interest in science.

We see corporate responsibility as making a key contribution to the success of Rolls-Royce. We believe that conducting business in an ethical and responsible manner creates competitive advantage by enabling us to:

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

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

With around 38,500 employees in more than 50 countries, our strongest contribution to society is the wealth generated by the thousands of highly skilled jobs we provide worldwide.

Governance

Each area of corporate responsibility has its own governance process or managing committee. These include:

- the ethics committee, consisting exclusively of independent non-executive directors;
- the health, safety and environment committee, chaired by the Chief Executive;
- the Environment Council, chaired by the Director – Engineering and Technology;
- the Environmental Advisory Board, chaired by a senior academic from the Massachusetts Institute of Technology;
- the Global Council, chaired by the Director – Human Resources;
- the Global Diversity and Inclusion Steering Group, chaired by the Chief Operating Officer; and
- the Group community investment and sponsorship committee, chaired by the Chief Executive.

Individual subject matter expertise is reviewed by the Corporate Responsibility Steering Group, which reports to the Board. This group comprises the Director – Human Resources, Director – Public Affairs, Director of Risk and the General Counsel and Company Secretary. In addition, the corporate responsibility risk register uses the Group risk process to identify the potential risks and opportunities, as well as mitigation plans to address these risks. Additional information can be found in the Principal risks and uncertainties section on pages 24 to 26.

External recognition

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

Business in the Community CORPORATE RESPONSIBILITY INDEX 2008

Business in the Community Corporate Responsibility Index (BitC)

The BitC Index assesses the extent to which corporate strategy is integrated into business practice throughout an organisation. It provides a benchmark for companies to evaluate their management practices in key areas of corporate responsibility and performance in a range of environmental and social impact areas. In this year's BitC Index, Rolls-Royce retained its Gold status with an overall score of 93 per cent.

Dow Jones Sustainability Indexes Member 2009/10

Dow Jones Sustainability World and European Indexes (DJSI)

Rolls-Royce has retained its position in the DJSI for the eighth consecutive year, thereby achieving international recognition of being amongst the best-in-class for addressing a range of sustainability issues. Our overall score of 80 per cent represented an improvement of one per cent on last year and we once again achieved first position in the Aerospace and Defence sector. The Group scored 100 per cent for environmental reporting, product impact and operational eco-efficiency and the best sector score for both climate strategy (91 per cent) and occupational health and safety (95 per cent).

CARBON DISCLOSURE PROJECT

Carbon Disclosure Project (CDP)

The CDP is an independent not-for-profit organisation holding the largest database of primary corporate climate change information in the world. Thousands of organisations from across the world's major economies measure and disclose their greenhouse gas emissions and climate change strategies through CDP.

For the second consecutive year, Rolls-Royce has been included within CDP's FTSE 350 Carbon Disclosure Leadership Index, in which the quality and depth of a company's response to the annual CDP questionnaire is scored.

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

Our approach

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

Business ethics
Rolls-Royce has a long history of conducting business responsibly and ethically. Our commitment to act with integrity is at the heart of the way we operate and we regard ethical behaviour as key to maintaining and strengthening our reputation for being trusted to deliver excellence.

Health, safety and the environment (HS&E)
With its heritage of technological and engineering excellence, Rolls-Royce is well placed to help society address the problems of climate change and energy security. We also believe that good HS&E performance in our operations is synonymous with good business. Our objective is to achieve world-class performance at every site and to be widely recognised for the excellence of our HS&E performance.

Employees
We aim to attract and retain the best people and create an inclusive working environment in which creativity, capability and motivation flourish. By continually improving levels of employee performance, we deliver on our commitments.

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

Business ethics

Rolls-Royce has a long history of conducting business responsibly and ethically. Our commitment to act with integrity is at the heart of the way we operate and we regard ethical behaviour as key to maintaining and strengthening our reputation.

In 2009, the Group completed a programme of face-to-face training in ethics for employees.

30

We have over 30 confidential reporting lines worldwide.

4,600

The ethics training programme included leadership workshops for 4,600 managers around the world.

The Board strongly believes that the Group's business should be conducted in a way that reflects the highest ethical standards. The ethics committee was established in 2008 to oversee the implementation of the Group's global ethics strategy and the management of ethical and reputational risk. The committee consists exclusively of independent non-executive directors and met four times in 2009. Further details of the committee and its principal terms of reference can be found on page 73 .

In 2009, as a demonstration of the Group's commitment to setting industry-leading standards of ethical business conduct, Rolls-Royce signed the statement of adherence to the Aerospace and Defence Industries Association of Europe Common Industry Standards.

Global Code of Business Ethics

In 2009, Rolls-Royce published an updated version of its Global Code of Business Ethics (the Global Code) and issued a personal copy to every employee. The revised Global Code sets out the principles for employees to follow when conducting business and provides practical guidance to help identify, resolve and report any ethical issues or dilemmas they may face. It sets standards of ethical behaviour for working together, conducting business with customers, suppliers and joint ventures, running our company, health safety and the environment, and working within our communities. Principles and guidance for managers and employees are provided in key areas such as diversity, discrimination and harassment, bribery and corruption, conflicts of interest and safe working. The Global Code encourages employees to ask for help and assures them that concerns can be raised without fear of reprisal. It is available in 16 languages and can be viewed on the Group's website at www.rolls-royce.com/cr/ethics.

Training and awareness programme

In 2009, the Group completed a programme of face-to-face training for all employees to strengthen awareness of the Group's values and embed the Global Code. The training programme included facilitated half-day leadership workshops for almost 4,600 managers across the Group. The aim of these workshops was to set the tone at the top, make managers aware of the content of the Global Code and equip them with the necessary tools to deal with ethics-related issues appropriately. Employee briefings were subsequently delivered by these managers to their teams using supporting materials including briefing guides, Global Code wall charts and a corporate values and ethics video. A tailored ethics e-learning course will be available in 2010 to reinforce the face-to-face training provided in 2009.

Confidential reporting line

An independently operated and confidential ethics reporting facility is available worldwide so employees can raise issues or concerns regarding business conduct independently of the normal management chain. This facility includes telephone lines and an external website. Rolls-Royce employees can call any one of over 30 telephone numbers in countries across the world to report any concerns they may have with regard to business conduct. Calls are made in total confidence, being handled independently by the partnership LRN – EthicsPoint. Reports are investigated by the business ethics and compliance team with support from the businesses, security, legal counsel and human resources as required. An ethics report steering group meets quarterly to review cases, identify trends and manage the associated ethical and reputational risks. The ethics committee monitors cases reported, the management of cases and the results for high risk investigations undertaken.

Global Code of Business Ethics

In 2009, Rolls-Royce published an updated version of its Global Code of Business Ethics and issued a personal copy to every employee.

16

Our Global Code of Business Ethics is available in 16 languages.

Confidential reporting

Independently operated and confidential ethics reporting lines are available for employees to raise issues or concerns regarding business conduct.

Business review
Corporate governance
Financial statements

Health, safety and the environment (HS&E)

Rolls-Royce is well placed to help society address the problems of climate change and energy security.

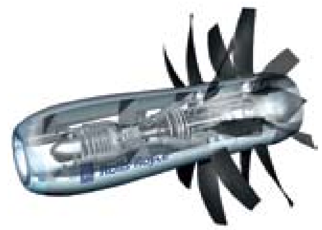
We also believe that good HS&E performance in our operations is synonymous with good business. Our objective is to achieve world-class performance at every site.

Policy and management arrangements

The Group's arrangements for HS&E governance and management systems implementation are detailed in our published booklet.

50

We are targeting a 50 per cent reduction in Total Reportable Injuries by 2012.



Future product developments

As part of the European Commission Clean Sky Joint Technology Initiative we are leading research on low fuel-burn geared open rotors.

Strong HS&E culture

An underlying theme of our strategy is to continue to develop a strong HS&E culture.

Business review
Corporate governance
Financial statements

HS&E management

We believe that all cases of work-related ill-health, injuries and environmental incidents are avoidable. Our vision is to have world-class levels of performance on every site and be recognised for the excellence of our HS&E performance. The Group's arrangements for HS&E governance and management systems implementation are detailed in our Policy & Management Arrangements booklet available on www.rolls-royce.com/cr. Performance improvement is delivered through the implementation of a focused strategy, the core elements of which cover: leadership, commitment and involvement; full implementation of the company HS&E management system and related standards; and implementation of best practice and reducing risks through the removal or minimisation of hazards in the workplace.

An underlying theme of our strategy is to continue to develop a strong HS&E culture. A team of HS&E professionals supports line management at the corporate, business and site levels. During 2009, we have made further progress to strengthen the capabilities of the HS&E function.

All the Group's businesses have third-party certification to the environmental management system standard ISO 14001. During 2009, we consolidated all of our third-party certification and surveillance activities into one provider – Bureau Veritas Certification. This is aimed at increasing the efficiency and effectiveness of the global programme. This also supports our drive to provide consistent standards across the Group and to focus our efforts on key issues. In this way we will derive greater benefit from the certification process.

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

We operate three sites in the UK which together manufacture, test and support nuclear reactor cores for the Royal Navy's submarines. The Nuclear Propulsion Assurance Committee regularly monitors the performance of both the submarines and recently formed civil nuclear businesses and seeks evidence that the highest standards of HS&E are maintained and that fit-for-purpose processes are followed.

The Group's contribution to developing best practice through third-party collaboration continues. We are taking a leading industry role in Registration, Evaluation, Authorisation and restriction of Chemicals (REACH), the latest EU chemicals regulation and continue to work with other companies, trade bodies, sectors and regulators on implementation. During 2009, efforts have again focused on raising awareness within our supply chain, such that appropriate arrangements for compliance and business continuity are introduced well ahead of deadlines. We continue to support the development of international standards within aviation, for the phased declaration of substances supplied to us to facilitate future REACH compliance and, where required, industry-wide substitution programmes. We also continue to consult widely with the European Chemicals Agency (ECHA) on pertinent matters relating to implementation and compliance within our sectors.

We continue to participate in and meet our ongoing commitments under various climate change agreements such as the EU Emissions Trading Scheme and the US Chicago Climate Exchange greenhouse gas emissions trading scheme. The Group is also preparing for the latest carbon emissions reduction regulations in the UK under the Carbon Reduction Commitment Energy Efficiency Scheme. Such measures, alongside the underpinning science, are fully considered when setting Group greenhouse gas reduction targets.

Operational performance

Shaped by our HS&E strategy, we continue to implement prioritised work programmes across all our sites to meet the challenging objectives and targets that have been set. In the past year, we have made excellent progress against these targets. There were no fatalities in the Group during 2009 and no prosecutions against the Group for HS&E offences. Comprehensive improvement programmes, with an enhanced level of support from the Corporate HS&E team, were initiated at the poorer performing sites during 2009. A significant improvement in performance has been achieved at these target sites.

During 2009, we introduced a web-based, global reporting system, which now provides the facility to collect and review HS&E performance in our operations on a monthly basis. This provides improved tracking of performance at site, business and Group levels. Our latest progress report is available on the Group's website at www.rolls-royce.com/cr/reports. Our data collection and reporting is subject to independent assurance and recommendations for improvement by Deloitte LLP.

Web-based reporting system

Our new system allows us to collect and review HS&E data globally.

Our 2007-2009 objectives and targets were to:

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

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

Reduce environmental impact
Achieve a ten per cent reduction in energy consumed (normalised by financial revenues) by the end of 2009

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

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

Detailed results will be published during 2010 on the Group's website at www.rolls-royce.com/cr/reports

A new set of objectives and targets for the period 2010-2012 have been agreed and are set out below:

Protect health
Reduce the Group incident rate of occupational diseases and other work related ill-health by ten per cent by end 2012

Prevent injury
Reduce Company Total Reportable Injury (TRI) rate by 50 per cent by end 2012

Reduce environmental impact
Five per cent reduction in company facility greenhouse gas emissions by end 2012 (absolute)

Ten per cent reduction in total Group greenhouse gas emissions by end 2012 (normalised by financial revenues)

Ten per cent reduction in total Group production waste (solid and liquid) by end 2012 (normalised by financial revenues)

70 per cent Group recycle rate of solid waste by end 2012

Greenhouse gas targets
An absolute reduction target for company facility greenhouse gas emissions of five per cent has been set for the period 2010-2012.

Reducing environmental impact
A new target has been set of increasing the company recycle rate for solid waste to 70 per cent by the end of 2012.

Product environmental performance

Rolls-Royce is both committed and well placed to find solutions to the substantial challenges posed by climate change. The Group believes that technology must be applied on an industrial scale, through companies such as Rolls-Royce with global reach, to achieve significant reductions in emissions.

The Group closely monitors developments in the underpinning science to help steer the significant research and development programmes undertaken across all product ranges. Such knowledge, supplemented by independent expert advice from the Group's Environmental Advisory Board made up of distinguished academics who are leading authorities in their respective fields, is also vital to the overall business strategy and design process.

In civil aerospace, we have used our technological expertise to reduce significantly the fuel consumption of our products and consequently carbon dioxide emissions, since the first jet aircraft entered service. For example, the Trent 1000 engine is 25 per cent more efficient than the first RB211 engine. The Trent 900 and 1000 engines, for the Airbus A380 and Boeing 787 respectively, and in future the Trent XWB for the Airbus A350 XWB, help us demonstrate progress towards meeting our Advisory Council for Aeronautics Research in Europe (ACARE) goal of a 15-20 per cent reduction in engine fuel burn by 2020 compared to 2000 levels. The Group also continues to drive for reductions in noise and improvements in air quality.

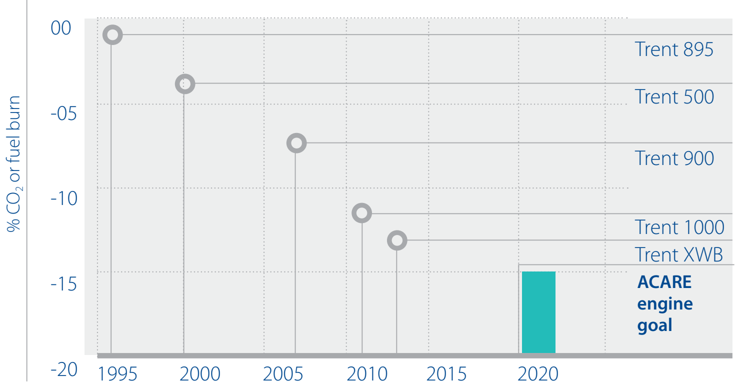
We are taking a leading role in research, including the Environmentally Friendly Engine (EFE), a combined UK Government, industry and university programme, as part of our continuing drive to improve the environmental performance of our aero engines. As part of the European Commission Clean Sky Joint Technology Initiative, we are leading a

€400 million engine research programme, where our efforts are focused on demonstrators for low-weight advanced turbofans and ultra-low fuel burn geared open rotors. Rolls-Royce is also leading other joint Government/industry programmes, including:

- Strategic Investment in Low-carbon Engine Technology (SILOET);
- Strategic Affordable Manufacturing in the UK through Leading Environmental Technologies (SAMULET); and
- Environmental Lightweight Fan (ELF).

Rolls-Royce is an active member of the UK Sustainable Aviation Council, which comprises manufacturers, airlines, airports and air navigation service providers and is an industry body committed to building a sustainable future for aviation. Its second progress report, published in 2009, includes an emissions reduction 'Roadmap' detailing that significant abatement is feasible in the UK by 2050.

Fuel saving[1] (%)



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

The aviation sector is closely examining the potential of bio-fuels to offer a sustainable lower-carbon alternative to kerosene. Rolls-Royce has supported a number of flight trials, whilst remaining conscious of the wider sustainability issues. Our position is that, to be acceptable, candidate alternative fuels must:

- be technically suitable;
- be deployable on a scale sufficient to displace a significant quantity of kerosene use;
- avoid harmful impacts on food availability and cost, water demand and ecosystems; and
- offer an overall lifecycle carbon footprint significantly lower than kerosene.

Environmental performance is fundamental across all of our businesses. For example, in the marine sector, our market leading Azipull thrusters use 16 per cent less energy than conventional thrusters, resulting in lower emissions. We are also extending our range of marine reciprocating engines capable of running on liquefied natural gas (LNG), which compared with diesel fuel in conventional engines, provide significantly lower CO_2, NO_x and SO_x emissions.

The Group continues to explore opportunities in low emission and alternative energy products and is working in partnership with the UK Energy Technologies Institute. As part of this work programme, a prototype tidal device has been developed and will be tested at the European Marine Energy Centre, in Orkney, Scotland.

Nuclear power is expected to represent an important component of future low-carbon electricity generation. Rolls-Royce has substantial capabilities in this area gained through supplying power systems for the UK nuclear-powered submarine fleet over many decades and, in response to the formidable challenge posed by climate change, has formed a civil nuclear business unit.

A new factory is planned to manufacture, assemble and test components for new civil nuclear power stations. These include pressure vessels, heat exchangers and other large and complex reactor parts, manufactured to exacting nuclear standards. The facility will have strong links with the Nuclear Advanced Manufacturing Research Centre, announced by the UK Government in July 2009, in which Rolls-Royce will be the leading industrial partner.

Improving product efficiency

The Trent 1000 engine is 25 per cent more efficient than the first RB211 engine.

Azipull thruster

Market leading Azipull thrusters use 16 per cent less energy than conventional marine thrusters.

Employees

We aim to attract and retain the best people and create an inclusive working environment in which creativity, capability and motivation flourish. By continually improving levels of employee performance, we deliver on our commitments.

Attracting new employees

Rolls-Royce aims to attract and retain the best people by having an inclusive working environment.

5

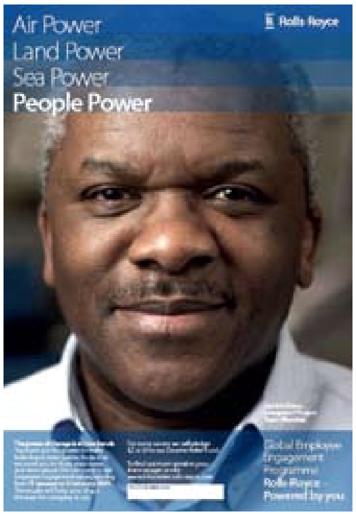
2009 was the fifth year that the Global Council had met. Its aim is to improve consultation and employee engagement.

42

A total of 42 employee delegates and a selection of senior management attend council meetings.

Global council

Delegates at the council can hear the discussions translated into their own languages.



Engagement survey

As a result of the survey, feedback improvements are being implemented. A pulse check of employee perceptions will be undertaken in early 2010.

80

80 per cent of employees completed the engagement survey.

Engaging employees

At the end of 2009, Rolls-Royce employed 38,500 permanent staff in over 50 countries. The long lifecycle of the Group's products makes it imperative that we have a skilled workforce that is committed to delivering excellence to customers over the long term. To achieve this and help improve performance, we aim to create an inclusive working environment that attracts and retains the best people, enhances their flexibility, capability and motivation and encourages them to be involved in the ongoing success of the Group.

In 2005, we formed a Global Council to improve our consultation and employee engagement. The full council meets twice a year and involves 42 employee delegates and a selection of senior management representatives from each business and function. Employee delegates are elected to represent both employees that are members of unions and those who are not. An executive committee of eight elected delegates meets senior management an additional four times throughout the year to ensure regular dialogue and timely consultation between council meetings.

In 2009, our global election process saw 30 per cent of Global Council delegates take up the responsibility for the first time. Due to the changing shape of our global workforce and the need for delegates to have effective communication and interaction during and in between Global Council meetings, we ran cultural awareness training for all delegates in 2009.

Since 2008, we have conducted an annual strategy storyboard, an interactive Group-wide briefing on corporate direction and performance. The storyboard is delivered globally through small face-to-face briefings and ensures all our employees have a good understanding of the Group's key objectives and the contribution each individual can make towards meeting them.

Our Employee Engagement Survey was redesigned at the end of 2008 to give clearer and more comprehensive feedback and was incorporated into a two-year rolling global engagement programme. The first improved global employee survey was conducted in January 2009 with a participation rate of 80 per cent, a marked increase from the 46 per cent participation in 2006. The new reporting format has allowed us to develop improvement activities that are being implemented across each business and function. A pulse-check survey to gauge employees' perceptions of progress will be undertaken in early 2010.

Rolls-Royce provides competitive pay and benefits in all its locations and actively encourages share ownership by offering ShareSave plans to all employees. Our employees have currently committed around £106 million to these plans. In the UK, statutory arrangements enable employees to receive part of their annual bonus in shares and to make monthly share purchases from their salary.

Encouraging diversity

The Group is committed to developing a diverse workforce and equal opportunities for all. This includes encouraging more women and people from minority backgrounds to pursue engineering careers. Our global governance framework for diversity includes a senior executive Global Diversity Steering Group that provides leadership and shapes strategic direction.

During 2009, we recruited MBA students from 11 nations, graduates for our worldwide graduate programme from 34 nations, and apprentices in the UK and Germany from five nations.

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

Launched in 2006, our UK Women's Network focuses on personal and professional skills development as well as providing support through networking and mentoring frameworks. Participation continues to grow and, during 2009, we supported the launch of a Women's Network in Indianapolis, North America, and we are currently supporting the launch of a network in Germany.

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

Learning and development

In December 2008, we launched MyLearning, a global system providing access for all employees to both instructor-led and online learning. Through this web-based system, employees are now able to view the training available, book onto a course, undertake online learning and review their training history. By the end of December 2009, employees from 44 countries had accessed the system, with over 11,000 employees undertaking more than 65,000 hours of online training.

We have begun to roll out a programme of competency definitions that will align generic jobs to behavioural and technical competencies. These competencies will allow all our employees to assess their skills and knowledge against those required to carry out their job successfully. Through MyLearning, employees can run a self-assessment and are then offered training to ensure that they develop the skills needed to meet the required competency levels.

During 2009 our learning and development team provided 9,000 days of leadership training and delivered learning and development programmes that supported capability development for individuals and the business. We continue to use trained facilitators to deliver global training programmes such as business ethics and our annual strategy storyboard to all employees.

About 1,000 employees have benefited from financial support and time off work to attend further education programmes at local colleges and universities and we provided £1.7 million to finance this type of learning.

Overall, we invested £24 million in the education, training and professional development of employees during the year.

Resourcing and deployment

We continue to focus on the recruitment, development, and deployment of leadership and professional capability across all of our functions globally. Leadership succession and individual career development is managed through development meetings held on a regular basis with senior leadership teams throughout the Group. Discussions in these forums are directly linked to the development of resourcing plans which identify the need for specialist, managerial, MBA, graduate and apprentice employees. Development meetings operate at four different levels in the organisation, ensuring a balanced

34

During 2009, we recruited MBA students from 11 nations, graduates from 34 nations and apprentices from five nations.

Trainees

During 2009, we recruited 199 graduates and 254 apprentices and technicians worldwide onto Rolls-Royce programmes.

Occupational health

The primary objective of the Group's occupational health strategy remains a culture of prevention rather than cure.

45

45 per cent of respondents made beneficial lifestyle changes.

focus on the development and advancement of employees including, high potential employees, technical specialists and senior executives. This ultimately enables effective deployment of people throughout the business.

During 2009, we recruited 199 graduates onto Rolls-Royce graduate programmes and 254 apprentices and technicians worldwide and an additional 256 students were employed on short-term training projects in the UK and North America. We remain in the upper quartile of The Times' Top 100 Graduate Employers survey and are ranked in first position for engineering companies.

Health and wellbeing

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

The strategy maintains four key areas of focus:
- screening and surveillance;
- rehabilitation;
- health promotion; and
- education.

We continue to demonstrate good progress against our screening and surveillance targets. These are detailed in the Responsible Operations report, published in April 2007 and subsequent updates available on the Group's website at www.rolls-royce.com/cr/reports.

The 'Know your body metrics' health promotion campaign designed to complement the 'Owners Handbook' on wellbeing rolled out in 2007 and 2008 has been continued in 2009 following popular demand. The programme is designed to raise awareness and understanding of cardiovascular risk factors.

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

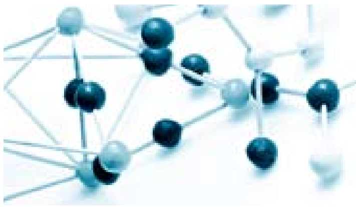
A pilot programme in one of our business units took place with the Sainsbury Centre for Mental Health based on the successful Australian programme entitled 'beyondblue'. Further training and awareness are planned to help managers identify depression in the workplace.

Business review
Corporate governance
Financial statements

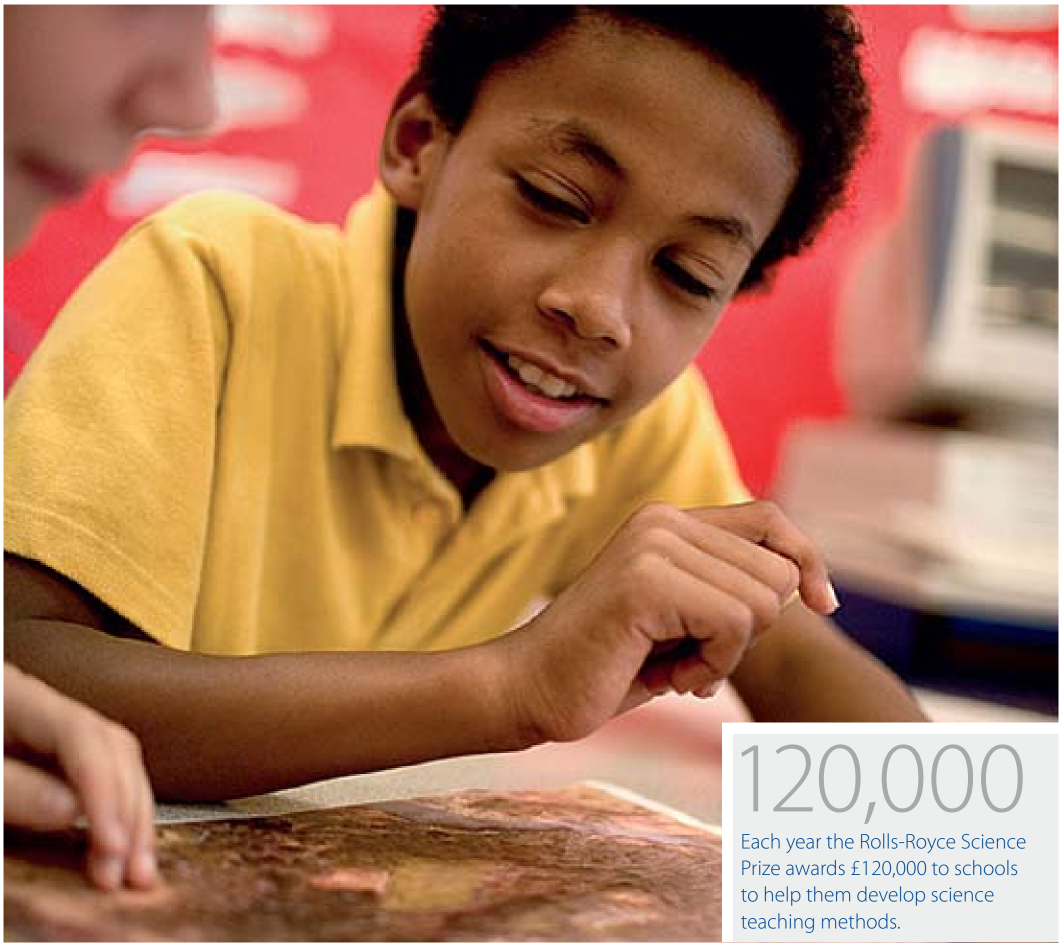
Society

Rolls-Royce has a firm, long-standing commitment to the communities in which we operate around the world.

Sustained investment in communities makes a positive difference and delivers tangible benefits to our business. Corporate responsibility is also a key enabler in delivering our global supply chain strategy.



Investing in science



120,000

Each year the Rolls-Royce Science Prize awards £120,000 to schools to help them develop science teaching methods.

6.7

The Group donated £6.7 million in 2009 for good causes.

Rolls-Royce Science Prize

Our flagship education programme, the Rolls-Royce Science Prize, recognises excellent and innovative science teaching in the UK.

Good supplier relationships

The Group sets and manages rigorous performance standards for suppliers through its quality system, Supplier Advanced Business Relationships.

4,000

In 2009, 4,000 tonnes of high-value metals were returned to our own supply chain for re-use.

Society

The Group continues to foster productive supplier relationships which:

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

We also set and manage rigorous performance standards for suppliers through our quality system, Supplier Advanced Business Relationships (SABRe). This includes a supplier code of conduct, which is complemented by the Group's purchasing code of conduct to ensure suppliers and employees work to the same standards.

We are an active member of the UK MoD/Industry Sustainable Procurement working group, and look to proactively engage suppliers in this topic. In 2010, we aim to address the integration of Sustainable Procurement into our sourcing decision process.

Over the last few years Rolls-Royce has voluntarily and publicly declared our carbon emissions by having our data analysed by the Carbon Disclosure Project (CDP). As part of our membership of the CDP we were able to extend this analysis into our external supply chain by inviting some of our suppliers from around the world to declare their carbon emissions. Due to the success of this analysis, we plan to extend this pilot programme in 2010.

We are committed to working with suppliers to eliminate waste. Success in recycling metals within our manufacturing facilities has been extended to support suppliers in recycling their waste metals. In 2009, we further extended our remit on metal recycling by engaging with selected customers to ensure that their time-expired engine parts enter the recycling process. In addition, in 2009 over 4,000 tonnes of high-value metals were returned from Rolls-Royce factories directly back to our own supply chain for re-use.

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

Community investment

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

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

During 2009, we conducted our sixth global survey of community and sponsorship contributions, including cash, employee time and gifts in kind, using the London Benchmarking Group model. The Group's total contributions across all these areas amounted to approximately £6.7 million.

Donations and sponsorship

The Group's charitable donations policy is to 'directly support causes primarily relating to educational, engineering and scientific objectives, as well as social objectives connected with the Group's business and place in the wider community'.

The Group's charitable donations amounted to £2.3 million, of which £1.5 million were made in the UK. These included support for Community Foundations, Emmaus for homeless people, and the main armed service benevolent funds. Rolls-Royce made charitable donations of US$800,000 in North America, €135,000 in Germany and £200,000 in other regions. These donations included support for the work of United Way in North America and for the victims of natural disasters in Vietnam, India, Indonesia and Brazil.

A further £2.1 million was contributed in sponsorships and educational programmes, including the Smithsonian National Air and Space Museum in North America, the Brandenburg Summer Festival in Germany and sponsorship of The Big Bang fair for young scientists and engineers in the UK.

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

Our flagship education programme, the Rolls-Royce Science Prize, recognises excellent and innovative science teaching in the UK. This year's winner, Kells Lane Primary School in Gateshead, England, received a total of £20,000 for its project, in which teachers developed a wind tunnel to test pupil-designed wind turbines. In all, £120,000 was awarded, with the help of the UK Science Learning Centre network, to 59 schools to improve science teaching and learning. As part of the Science Prize, the Group sponsors Project ENTHUSE which provides free professional development courses to teachers in the UK through the National Science Learning Centre.

Employee time

Employee time contributed during 2009 is estimated at a value of at least £1.5 million, with more than 5,000 employees participating in activities such as community projects and team-building activities with societal benefits.

Over 200 employees in the UK, North America and Germany took part in 20 projects during the year as part of their personal development. These projects are recognised at the Group's Global Learning and Development Awards.

Employee giving

In addition to the Group's own contributions, Rolls-Royce finances the administration of a Payroll Giving Scheme for UK employees, enabling them to make tax-free donations to their chosen charities. In the UK during 2009, employees gave almost £430,000 to more than 350 charitable causes of their choice. The scheme is recognised as Gold Award standard by the UK Government's Payroll Giving Quality Mark, with approximately 14 per cent of UK employees participating in the scheme. In North America, employees have contributed over US$550,000 directly from payroll to good causes through the United Way scheme, a percentage of which is matched by the Group.

In-kind support

The Group also supports community and educational organisations with in-kind donations, including places on Group training courses and the loan of engines and components.

5,000

Almost 5,000 employees participated in community projects.

Employee giving

Employees contributed over US$550,000 through the United Way scheme.

United Way

Business review Corporate governance Financial statements

Finance Director's review

Andrew Shilston, Finance Director

"In 2009, the Group delivered increases in revenue and profit. The order book also remained resilient in difficult market conditions."

The Group delivered another year of strong progress in the face of significant challenges in 2009. The global recession, together with industry specific issues, provided substantial challenges, including the continued delay of a number of major new aerospace programmes. However, a resilient financial performance provides clear evidence of the strength of the business and its ability to adjust quickly in a volatile environment.

Our businesses are being affected by the same economic factors as many of our peers and competitors. However, the Group's breadth both by sector and geographical mix, the age of our installed fleet of products, the strong positions we hold on current and future major programmes, together with the Group's services revenues, provide us with significant advantages and have helped deliver a resilient overall result for the year.

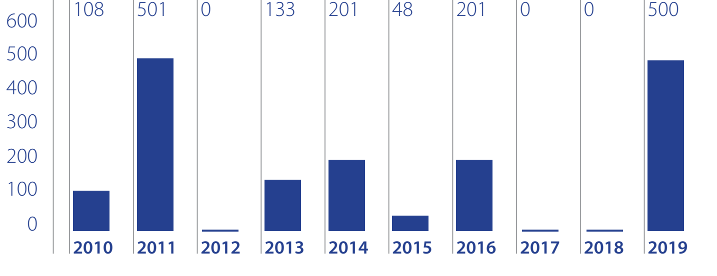
The financial performance in 2009 met the expectations of the Board and the guidance provided at the start of the year, delivering an 11 per cent increase in underlying Group revenues with underlying profit before taxes up four per cent to £915 million.

As anticipated there was a cash outflow in the year of £183 million. This was as a consequence of the global economic downturn and programme delays impacting the working capital cycle which was exacerbated by year-end revaluation effects.

The published results were heavily influenced by the significant movements in foreign exchange rates in 2009, especially the GBP/USD and the GBP/EUR which are explained on page 59.

The Group has maintained a strong financial position throughout the year and continues to hold strong credit ratings from both Standard & Poor's (A-, Stable) and Moody's (A3, Stable). At the year end, the Group held gross cash balances of £3.0 billion with £1.7 billion of outstanding debt commitments – a net cash position of £1.3 billion with the average net cash having also increased to £635 million over 2009. The redemptions on the Group's existing bond financing, at around £1.7 billion, are well spread with around US$187 million due in the second half of 2010 and a €750 million Eurobond due in 2011 as shown in the chart below. The Group had a further £450 million in term funding available to it that was undrawn at the year end. The Group has essentially completed the refinancing of the 2011 Eurobond via the successful £500 million GBP bond issued in the first half of 2009, the proceeds of which are now held on term deposit and will be available to settle the 2011 bond when it falls due. There are no other material maturities until 2013.

Maturity profile of outstanding Group debt commitments



The changes made to the Group's UK pension schemes over the last few years have enabled the deficit to remain stable and modest and the schemes ended the year with a net deficit of £380 million on an accounting basis, as detailed in note 18 of the financial statements on page 131. The triennial actuarial valuation of the Rolls-Royce Pension Fund, representing 64 per cent of future liabilities, was completed in the year producing a pleasing result with no material changes in the scale of the deficit or future funding levels. The stability in ongoing funding is a direct result of changes made to the Group's pension schemes to reduce the volatility of the deficit, and to provide stability and visibility of cash funding requirements over the next three years.

Foreign exchange effects on published results

The pace and extent of currency movements have continued to have a significant effect on the Group's financial reporting in 2009, with the GBP/USD and GBP/EUR rates having the biggest impact. These movements have influenced both the reported income statement and the cash flow and closing net cash position (as set out in the cash flow statement and note 2 in the financial statements) in the following ways:

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

The principal movements in 2009 were as follows:

	Open	Close
GBP–USD	£1–$1.438	£1–$1.615
GBP–EUR	£1–€1.034	£1–€1.126
Oil–Spot Brent	$49/bbl	$77/bbl

The impact of this mark to market is included in net financing in the income statement and caused a net £1,835 million benefit, contributing to a published profit before tax of £2,957 million. These adjustments are non-cash, accounting adjustments required under IAS 39 *Financial Instruments: Recognition and Measurement*. As a result, reported earnings do not reflect the economic substance of derivatives that have been settled in the financial year, but do include the unrealised gains and losses on derivatives that will only affect cash flows when they are settled at some point in the future to match trading cash flows.

Underlying earnings are presented on a basis that shows the economic substance of the Group's hedging strategies in respect of transactional exchange rates and commodity price movements. Further details and information are included within the section on key performance indicators on page 19 and in notes 2 and 5 of the financial statements.

Underlying profit before finance costs of £915 million benefited from £71 million of foreign exchange benefits compared to 2008. The achieved rate on selling US dollar income, around one and a half cents better in 2009 than 2008, contributed £16 million of transactional benefits. In addition, the improvement in the average GBP-USD and GBP-EUR exchange rates, 29 and 14 cents respectively, contributed translation benefits totalling £55 million to underlying profit before tax in the year.

The achieved rate on selling net US dollar income is expected to improve by six to nine cents in 2010 compared to 2009, as the Group is able to benefit from forward contracts at better rates. Revaluation effects, which are measured at a point in time, do not, therefore, represent additional currency headwinds or benefits.

2. Cash flow and balance sheet – the Group maintains a number of currency cash balances which vary throughout the financial year. Given the significant movements in foreign exchange rates in 2009, a number of these cash balances were reduced by the effects of retranslation at the year end, causing a reduction of £141 million in the 2009 cash flow and hence the closing balance sheet cash position.

Summary

The Group's revenues increased by 15 per cent in 2009 to £10,414 million with 86 per cent of revenues from customers outside the UK. Underlying revenues grew 11 per cent in 2009 with double-digit increases in defence aerospace, marine and energy and stable revenues in civil aerospace.

- Underlying revenues in the civil aerospace division were stable at £4,481 million (2008 £4,502 million) with a four per cent decline in service revenues being offset by a four per cent improvement in revenues from original equipment. Original equipment revenues were supported by a record year for the Trent family, with 224 engines delivered, helping to offset a 39 per cent reduction in deliveries for the corporate and regional sector. Overall 844 engines were delivered in the year, including 347 V2500 engines, and 273 engines for various corporate and regional applications. Revenues from services were held back by reduced discretionary spares and service activity as customers reduced overhaul activity given lower utilisation patterns on a number of large aircraft types.
- Underlying defence aerospace revenues grew by 19 per cent supported by strong growth in deliveries for the military transport sector. New equipment revenues grew 30 per cent and services revenues increased by ten per cent over 2008.
- The marine business continued to grow strongly in the year with underlying revenues increasing 17 per cent from 2008 to £2,589 million. Overall new equipment revenues increased by 21 per cent to £1,804 million with services revenues increasing ten per cent to £785 million supported by the expansion of the marine services network as six facilities were opened or expanded in the year.

- The energy business made strong progress in the year with underlying revenues up 36 per cent to £1,028 million, supported by good growth in both original equipment and services activities.

Overall underlying services revenues increased by four per cent in 2009 to £4,927 million and accounted for 49 per cent of Group revenues for the year.

Underlying profit margins before financing costs reduced slightly from 10.0 per cent in 2008 to 9.7 per cent in 2009. The reduction in margin reflected an increased mix of original equipment and increased unit costs. Underlying financing costs increased by £29 million to £68 million (2008 £39 million) including an increase in the net interest charge of £33 million as a consequence of the additional £500 million bond issue in April 2009, and finance costs associated with financial risk and revenue sharing partnerships.

Restructuring charges in 2009 totalled £55 million (2008 £82 million) as the Group continued its focus on operational improvements, including the reduction in the number of people working in support functions. These costs are included within operating costs.

A final payment to shareholders of nine pence per share, in the form of C Shares, is proposed, making a total of 15.00 pence per share, a five per cent increase over the 2008 total.

Order book

The order book at December 31, 2009, at constant exchange rates, has remained resilient at £58.3 billion (2008 £55.5 billion). This included firm business that had been announced but for which contracts had not yet been signed of £6.8 billion (2008 £6.1 billion).

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

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

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

Aftermarket services

The Group continues to be successful in developing its aftermarket services activities. These grew by four per cent on an underlying basis in 2009 and accounted for 49 per cent of the Group revenues.

In particular, TotalCare packages in the civil aerospace sector now cover 59 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 £970 million (2008 £848 million).

Cash

There was a cash outflow in the year of £183 million (2008 £570 million inflow) partly the consequence of revaluing year end non-GBP cash balances of £141 million (2008 £439 million inflow) but also reflecting £94 million of investments in acquisitions and joint ventures and associates during the period.

Working capital increased by £78 million during the year with increased financial working capital offsetting inventory which reduced by £119 million. Reduced inventory levels was a significant achievement given the volatility caused by the economic downturn, ongoing delays of major new programmes and the growth in the non-civil aerospace segments during 2009.

Cash investments of £597 million (2008 £675 million) in property, plant and equipment and intangible assets, payments to shareholders of £250 million (2008 £200 million) and tax payments of £119 million (2008 £117 million) represented the major cash outflows in the period.

Despite a modest cash outflow in 2009, the average net cash was £635 million (2008 £375 million). The net cash balance at the year end was £1,275 million (2008 £1,458 million).

Taxation

The overall tax charge on the profit before tax was £740 million (2008 £547 million credit), a rate of 25.0 per cent (2008 28.9 per cent).

The tax charge on underlying profit was £187 million (2008 £217 million) a rate of 20.4 per cent (2008 24.7 per cent).

The overall tax charge was reduced by £26 million in respect of the expected benefit of the UK research and development tax credit. In addition, £35 million of prior years' tax provisions were released in the year. This was partly following settlement of a number of outstanding tax issues and partly as a result of a change in UK tax law generally exempting foreign dividends from UK taxation. These items also reduced the underlying tax charge by the same amounts. The underlying tax rate is expected to increase in 2010 to around 24 per cent.

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

The Group operates internationally and is subject to tax in many differing jurisdictions. As a consequence, the Group is routinely subject to tax audits and examinations which, by their nature, can take a considerable period to conclude. Provision is made for known issues based on management's interpretation of country specific legislation and the likely outcome of negotiation or litigation. The Group believes that it has a duty to shareholders to seek to minimise its tax burden but to do so in a manner which is consistent with its commercial objectives and meets its legal obligations and ethical standards. While every effort is made to maximise the tax efficiency of its business transactions, the Group does not use artificial structures in its tax planning. The Group has regard for the intention of the legislation concerned rather than just the wording itself. The Group is committed to building open relationships with tax authorities and to following a policy of full disclosure in order to effect the timely settlement of its tax affairs and to remove uncertainty in its business transactions. Where appropriate, the Group enters into consultation with tax authorities to help shape proposed legislation and future tax policy.

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

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

Pensions

The charges for pensions are calculated in accordance with the requirements of IAS 19 *Employee Benefits*. During 2007, the Group's principal UK defined benefit schemes adopted a lower risk investment strategy in which the interest rate and inflation risks were largely hedged and the exposure to equities reduced to around 20 per cent of scheme assets. As reported last year, the primary objective of the revised investment strategy was to reduce the volatility of the pension schemes to enable greater stability in the funding requirements. The March 31, 2009 valuation of our largest pension fund has demonstrated the success of these measures. After increasing the allowance for life expectancy, the deficit has fallen slightly compared to the previous valuation in 2006. This means that the deficit reduction contributions which have been in place since 2003 will continue at their current level but are now projected to end slightly earlier than previously envisaged.

Further information and details of the pensions' charge and the defined benefit schemes' assets and liabilities are shown in note 18 to the financial statements. The net deficit, after taking account of deferred tax, was £590 million (2008 £399 million restated). Changes in this net position are affected by the assumptions made in valuing the liabilities and the market performance of the assets.

Investments

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

The Group has a portfolio of projects at different stages of their lifecycles. 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 (R&D) investment amounted to £864 million (2008 £885 million). Net research and development charged to the income statement was £379 million (2008 £403 million). The level of self-funded investment in research and development is expected to remain at approximately four to five per cent of Group revenues 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 modest increase in the level of net research and development charged within the income statement in 2010.

The continued development and replacement of operational facilities contributed to the total expenditure in property, plant and equipment of £291 million (2008 £283 million). Investment in 2010 is anticipated to be slightly increased compared to the 2009 level as the investments in new facilities in the US and Singapore commence.

Investment in training was £24 million (2008 £30 million).

Intangible assets

The Group carried forward £2,472 million (2008 £2,286 million) of intangible assets. This comprised purchased goodwill of £984 million, engine certification costs and participation fees of £454 million, development expenditure of £546 million, recoverable engine costs of £290 million and other intangible assets of £198 million. Expenditure on intangible assets is expected to increase modestly in 2010.

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain reductions in assumed market share, programme timings, increases in unit cost assumptions and adverse movements in discount rates. There have been no impairments in 2009. Further details are given in note 8.

Partnerships

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

Joint ventures

Joint ventures are an integral part of our business. They are involved in engineering, manufacturing, repair and overhaul, and financial services. They are also common business structures for companies participating in international, collaborative defence projects. They share risk and investment, bring expertise and access to markets and provide external objectivity. Some of our joint ventures have become substantial businesses. A major proportion of the debt of the joint ventures is secured on the assets of the respective companies and is non-recourse to the Group.

Risk and revenue sharing partnerships (RRSPs)

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

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

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

The sharing of risk is fundamental to RRSP agreements. Partners share financial investment in the programme, typically through:

- market risk as they receive their return from future sales;
- currency risk as their returns are denominated in US dollars;
- sales financing obligations;
- warranty costs; and
- where they are manufacturing or development partners, technical and cost risk.

Partners that do not undertake development work or supply components are referred to as financial RRSPs and are accounted for as financial instruments as described in the accounting policies on page 97.

In 2009, the Group received other operating income of £89 million (2008 £79 million).

Payments to RRSPs are recorded within cost of sales and increase as the related programme sales increase. These payments amounted to £231 million (2008 £268 million).

The classification of financial RRSPs as financial instruments has resulted in a liability of £363 million (2008 £455 million) being recorded in the balance sheet and an associated underlying financing cost of £25 million (2008 £26 million) recorded in the income statement.

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

Risk management

The Board has an established, structured approach to risk management. The risk committee (see page 73) 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 key risks.

Financial risk

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

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

All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework described on page 74.

Counterparty credit risk

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

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

Funding and liquidity

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

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

Short-term investments are generally held as bank deposits or in 'AAA' rated money market funds. The Group operates a conservative investment policy which limits investments to high quality instruments with a short-term credit rating of 'A-1' from Standard & Poor's or better and 'P-1' from Moody's. Counterparty diversification is achieved with suitable risk-adjusted concentration limits. Investment decisions are refined through a system of monitoring real-time equity and credit-default swap (CDS) price movements of potential investment counterparties which are compared to other relevant benchmark indices and then risk-weighted accordingly.

The Group's borrowing facilities increased during 2009 following the successful placement of a £500 million ten-year bond. As at December 31, 2009 the Group had total committed borrowing facilities of £2.15 billion (2008 £1.65 billion). Debt maturities in 2010 and 2011 are £108 million and £501 million respectively. The proceeds of the recent £500 million bond issue are anticipated to be used to pay down the £501 million of debt maturities in 2011. The maturity profile of the borrowing facilities is staggered to ensure that refinancing levels are manageable in the context of the business and market conditions.

There are no rating triggers contained in any of the Group's facilities that could require the Group to accelerate or repay any facility for a given movement in the Group's credit rating.

The Group's £250 million bank revolving credit facility contains a rating price grid, which determines the borrowing margin for a given credit rating. The Group's current borrowing margin would be 20 basis points (bp) over sterling LIBOR if drawn. The borrowing margin on this facility increases by approximately 5bp per one notch rating downgrade, up to a maximum borrowing margin of 55bp. The facility was not drawn during 2009.

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

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

Credit rating

The Group subscribes to both Moody's Investors Service and Standard & Poor's for its official publicised credit ratings. As at December 31, 2009 the Group's assigned long-term credit ratings were:

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

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

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

Currency risk

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

The Group regards its interests in overseas subsidiary companies as long-term investments and manages its translational exposures through the currency matching of assets and liabilities where applicable. The matching is reviewed regularly, with appropriate risk mitigation performed where material mismatches arise.

The Group has exposure to a number of foreign currencies. The most significant transactional currency exposures are USD to GBP and USD to EUR.

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

i) Revenues and costs are currency matched where it is economic to do so. The Group actively seeks to source suppliers with the relevant currency cost base to avoid the risk or to flow down the risk to those suppliers that are capable of managing it. Currency risk is also a prime consideration when deciding where to locate new facilities. US dollar income converted into sterling represented 23 per cent of Group revenues in 2009 (2008 26 per cent). US dollar income converted into euros represented two per cent of Group revenues in 2009 (2008 four per cent).

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

Market exchange rates

	2008	**2009**
USD per GBP		
– Year-end spot rate	1.438	**1.615**
– Average spot rate	1.854	**1.566**
EUR per GBP		
– Year-end spot rate	1.034	**1.126**
– Average spot rate	1.258	**1.123**

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 2009 the Group had US$18.8 billion of forward cover (2008 US$17.1 billion).

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates. Note 16 to the financial statements includes the impact of revaluing forward currency contracts at market values on December 31, 2009, showing a negative value of £144 million (2008 negative value of £2,181 million) which will fluctuate with exchange rates over time. The Group has entered into these forward contracts as part of the hedging policy, described above, in order to mitigate the impact of volatile exchange rates.

Interest rate risk

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

Commodity risk

The Group has an ongoing exposure to the price of jet fuel and base metals arising from business operations. The Group's objective is to minimise the impact of price fluctuations. The exposure is hedged, on a similar basis to that adopted for currency risks, in accordance with parameters contained in written policies set by the Board.

Sales financing

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

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

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

The permitted levels of gross and net exposure are limited in aggregate, by counterparty, by product type and by calendar year. The Group's gross exposures were divided approximately 55:45 between AVGs and credit guarantees in 2009 (2008 55:45). They are spread over many years and relate to a number of customers and a broad product portfolio.

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

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

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

The Group seeks to minimise the level of exposure from sales finance commitments by:
- the use of third-party non-recourse debt where appropriate;
- the transfer, sale, or reinsurance of risks; and
- ensuring the proportionate flow down of risk and exposure to relevant RRSPs.

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

Where exposures arise, the strategy has been, and continues to be, to assume where possible liquid forms of financing commitment that may be sold or transferred to third parties when the opportunity arises. Note 22 to the financial statements describes the Group's contingent liabilities. There were no material changes to the Group's gross and net contingent liabilities during 2009.

Accounting standards
The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU. In 2009, the changes that have had the most significant effect on the Group's financial statements are:
- Amendments to IAS 1 *Presentation of Financial Statements*: this relates to presentation only and there is no impact on the reported results. The amendments require (i) a statement of comprehensive income in place of the statement of recognised income and expense; (ii) a balance sheet at the beginning of the comparative period when there has been a change in accounting policy; and (iii) the statement of changes in equity to be presented as a primary statement.
- IFRIC 14 *IAS 19 The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*: this interpretation applies where regulatory funding requirements for pension schemes will result in an unrecognisable surplus arising in the future. It has been adopted with effect from January 1, 2008. An additional liability of £491 million was recognised at that date. Further details are shown in note 18.
- IFRS 8 *Operating Segments*: this standard amends the requirements for disclosure of segmental performance and does not have any effect on the Group's overall reported results. Note 2 is presented in accordance with the new requirements. The key change is that the basis for reporting the segmental results is the same as that used internally, which is equivalent to the underlying results, reported as additional information in prior years.

A summary of other less significant changes and those which have not been adopted in 2009, is included within the accounting policies in note 1 to the financial statements.

Regulatory developments
In response to the financial crisis, governments and regulators around the world are considering various regulatory reforms to the financial markets with the aim of improving transparency and reducing systemic risk. While the proposed reforms are predominantly directed at financial institutions, some of them may have implications for non-financial institutions.

In particular, proposals by both US and European regulators to reform the Over-the-Counter (OTC) derivatives market could have implications for the Group in terms of future funding requirements and increased cash flow volatility, if parties to future OTC derivative transactions are required to post collateral to reduce counterparty risk.

Share price
During the year the Company's share price increased by 44 per cent from 335.5p to 483.5p, compared to a 16 per cent increase in the FTSE aerospace and defence sector and a 22 per cent increase in the FTSE 100. The Company's shares ranged in price from 258.50p in March to 500.0p in December.

The number of ordinary shares in issue at the end of the year was 1,854 million, an increase of 12 million relating to the exercise of share options.

The average number of ordinary shares in issue was 1,845 million (2008 1,820 million).

Andrew Shilston
Finance Director
February 10, 2010

Corporate governance

Introduction

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

The Company is subject to the Combined Code on Corporate Governance published in June 2008 by the Financial Reporting Council (the Combined Code). A printed copy of the code can be obtained free of charge from FRC publications, telephone: +44 (0)20 8247 1264, email: customer.services@cch.co.uk and online at: www.frcpublications.com.

The Board confirms that throughout 2009, the Company complied with the Combined Code. This report, which includes the Directors' remuneration report on pages 80 to 90, explains how the Company discharges its corporate governance responsibilities.

Board of directors

Simon Robertson
Non-executive Chairman
Chairman of the nominations committee
Simon Robertson was 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 Limited, and The Economist Newspaper Limited. He is a director of The Royal Opera House Covent Garden Limited and a Trustee of The Eden Project and the Royal Opera House Endowment Fund. He is the former President of Goldman Sachs Europe Limited. Age 68.

Sir John Rose
Chief Executive
A member of the nominations committee
Sir John Rose was appointed to the Board in 1992, having joined Rolls-Royce in 1984. He has been Chief Executive since 1996. He is a Trustee of The Eden Project. Age 57.

Helen Alexander CBE
Non-executive director
Chairman of the remuneration committee and a member of the ethics and nominations committees
Helen Alexander CBE was appointed to the Board in 2007. She is President of the CBI and Chairman of the Port of London Authority and of Incisive Media. She is a non-executive director and chair of the remuneration committee at Centrica plc and senior adviser to Bain Capital. She was CEO of the Economist Group from 1997 to 2008. Helen is also senior trustee of the Tate Gallery and a trustee of the World Wide Web Foundation. Age 53.

Peter Byrom BSc, FCA
Non-executive director
A member of the remuneration, ethics and nominations committees
Peter Byrom was appointed to the Board in 1997. He is Chairman of Domino Printing Sciences plc and a non-executive director of AMEC plc. He is a Fellow of the Royal Aeronautical Society. He was a director of NM Rothschild & Sons Limited from1977 to 1996. Age 65.

Iain Conn
Non-executive director, Senior Independent Director
A member of the audit and nominations committees
Iain Conn was appointed to the Board in 2005. He is an executive director of BP p.l.c. having held a range of executive positions within the BP Group worldwide. He is Chairman of the Advisory Board of The Imperial College Business School. Age 47.

Professor Peter Gregson
Non-executive director
A member of the remuneration and nominations committees
Peter Gregson was appointed to the Board in 2007. He is President and Vice-Chancellor of Queen's University Belfast and serves on the Northern Ireland Economic Development Forum, the Council of CBI Northern Ireland and the Steering Group of the US-Ireland Research and Development Partnership. He is a Fellow of the Royal Academy of Engineering, a Member of the Royal Irish Academy, and Deputy Lieutenant of Belfast. He was formerly Professor of Aerospace Materials and Deputy Vice-Chancellor of the University of Southampton and has served on the Councils of the Royal Academy of Engineering and the Central Laboratory of the Research Councils. Age 52.

James Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Jim Guyette was appointed to the Board in 1998 having joined Rolls-Royce in 1997. He is a director of the PrivateBank and Trust Company of Chicago, Illinois and of priceline.com Inc. Until 1995 he was Executive Vice President, Marketing and Planning of United Airlines. Age 64.

Dr John McAdam
Non-executive director
A member of the remuneration and nominations committees
John McAdam was appointed to the Board in 2008. He is Chairman of United Utilities Group PLC and of Rentokil Initial plc, the Senior Independent Director of J Sainsbury plc and a non-executive director of Sara Lee Corporation. He was the Chief Executive of ICI plc until ICI's acquisition by Akzo Nobel. Age 61.

John Neill CBE
Non-executive director
A member of the audit and nominations committees
John Neill was appointed to the Board in 2008. He is the Chief Executive of the Unipart Group of Companies. He is a member of the Council and Board of Business in the Community and is a non-executive director of Charter International plc. He is Vice President of the Society of Motor Manufacturers and Traders, BEN, the automotive industry charity and The Institute of the Motor Industry. Age 62.

John Rishton
Non-executive director
Chairman of the audit committee and a member of the ethics and nominations committees
John Rishton was appointed to the Board in 2007. He is Chief Executive Officer of Royal Ahold. He began his career in 1979 at Ford Motor Company and held a variety of positions both in the UK and in Europe. In 1994 he joined British Airways Plc where he was Chief Financial Officer from 2001 to 2005. He is a former non-executive director of Allied Domecq. Age 51.

Andrew Shilston MA, ACA, MCT
Finance Director
Andrew Shilston was appointed to the Board in 2003 having joined Rolls-Royce in 2002. He was a non-executive director of Cairn Energy PLC until May 2008 and he was Finance Director of Enterprise Oil plc from 1993 until 2002. Age 54.

Colin Smith BSc Hons, FREng, FRAeS, FIMechE
Director – Engineering and Technology
Colin Smith was 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 54.

Ian Strachan
Non-executive director
Chairman of the ethics committee and a member of the audit and nominations committees
Ian Strachan was appointed to the Board in 2003. He is a non-executive director of Xstrata plc, Transocean Inc and Caithness Petroleum Limited. He is the former Chief Executive of BTR plc, former Deputy Chief Executive (1991 to 1995) and Chief Financial Officer (1987 to 1991) of Rio Tinto plc, former non-executive Chairman of Instinet Group Inc and former non-executive director of Johnson Matthey plc, Commercial Union and Reuters Group plc. Age 66.

Mike Terrett
Chief Operating Officer
Mike Terrett was appointed to the Board in 2007, having joined Rolls-Royce in 1978. He has held a variety of senior positions in the development of new aero-engine programmes, including Managing Director of Airlines and President and Chief Executive Officer of International Aero Engines (IAE), based in the United States. Prior to his appointment as Chief Operating Officer he was President – Civil Aerospace. He is a Member of the Institute of Mechanical Engineers and a Fellow of the Royal Aeronautical Society. Age 53.

Tim Rayner
General Counsel and Company Secretary
Tim Rayner joined Rolls-Royce in 2007 having previously been General Counsel and Company Secretary at United Utilities PLC. Age 49.

The Group Executive

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

Tom Brown	Director – Human Resources
John Cheffins	Acting President – Energy
Miles Cowdry	Director – Global Corporate Development
James Guyette	President and Chief Executive Officer of Rolls-Royce North America Inc.
Dr Michael Haidinger	President – Rolls-Royce Deutschland Ltd & Co KG
Lawrie Haynes	President – Nuclear
Mark King	President – Civil Aerospace
Dan Korte	President – Defence Aerospace
Alain Michaelis	President – Gas Turbine Supply Chain & Deputy Chief Operating Officer
Peter Morgan	Director – Corporate Affairs
Dr Mike Orris	Chief Procurement Officer
John Paterson	President – Marine
Tim Rayner	General Counsel and Company Secretary
Andrew Shilston	Finance Director
Colin Smith	Director – Engineering and Technology
Mike Terrett	Chief Operating Officer
Tony Wood	President – Gas Turbine Services

International Advisory Board

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

Lord Powell of Bayswater
Chairman of IAB, former Foreign Affairs and Defence Adviser to Prime Ministers Margaret Thatcher and John Major

Bernard Duc, CBE
Senior Partner HMI Ltd (Hong Kong), Chairman of the Rolls-Royce South East Asia Advisory Board, former Deputy Chairman of the Rolls-Royce European Advisory Board

Sir Rod Eddington
Chairman, J.P. Morgan – Australia & New Zealand and former Chief Executive, British Airways Plc

Dr Fan Gang
Professor at China's Academy of Social Sciences and Director of National Economic Research Institute

Carla Hills
Chair and CEO, Hills & Company, International Consultants, former US Trade Representative, former Secretary of Housing and Urban Development, former Assistant Attorney General

General Sir Mike Jackson
Former Chief of the General Staff, UK Ministry of Defence

Mustafa Koç
Chairman of Koç Holding, A.Ş.

Taizo Nishimuro
Chairman of Tokyo Stock Exchange Group, Inc. and former Chairman of Toshiba Corporation

Lubna Olayan
CEO and Deputy Chairperson of the Olayan Financing Company

Eduardo Serra
President and founder of Eduardo Serra y Asociados (ESYA), former Spanish Defence Minister, former President of the Royal Board of Trustees of the Prado Museum

Rair Simonyan
Chairman, Morgan Stanley, Russia, former first VP of Russian state oil company, Rosneft

Ratan Tata
Chairman of Tata Sons Limited

Matthias Wissmann
President of the German Association of the Automotive Industry (VDA), Vice-Chairman of the Federation of German Industries (BDI) and Senior International Counsel at WilmerHale, Former Federal Minister of Research and Technology and of Transports of Germany

Lee Hsien Yang
Chairman, Fraser and Neave Limited

Ernesto Zedillo
Former President of Mexico, Director, Yale Center for the Study of Globalization

Composition of the Board

Simon Robertson chairs the Board of directors and Sir John Rose is the Chief Executive. The division of responsibilities between them is set down in writing and agreed by the Board. Iain Conn is the Company's Senior Independent Director. There are currently 14 directors on the Board comprising the non-executive Chairman, the Chief Executive, four other executive directors and eight non-executive directors.

The quality and broad experience of the directors, the balance of the Board's composition and the dynamics of the Board as a group, ensure the Board's effectiveness and also prevents any individual or small group dominating the Board's decision making. Each executive director receives a service contract on appointment (see page 83 for further information) and each non-executive director receives a letter setting out the conditions of his or her appointment.

Non-executive directors are appointed for an initial term of three years, which may be extended with the agreement of the Board, although reappointment is not automatic. Executive directors are employees who have executive responsibilities in addition to their duties as directors. Non-executive directors are not employees and do not participate in the daily business management of the Group. There were no Board changes during the year.

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

The directors retiring under the annual re-election provisions contained in the Articles of Association are Professor Peter Gregson, Dr John McAdam, Helen Alexander CBE and Andrew Shilston. They all offer themselves for re-election.

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

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

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

Independence of the non-executive directors

The Board applies a rigorous process in order to satisfy itself that its non-executive directors remain independent. The Combined Code does not regard the Chairman as being independent in view of his unique role in corporate governance. However, on his appointment as Chairman on January 1, 2005, Simon Robertson met the criteria for independence contained in the Combined Code. His other significant commitments are described on page 66.

The Board reviews the independence of the non-executive directors every year, based on the criteria in the Combined Code. This review was undertaken in 2009 and the Board concluded that all the non-executive directors (other than the Chairman) were independent in character and judgement. The Board determined that Peter Byrom remains independent in character and judgement notwithstanding that he has served on the Board for more than nine years, that there are no relationships or circumstances which are likely to affect his independent judgement and that he is in no way dependent on the remuneration he receives from the Company.

Role of the Board

The Board is responsible to all the Company's stakeholders for its conduct and for the performance of the Company. The day-to-day running of the Company is delegated by the Board to the executive team under the leadership of Sir John Rose, the Chief Executive. The Board retains responsibility for the approval of certain matters which affect the shape and risk profile of the Company, as well as items such as the annual budget and performance targets, the financial statements, payments to shareholders, major capital investments and any substantial change to balance sheet management policy. This division of responsibilities between the Board and the executive team is set out in detail in a schedule approved annually by the Board, which also defines those decisions which can only be taken by the Board itself.

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

Primary goal

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

The Board's tasks

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

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

Directors' induction, training and information

Newly appointed directors participate in a structured induction programme and receive a comprehensive data pack providing detailed information on the Group. An existing executive director acts as a mentor to each newly appointed non-executive director, giving guidance and advice as required. As part of their briefing, non-executive directors visit key sites and meet a cross-section of managers and employees to gain a better understanding of the Group and its operations. Ongoing training is available for all the directors, including presentations by the executive team on particular aspects of the business. There is a procedure for directors to take independent professional advice at the Company's expense. This is in addition to the access every director has to the General Counsel and Company Secretary.

Board effectiveness

The Chairman and the non-executive directors meet at least once a year without the executive directors present, in order to review the operation of the Board. The Chairman has an annual meeting with each non-executive director to review his or her contribution to the Board. The Senior Independent Director chairs an annual meeting of the executive and non-executive directors (excluding the Chairman) to review the performance of the Chairman, the outcome of which is reported back to him. Each year, the Chairman reviews the performance of the Chief Executive as part of the annual salary review process overseen by the remuneration committee. The Chief Executive reviews the performance of the other executive directors in the same way.

In the autumn of 2009, the JCA Group conducted a Board review which took the form of a facilitated self-evaluation by the Board. The review included confidential, unattributable, one-on-one interviews with each Board member and the Company Secretary which covered corporate governance, board effectiveness, strategy development, risk management and Board and Committee organisation, composition, operation and dynamics. The Board members unanimously agreed that the Board was working as an effective whole. The review highlighted the crucial importance of strategic execution and the need to remain vigilant to future business challenges. In addition, Board members welcomed the introduction of closer co-ordination between the audit, ethics and remuneration committees.

Conflicts of interest

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

Indemnity

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

Board committees

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

Attendance at meetings of the Board and its principal committees in 2009

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

Remuneration committee

The committee has responsibility for making recommendations to the Board on the Group's policy regarding executive remuneration. The committee determines, on the Board's behalf, the specific remuneration packages of the Chairman, the executive directors and a number of senior executives. The committee met six times during the year. The committee's membership and principal terms of reference are set out in the Directors' remuneration report on page 80.

Nominations committee

In 2009, Simon Robertson chaired the nominations committee. Its other members were Helen Alexander CBE, Peter Byrom, Iain Conn, Professor Peter Gregson, Dr John McAdam, John Neill CBE, John Rishton, Sir John Rose and Ian Strachan. The committee met once during the year.

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

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

Audit committee

The audit committee consists exclusively of independent, non-executive directors. During 2009, John Rishton, who has recent and relevant financial experience, chaired the committee. In 2009, its other members were Iain Conn, John Neill CBE and Ian Strachan. The committee met five times during the year. The Director of Risk, Head of Business Assurance and a representative of the external auditors normally attend the meetings. Additionally, the Head of Business Assurance has direct access to the committee. The Chairman of the Board, the Chief Executive, the Finance Director and any other Board member or senior executive may attend the meetings as necessary, at the invitation of the audit committee chairman.

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

The committee has responsibility for recommending to the Board the appointment of the external auditors and for reviewing the nature, scope and results of the annual external audit. It also approves the audit fee and, on an annual basis, assesses the effectiveness and independence of the external auditors. A resolution to reappoint the auditors, KPMG Audit Plc, and to authorise the directors to determine the auditors' remuneration, will be proposed at the 2010 AGM. The committee keeps under review the Group's internal controls and systems for assessing and mitigating financial and non-financial risk. It also reviews and approves the business assurance work programme and ensures that this function is adequately resourced and co-ordinated with the work of the external auditors. Twice a year the committee receives a written report on the reviews conducted throughout the Group by business assurance and reports from senior executives on the key business risks and risk systems in selected sectors.

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

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

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

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

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

Ethics committee

The ethics committee consists exclusively of independent non-executive directors. Ian Strachan chairs the committee and its other members during 2009 were Helen Alexander CBE, Peter Byrom and John Rishton. The committee met four times during the year. The Director of Risk, who has executive responsibility for ethics, attends the meetings. The Chairman of the Board, the Chief Executive and other executives of the Company may be invited to attend meetings of the committee.

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

The committee reviews recommendations on ethical matters made by external regulatory authorities or other bodies and is responsible for making recommendations to the Board about whether these should be applied to the Company and, if so, to what extent. It also has responsibility for monitoring reports on issues raised through the Group's confidential reporting line and for reviewing the results of subsequent investigations.

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

Risk committee

The Board has a risk committee, chaired by the Chief Executive, with specific accountability for the system of risk management and for reporting key risks and their associated mitigating actions to the Board. In 2009, its other members were James Guyette, Andrew Shilston, Colin Smith and Mike Terrett. The risk committee met twice in 2009 and reports annually to the Board on the policy, process and operation of the risk management system and the principal risks facing the Group, identified through the risk management system.

Rolls-Royce believes that the proactive management of risks is a fundamental part of achieving its business objectives. This responsibility flows from the top of the organisation.

Internal control and risk management

The Board – system of internal control and its effectiveness

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

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

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

Financial reporting

The Group has a comprehensive budgeting system with an annual budget approved by the Board. Revised forecasts for the year are reported at least quarterly. Actual results, at both a business and Group level, are reported monthly against budget and variances reviewed. Financial managers are required to acknowledge in writing that their routine financial reporting is based on reliable data and that their results are properly stated in accordance with Group requirements. In addition, for annual reporting, business presidents and finance directors are required to acknowledge that their business has complied with the Group Finance Manual.

The audit committee – reviewing internal controls

The audit committee keeps under review the Group's internal controls and systems for assessing and mitigating financial and non-financial risk. In addition, the committee reviews the Group's procedures for detecting, monitoring and managing the risk of fraud.

The committee reviews and approves the business assurance work programmes and ensures that this function is adequately resourced and co-ordinated with the work of the external auditors. Twice a year, the committee receives a report on the reviews conducted throughout the Group by business assurance and a report from senior executives on the key risks and risk systems in selected customer facing businesses and key functions.

The business assurance function, working closely with external auditors, undertakes a programme of financial and operational audits or reviews agreed by the audit committee and covering all Group activities. The programme includes independent reviews of the systems of internal control, selected on the basis of risks material to the Group. The findings and status of corrective actions taken to address these are reported to the audit committee.

The risk committee – implementation of the Board's policies

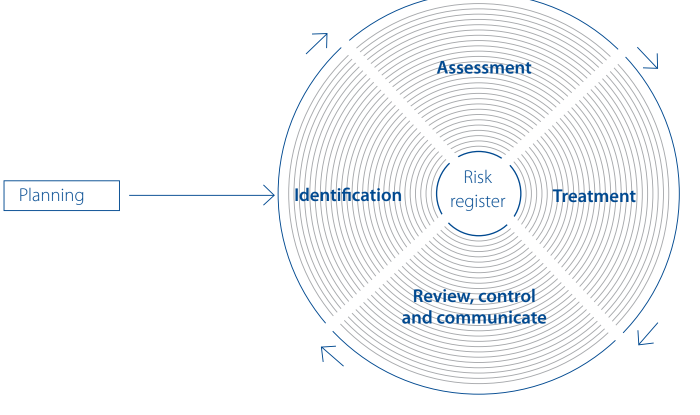
The risk committee has accountability for the system of risk management and for reporting the principal risks and associated mitigating actions, including those risks potentially affecting the Group's reputation. It has responsibility for implementing the Board's policies on risk and internal control and reviews the results of the risk management process, which operates at all levels in the Group. The risk committee has developed a risk policy which states that risk management is a part of every manager's responsibility and that risk management is to be embedded within the day-to-day management activity. The committee reports annually to the Board on the policy, process and operation of the risk management system and the principal risks facing the Group, identified through the risk management system.

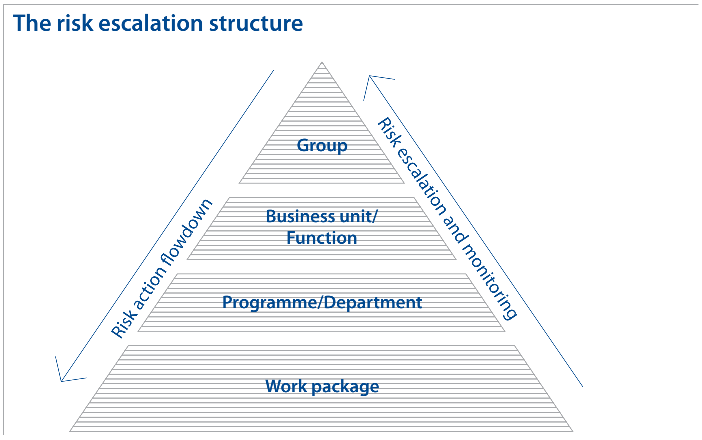
Specific committees have accountability for reviewing certain categories of risk. The financial risk committee reviews credit, market or liquidity risks. The ethics committee reviews those risks with a significant ethical dimension, often identified as threats to reputation.

Risk management process – how risks are managed throughout the Group

Risks are defined as threats to the achievement of business objectives or to the continuing reputation of the Group. As part of the business cycle each part of the Group is required formally to identify and document key risks together with appropriate mitigating activities.

The risk management process





The process provides methods for escalation and delegation to the appropriate levels within the organisation and ensures that actions are owned, defined, resourced and effective.

Risks may arise from a variety of internal and external sources. They may be associated with regulations, customer requirements, economic conditions or competitor actions. They could result from the capability of the processes used to execute the business or from external causes, such as war, terrorist activity or pandemics.

Management has continued to perform comprehensive risk reviews for all major programmes, including business change plans. Independent gated reviews are conducted where key risks and mitigating actions are identified and reported to management for incorporation into programme plans. The risk management process places significant emphasis on learning from and sharing prior experience.

Risks are documented in a framework of risk registers and are subject to regular review by management. The top-level corporate risk register is updated and reviewed by the risk committee twice per year and the Board also considers these risks in the context of the Group's business strategy. This ongoing process has been in place during 2009, up to and including the date of approval of the Annual report.

Implementation of the process

Development, implementation and maintenance of the standard global process are the responsibility of a dedicated enterprise risk management team. This team is part of the Department of Risk, which reports to the Finance Director. The team has created a comprehensive framework for the assessment of risk management process maturity that enables focused improvement actions and drives consistent application of the risk management process throughout the Group.

An integrated range of tools and training underpins the risk process. Implementation of an enterprise-wide software application enables the recording, analysis, communication and management of risks across the Group.

A global network of risk champions, mentors and facilitators drive the application of the standard process in their parts of the business and help to develop, embed and share best practice throughout the Group.

The risk management process is subject to continuous improvement. In 2009, training has been enhanced and a comprehensive curriculum of risk, reputation and ethics training has been developed for delivery at all levels of the organisation.

Shareholders and share capital

Share capital and voting rights

At December 31, 2009, the Company's authorised share capital was £3,500,050,000.60 and comprised: 2,499,999,998 ordinary shares of 20p; 2,000,000,000,000 C Shares of 0.1p; one Special Share of £1; and 50,000 preference shares of £1.

On December 31, 2009, there were 1,854,087,040 ordinary shares, 12,577,437,184 C Shares and one Special Share in issue. The ordinary shares are listed on the London Stock Exchange.

Payments to shareholders

At the AGM on April 28, 2010 the directors will recommend an issue of 90 C Shares with a total nominal value of nine pence for each ordinary share. Together with the interim issue on January 4, 2010 of 60 C Shares for each ordinary share with a total nominal value of six pence, this is the equivalent of a total annual payment to ordinary shareholders of 15 pence for each ordinary share.

Communication with shareholders

The Company attaches importance to the effectiveness of its communications with shareholders. It publishes an Annual report which is available on the Group's website. There are also separate reports covering the environment and community relations. The Company maintains a regular dialogue with institutional shareholders and the financial community. This includes presentations of the preliminary and interim results, regular meetings with major shareholders, participation in stockbrokers' seminars and site visits.

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

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

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

Share class rights

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

Ordinary shares

Holders of ordinary shares are entitled to receive the Company's Annual report. They are also entitled to attend and speak at general meetings of the Company, to appoint one or more proxies or, if they are corporations, corporate representatives, and to exercise voting rights. They have the right to ask questions at the AGM relating to the business of the meeting and for these to be answered, unless such answer would interfere unduly with the business of the meeting, involve the disclosure of confidential information, if the answer has already been published on the Company's website or if it is not in the interests of the Company or the good order of the meeting that the question be answered. Holders of ordinary shares may receive a bonus issue of C Shares or a dividend and on liquidation may share in the assets of the Company.

Holders of not less than five per cent of the issued ordinary share capital of the Company may requisition a general meeting of the Company. Members who represent at least five per cent of the total voting rights of all the members who have a right to vote at the meeting or at least 100 members who can vote and hold shares paid up on average, per member, as to at least £100, can require the Company to include a matter (other than a proposed resolution) at an AGM unless it is defamatory, frivolous or vexatious. Alternatively, such members may require the Company to circulate a statement of not more than 1,000 words with respect to a matter referred to in a proposed resolution or other business to be dealt with at a general meeting. The members do not have to meet the costs of circulating the statement provided sufficient requests are received before the end of the financial year preceding the meeting.

C Shares

Since January 2009, the Company has issued non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. Shareholders can choose to:

- redeem all C Shares for cash;
- redeem all C Shares for cash and reinvest the proceeds in additional ordinary shares using the C Share Reinvestment Plan operated by Computershare Investor Services PLC (the Registrar); or
- keep the C Shares.

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

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

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

Special Share

Certain rights attach to the special rights non-voting share (Special Share) issued to HM Government (Special Shareholder). Subject to the provisions of the Companies Act 2006, the Treasury Solicitor may redeem the Special Share at par at any time. The Special Share confers no rights to dividends but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

Certain Articles (in particular those relating to the foreign shareholding limit, disposals and the nationality of directors) that relate to the rights attached to the Special Share may only be altered with the consent of the Special Shareholder. The Special Shareholder is not entitled to vote at any general meeting or any other meeting of any class of shareholders.

Preference shares

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

B Shares
Up to July 2008, the Company had issued B Shares as an alternative to paying a cash dividend. All remaining B Shares were redeemed on September 22, 2008 and cancelled. The Company has no intention of issuing further B Shares.

Restrictions on transfer of shares and limitations on holdings
There are no restrictions on transfer or limitations on the holding of the ordinary shares or C Shares other than under the Articles of Association (as described below), under restrictions imposed by law or regulation (for example, insider trading laws) or pursuant to the Company's share dealing code. The Articles of Association provide that the Company should be and remain under United Kingdom control. As such, an individual foreign shareholding limit is set at 15 per cent of the aggregate votes attaching to the share capital of all classes (taken as a whole) and capable of being cast on a poll and to all other shares that the directors determine are to be included in the calculation of such holding.

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

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

Authority to issue shares
At the AGM in 2009, authority was given to the directors to allot new ordinary shares up to a nominal value of £124,899,130, equivalent to one-third of the issued share capital of the Company as at February 11, 2009. Such authority is valid until the AGM in 2010 or 18 months from April 30, 2009, whichever is the earlier. A further special resolution was passed to effect a disapplication of pre-emption rights for a maximum of five per cent of the issued share capital of the Company as at February 11, 2009. The directors propose to renew these authorities at the AGM in 2010.

At the AGM in 2009, authority was given to the directors to allot new C Shares up to a nominal value of £350 million as an alternative to a cash dividend. Such authority is valid until the AGM in 2010 or 18 months from April 30, 2009 whichever is the earlier. The directors propose to renew this authority at the AGM in 2010.

Authority to purchase own shares
At the AGM in 2009, the Company was authorised by shareholders to purchase up to 185,137,887 of its own ordinary shares representing ten per cent of its issued ordinary share capital as at February 11, 2009. The Company did not make use of this authority during 2009.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2010 and a resolution to renew it will be proposed at that meeting.

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

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

Major shareholdings
At February 10, 2010, the following companies had notified an interest in the issued ordinary share capital of the Company in accordance with the Financial Services Authority's Disclosure and Transparency Rules:

Company	Date notified	% of issued ordinary share capital
AXA S.A.	January 11, 2010	4.90
BlackRock Inc.	December 3, 2009	5.34
Invesco Limited	February 4, 2008	6.91
Legal & General Group plc	October 14, 2009	3.96

Other statutory information

Political donations
In line with its established policy, the Group made no political donations pursuant to the authority granted at the 2009 AGM.

Although the Company does not make, and does not intend to make, donations to political parties, within the normal meaning of that expression, the definition of political donations under the Companies Act 2006 is very broad and includes expenses legitimately incurred as part of the process of talking to members of parliament and opinion formers to ensure that the issues and concerns of the Group are considered and addressed. These activities are not intended to support any political party and the Group's policy is not to make any donations for political purposes in the normally accepted sense.

A resolution will therefore be proposed at the 2010 AGM seeking shareholder approval for the directors to be given authority to make donations and incur expenditure which might otherwise be caught by the terms of the Companies Act 2006. The authority sought will be limited to a maximum amount of £25,000 per Group company but so as not to exceed £50,000 for the entire Group in aggregate.

During the year, one of our US subsidiaries made a contribution towards the running expenses of a political action committee (PAC) organised by its employees in an amount of US$24,636 (2008: US$23,700). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act. The Rolls-Royce PAC is independent of the Company and independent of any political party. Its funds are contributed voluntarily by employees and the Company cannot affect how they are applied. Such contributions do not require authorisation by shareholders under the Companies Act 2006 and therefore do not count towards the £25,000 and £50,000 limits for political donations and expenditure for which shareholder approval will be sought at the AGM.

Change of control

Contracts and joint venture agreements

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

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various lenders. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At December 31, 2009 these facilities were less than 50 per cent drawn.

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

Employee share plans

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

- Executive Share Option Plan – All options granted have vested and are exercisable. Consequently, no early vesting is currently possible. This Plan has now expired and no further options can be granted;
- Performance Share Plan – Awards would vest pro-rata to service in the performance period, subject to remuneration committee judgement of Company performance;
- Annual Performance Related Award deferred shares – The shares would be released from trust immediately;
- ShareSave – Options would become exercisable immediately. The new company might offer an equivalent option in exchange for cancellation of the existing option; and
- Share Incentive Plan – Consideration received as shares would be held within the Plan, if possible, otherwise the consideration would be treated as a disposal from the Plan.

Essential commercial relationships

Supply chain

Certain suppliers to the Group contribute key components or services, the loss of which could cause disruption to the Group's deliveries. However, none are so vital that their loss would affect the viability of the business as a whole. When dealing with suppliers, the Group is guided by the Supply Chain Relationships in Aerospace (SCRIA) initiative. It seeks the best possible terms from suppliers and when entering into binding purchasing contracts, gives consideration to quality, delivery, price and the terms of payment. In the event of disputes, efforts are made to resolve them quickly. As the Company is a holding company and does not itself trade, it owed no amounts to trade creditors at December 31, 2009 and therefore the number of creditor days required to be shown in this report to comply with the provisions of the Companies Act 2006 is nil.

Customers

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

Annual report and the financial statements

Statement of directors' responsibilities in respect of the Annual report and the financial statements

The directors are responsible for preparing the Annual report and the Group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRS as adopted by the EU and applicable law and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of their profit or loss for that period. 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 IFRSs 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 adequate accounting records that are sufficient to show and explain the parent company's transactions and 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 Companies Act 2006. 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 complies with that law and those regulations.

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

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out on pages 1 to 41 of the business review. The financial position of the Group, its cash flows, liquidity position, borrowing facilities and financial risks are described in pages 58 to 65 of the business review. In addition, notes 1, 13, 14 and 16 of the consolidated financial statements include the Group's objectives, policies and processes for financial risk management, details of its cash and cash equivalents, indebtedness and borrowing facilities and its financial instruments, hedging activities and its exposure to counterparty credit risk, liquidity risk, currency risk, interest rate risk and commodity pricing risk.

As described on page 63, the Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds, notes and finance leases. The chart on page 58 shows the maturity profile of the Group's outstanding debt facilities; a total of £108 million is due to expire in 2010. The Group has a further £450 million of term funding available that is currently undrawn.

The Group's forecasts and projections, taking into account reasonably possible changes in trading performance, show that the Group has sufficient financial resources. As a consequence the directors have a reasonable expectation that the Company and the Group are well placed to manage their business risks and to continue in operational existence for the foreseeable future, despite the current uncertain global economic outlook. Accordingly, the directors continue to adopt the going concern basis in preparing the consolidated financial statements.

Disclosure of information to auditors

Each of the persons who is a director at the date of approval of this report confirms that:

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

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

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the Companies Act 2006.

Responsibility statement

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

i) each of the Group and parent company financial statements, prepared in accordance with IFRS and UK Accounting Standards respectively, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole; and

ii) the Directors' report on pages 1 to 79, incorporating by reference the Directors' remuneration report on pages 80 to 90, includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

Tim Rayner
General Counsel and Company Secretary
February 10, 2010

Directors' remuneration report

This report to shareholders:
- explains the policy under which the executive directors, the Chairman and the non-executive directors are remunerated; and
- gives details of the remuneration, fees and share interests of the directors.

It provides the information required by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the Regulations) and describes how the Company applies the principles of the Combined Code in relation to executive directors' remuneration. The Company confirms that it complies with the requirements of the Combined Code.

The report was approved by the remuneration committee (the committee) on February 9, 2010 and was signed on the Board's behalf by Helen Alexander CBE as the Chairman of the committee. A resolution will be put to shareholders at the AGM on April 28, 2010 inviting them to approve this report.

The remuneration committee

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

The committee consists exclusively of independent, non-executive directors. During 2009, it was chaired by Helen Alexander CBE. Its other members were Peter Byrom, Professor Peter Gregson and Dr John McAdam.

In 2009, Simon Robertson, Chairman, Sir John Rose, Chief Executive, the Director – Human Resources and the General Counsel and Company Secretary, attended meetings by invitation of the committee but were not present during any discussion of their own emoluments. The committee met on six occasions in 2009 and details of members' attendance are set out in the table on page 72.

Advice to the remuneration committee

The committee may call for information and advice from advisers inside and outside the Group. In 2009, Sir John Rose made recommendations to the committee relating to the performance of his direct reports and Simon Robertson made recommendations to the committee relating to the performance of Sir John Rose. Internal support to the committee was provided primarily by the Director – Human Resources, advised by Deloitte LLP. Additional advice was provided by senior employees from human resources and finance.

The committee received advice on remuneration matters from Deloitte LLP and the Group's lawyers, Freshfields Bruckhaus Deringer LLP. During 2009, Deloitte LLP also advised the Group on tax, assurance, pensions and corporate finance and Deloitte MCS Limited provided consulting services.

Remuneration policy

The policy framework

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

Accordingly the Board has adopted, on the recommendation of the committee, a remuneration policy reflecting the following broad principles which it will continue to apply in 2010:
- the remuneration of executive directors and other senior executives should reflect their responsibilities and contain incentives to deliver the Group's performance objectives; it must also be capable of attracting and retaining the individuals necessary for business success;
- total remuneration should be based on Group and individual performance, both in the short and long term; and
- the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the senior executives to acquire shares in the Company.

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

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

The main components of remuneration

The main components of remuneration comprise base salary, benefits, annual incentive arrangements, long-term share-based incentives and pension and life assurance benefits.

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

All salary increases must be justified on the basis of performance and are not automatic. Other benefits are generally at the median of market practice. In 2009, there were no increases in base salaries for executive directors. With effect from March 1, 2010 the median increase in executive directors salaries will be two per cent. This is broadly in line with salary increases of other employees in the Group.

Benefits
Executive directors and senior executives are entitled to a company car or car allowance, private medical insurance and financial counselling. James Guyette is entitled to a housing allowance and the costs of additional housing are met for Mike Terrett.

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

Target and maximum APRA bonus opportunity
Under APRA as operated in 2009, executive directors were eligible for awards in accordance with the table below:

	Target bonus (as a % of salary)[1]	Maximum bonus (as a % of salary)[1,2]
James Guyette	75	125
Sir John Rose	81	135
Andrew Shilston	75	125
Colin Smith	75	125
Mike Terrett	75	125

[1] The target bonuses are 60 per cent of the maximum bonus figure in the table.
[2] It is possible for a bonus award to be increased by a further 20 per cent to reflect exceptional personal performance. Therefore the overall maximum is 162 per cent for Sir John Rose and 150 per cent for the other executive directors.

APRA performance measures
The APRA performance measures set by the committee are based on the Group's annual operating plans. For 2009, the measures for executive directors included underlying profit, cash flow and individual contribution assessed with reference to the achievement of personal objectives and overall personal performance. These measures will remain unchanged for 2010. The committee is mindful of corporate, environmental, social and governance risks when setting personal objectives. Forty per cent of any APRA bonus depends on personal performance.

In 2009, a high proportion of the annual remuneration for executive directors was based on performance. For the Chief Executive, his 162 per cent maximum bonus opportunity meant that 62 per cent of his combined basic pay and bonus opportunity was directly related to annual financial and personal performance. In 2009, the level of achievement against the financial measures was sufficient to generate up to 45 per cent of the maximum bonus for individual participants subject to the achievement of their personal objectives.

Deferred APRA
In 2009, the percentage of APRA delivered in the form of a deferred award in the Company's shares increased from 33 per cent to 40 per cent. A participant who is granted a deferred share award under APRA must normally continue to remain an employee of the Group for two years from the date of the award in order to retain the shares, although shares will be released early in certain circumstances including retirement or redundancy.

The value of any deferred share awards is derived from the annual bonus criteria and is therefore dependent on personal and business financial performance. The release of deferred share awards is not dependent on the achievement of any further performance conditions. This arrangement provides a strong link between performance and remuneration, promotes a culture of share ownership amongst the Group's senior management and encourages decisions in the long-term interest of shareholders. The deferred share element operated for 2009 will result in share awards as described in the directors' emoluments table on page 85. Details of deferred shares held under the plan are shown in the table on page 89.

Other annual incentives
The same targets as set for APRA are used for the Managers' Bonus Scheme and the All-Employee Bonus Scheme. The Managers' Bonus Scheme typically enables managers worldwide to receive a bonus of up to ten per cent of pay and the All-Employee Bonus Scheme up to two weeks' pay, based on corporate and business performance. Those participating in the Managers' Bonus Scheme or APRA are excluded from the All-Employee Bonus Scheme.

Rolls-Royce Group plc Performance Share Plan

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

Under the rules of the PSP, selected executives are granted conditional share awards entitling them to a number of shares determined by reference to corporate performance over a three-year performance period. The measures of corporate performance are Cash Flow Per Share (CPS), Earnings Per Ordinary Share (EPS) and Total Shareholder Return (TSR). These measures are considered particularly important in generating shareholder value and are explained in more detail below. There is no retesting of the performance criteria and no automatic vesting in the event of a takeover. In the three-year period to December 31, 2009 the Company's financial and TSR performance generated 116.25 per cent of the number of shares awarded under the rules of the plan.

Performance measures

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

The number of shares released (if any) will be determined in accordance with CPS targets, which will not be adjusted for inflation. CPS is calculated as cash flow after interest, taxation and capital expenditure, but before cost of business acquisitions or proceeds of disposals and payments to shareholders, divided by the weighted average number of shares in issue. Intermediate levels of performance attract pro rata releases. The Company's TSR over the performance period will be compared with the TSR of the companies constituting the FTSE 100 index on the date of grant. This comparison will be carried out by an independent agency.

If the Company's TSR is above the median of the FTSE 100 index, the number of shares due to be released to an executive will be increased by between 25 per cent and 50 per cent. This increase is on a straight-line basis between the median and upper-quartile TSR performance in the performance period.

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

The following CPS targets will apply to the grants to be made in 2010.

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

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

PSP award levels

The size of awards under the PSP is set taking into account competitive levels within the marketplace for UK companies of a similar size and complexity to the Group. In 2009, Sir John Rose received a conditional award of shares with a market value at the time of grant of 120 per cent of his annual salary. For other executive directors the grant was 100 per cent. As described above, the number of shares released is increased if the Company's TSR is between the median and upper-quartile of the FTSE 100 index.

For 2010, the size of awards under the PSP will be unchanged and will therefore be as follows:

	PSP award (as a percentage of salary)	PSP award overall maximum (as a percentage of salary)
James Guyette	100	150
Sir John Rose	120	180
Andrew Shilston	100	150
Colin Smith	100	150
Mike Terrett	100	150

Share retention policy

The committee believes it is important that the interests of the executive directors should be closely aligned with those of shareholders. The deferred APRA award and the PSP provide considerable alignment. However, participants in the PSP are also required to retain at least one half of the number of after tax shares released from the PSP, until the value of their shareholding reaches 200 per cent of salary for the Chief Executive and 150 per cent for other executive directors. When this level is reached, it must be retained until retirement or departure from the Company.

Executive share option plan

No options have been granted under the executive share option plan since the introduction of the PSP. The Rolls-Royce 1999 Executive Share Option Plan has now expired and no further options can be granted.

All-employee share plans

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

i) the ShareSave Plan – a savings-related share option plan available to all employees. In the UK, this plan operates within UK tax legislation (including a requirement to finance the exercise of the option using the proceeds of a monthly savings contract) but the key principles are applied globally. The exercise of the option is not subject to the achievement of a performance target;
ii) the 'Free Share' element of the Share Incentive Plan (SIP) under which UK employees receive shares as part of the Company component of any bonus paid for 2009. The SIP attracts tax benefits for UK employees; and
iii) the 'Partnership Share' element of the SIP under which UK employees may make regular purchases of shares from pre-tax income.

Service contracts

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

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

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

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

1 James Guyette has a contract with Rolls-Royce North America Inc, drawn up under the laws of the Commonwealth of Virginia, US. It provides that, on termination without cause, he is entitled to 12 months' severance pay without mitigation and appropriate relocation costs.
2 In the event of the service contract being terminated by the Company, other than in accordance with the contract's terms, Sir John Rose is entitled to receive a liquidated sum of 12 months' salary and benefits. Performance related payments are not covered under this arrangement, although an annual bonus may be paid if he is in post at the end of the performance year.

External directorships of executive directors

During the year, James Guyette served as a director of The PrivateBank and Trust Company of Chicago, Illinois and of priceline.com Inc., and retained the relevant fees from serving on the boards of these companies, as shown in the table below:

External directorship fees

	Payment received £000
James Guyette[1,2]	70

1 James Guyette was paid in US dollars translated at £1 = $1.566.
2 In addition to an annual fee, James Guyette received 2,516 Restricted Stock Units (RSUs) in PrivateBank. During 2009, a total of 2,059 RSUs vested. Also during 2009, 500 shares of restricted stock vested at US$67.09 per share, 500 shares of restricted stock vested at US$82.96 per share and 215 shares of RSUs vested at US$82.37 in priceline.com. He was granted 1,330 shares of restricted stock at US$82.65 per share and exercised the following stock options in priceline.com: 3,333 at an option price of US$18.36 per share achieving a market price of US$201.76 per share; 8,000 at an option price of US$22.59 per share achieving a market price of US$200.53 per share and 8,000 at an option price of US$22.59 per share achieving a market price of US$199.16 per share.

Non-executive directors

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

Non-executive directors' fees

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

The Chairman receives a fee of £370,000 per annum. The other non-executive directors receive a basic fee of £55,000 per annum and an additional fee for carrying out specific duties as follows:

Senior Independent Director	£10,000
Chairman of audit committee	£15,000
Chairman of remuneration committee	£12,000
Chairman of ethics committee	£12,000

The total fees paid to the Chairman and non-executive directors for the year ended December 31, 2009 are shown in the emoluments table on page 85.

Following a review of the fees payable to non-executive directors there will be no increases in their fees for 2010.

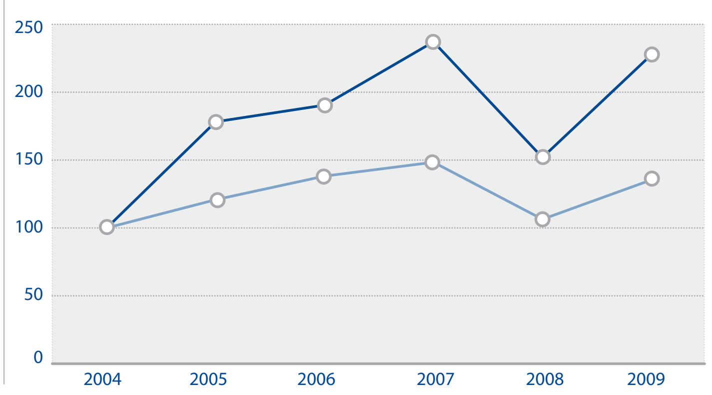
The Chairman and the non-executive directors are not eligible to participate in any of the Group's share schemes, incentive arrangements or pension schemes. A facility is in place which enables non-executive directors to use some or all of their fees, after the appropriate statutory deductions, to make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

Performance graph

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

This graph shows the growth in value of a hypothetical £100 holding in Rolls-Royce Group plc ordinary shares over five years, relative to the FTSE 100 index. The values of the hypothetical £100 holdings at the end of the five-year period were £227.60 and £135.40 respectively.

Total shareholder return over five years



Aggregate directors' remuneration

The total amounts for directors' remuneration were as follows:

	2009 £000	2008 £000
Emoluments	**5,237**	5,022
Gains on exercise of share options	**51**	9
Value of shares vested under long-term incentive awards	**1,586**	3,458
Money purchase pension contributions	**524**	558
	7,398	9,047

Directors' emoluments

The individual directors' emoluments paid during the year are as follows:

	Basic salaries £000	Total fees £000	Annual Performance Related Award plan (APRA) Cash bonus £000	Deferred shares[1] £000	Total APRA £000	Pension payments[2] £000	Taxable benefits[3] £000	2009 Aggregate emoluments excluding pensions contributions[4] £000	2008 Aggregate emoluments excluding pensions contributions[4] £000
James Guyette[5]	491	–	132	88	220	–	53	764	623
Sir John Rose	850	–	240	160	400	–	20	1,270	1,253
Andrew Shilston	550	–	135	90	225	–	12	787	768
Colin Smith	386	–	101	67	168	97	8	659	641
Mike Terrett	500	–	125	84	209	104	85	898	924
Helen Alexander CBE	–	67	–	–	–	–	–	67	63
Peter Byrom	–	55	–	–	–	–	–	55	55
Iain Conn	–	65	–	–	–	–	–	65	65
Professor Peter Gregson	–	55	–	–	–	–	–	55	55
Dr John McAdam	–	55	–	–	–	–	–	55	48
John Neill CBE	–	55	–	–	–	–	–	55	7
John Rishton	–	70	–	–	–	–	–	70	70
Simon Robertson	–	370	–	–	–	–	–	370	367
Ian Strachan	–	67	–	–	–	–	–	67	59
Former directors who did not serve during the 2009 financial year	–	–	–	–	–	–	–	–	24
	2,777	859	733	489	1,222	201	178	5,237	5,022

[1] Shares forming part of the bonus under APRA have been valued at the date of award. An investment is expected to be made by March 31, 2010 when the trustee will acquire the required number of shares at the prevailing market price.
[2] Colin Smith received a cash allowance in lieu of future pension accrual. Mike Terrett also received a cash allowance until he started to receive his pension from November 1, 2009.
[3] Taxable benefits include the following: company car or car allowance, private medical insurance and financial counselling. In the case of James Guyette, the figure in the above table includes a housing allowance and appropriate club membership fees. In the case of Mike Terrett, the figure in the above table includes housing costs paid on his behalf and the tax charge on that benefit paid by the Company.
[4] Details of the directors' pensions are set out on page 86.
[5] James Guyette was paid in US dollars translated at £1 = $1.566.

Payments made to former directors of the Company

John Cheffins retired from the Board on September 30, 2007. Following his retirement, he has continued to be retained by the Company to give support and advice on the strategy and implementation of Rolls-Royce Fuel Cell Systems Limited, supply chain management and the assembly and test facilities. He was paid £25,800 and benefits totalling £1,428 up to March 25, 2009. He was appointed on March 25, 2009 as Acting President – Energy for approximately three days per week. He was paid £231,860 for the period March 25, 2009 to December 31, 2009 (paid in Canadian dollars translated at £1 = CAD$1.782).

Dr Mike Howse retired from the Board on June 30, 2005. Following his retirement, he has continued to be retained by the Company for his expertise in engineering and was paid £27,720.

Sir Robin Nicholson retired as a non-executive director on May 4, 2005. He was retained by Rolls-Royce Fuel Cell Systems Limited for his management and technical expertise and to provide advice on business related matters and was paid total fees of £22,500.

Pensions

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

Colin Smith has opted out of future pension accrual with effect from April 1, 2006. He receives a cash allowance in lieu of future pension accrual – see note 8 below. Mike Terrett opted out of future pension accrual with effect from April 1, 2006 and started to receive his pension from November 1, 2009 – see note 9 below. He received a cash allowance in lieu of further pension accrual until drawing his pension on November 2, 2009. Since starting to receive their pensions, neither Sir John Rose nor Mike Terrett accrue any further pension benefit or allowance in lieu of pension benefit from their ongoing employment with the Group.

Details of the pension benefits, which accrued over the year in the Group's registered UK defined benefit pension schemes[1], are given below.

	Increase/decrease in accrued pension year ended Dec 31, 2009[2] £000pa		Total accrued pension entitlement at the year ended Dec 31, 2009[3] £000pa	Transfer value of accrued pension as at Dec 31, 2009[4] £000	Transfer value as at Dec 31, 2008 of accrued pension at that date[4] £000	Increase/decrease in transfer value over 2009 net of the member's own contributions[5] £000	
Sir John Rose [6]	1	-21	450	8,542	10,632	-2,090	-395
Andrew Shilston [7]	3	2	15	354	307	202	40
Colin Smith [8]	17	5	258	3,837	3,847	-10	4
Mike Terrett [8,9]	-11	-23	239	5,188	5,230	-42	-651

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

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

	Increase in accrued retirement lump sum during the year ended Dec 31, 2009[2] £000pa		Total accrued retirement lump sum at the year ended Dec 31, 2009[10] £000pa	Transfer value of accrued retirement lump sum as at Dec 31, 2009[11] £000	Transfer value as at Dec 31, 2008 of accrued retirement lump sum at that date[11] £000	Increase in transfer value over 2009 net of the member's own contributions[5] £000	
James Guyette [12,13]	85	59	717	717	633	435	409

1 Members of the schemes have the option to pay Additional Voluntary Contributions. Neither the contributions nor the resulting benefits are included in the above table.
2 The figures on the right of this column show the increase/decrease in pension/retirement lump sum during the year ended December 31, 2009 but in this case excluding the effect of inflation.
3 The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year, or to April 1, 2006 for members with enhanced protection from 'A' day.
4 The transfer values stated represent liabilities of the Rolls-Royce sponsored pension schemes and are not sums paid to the individuals. The transfer values of the accrued pensions as at December 31, 2009 have been calculated on a basis adopted by the Trustees on October 6, 2008 following receipt of actuarial advice.
5 The figures on the right of this column show the transfer value of the increase/decrease in pension/retirement lump sum during the year ended December 31, 2009 excluding the effect of inflation, and net of the member's own contributions.
6 Sir John Rose started to receive his pension from February 1, 2008. The transfer value as at December 31, 2008 was calculated using market gilt yields on that date and included cash taken on retirement whereas the transfer value as at December 31, 2009 is the value of benefits in payment calculated using gilt yields applicable on that date.
7 The Group operates the Rolls-Royce Supplementary Retirement Scheme (the Scheme). The purpose of the Scheme is to fund pension provision above the pensionable earnings cap which was imposed on approved pension schemes by the 1989 Finance Act. Membership of the Scheme is restricted to executive directors and to a limited number of senior executives. Andrew Shilston is a member of this Scheme. He joined the Group after the introduction of the earnings cap and his terms and conditions on joining included a commitment to provide pension and life cover based on total salary. Employer contributions to the Scheme during 2009 have been added to the increase in transfer value over 2009 for the registered defined benefit plans, and are therefore included in the figures shown in the right hand column of the first table.
8 Colin Smith receives a cash allowance in lieu of future pension accrual. Mike Terrett also received a cash allowance until he started to receive his pension from November 1, 2009. Had they elected to continue to accrue pension the estimated cost of that accrual would be higher than the cash allowance to be paid in lieu.
9 Mike Terrett started to receive his pension from November 1, 2009. The total accrued pension entitlement at December 31, 2009 is after allowance for early payment of pension and taking a part of his pension as lump sum. The transfer value is the value of benefits in payment as at December 31, 2009 increased by cash taken on retirement.
10 The lump sum entitlement shown is that which would be paid on immediate retirement based on service to the end of the year.
11 The transfer values have been calculated on the basis of actuarial advice.
12 Benefits are translated at £1 = US$1.615.
13 James Guyette is a member of two defined benefit plans in the US, one qualified and one non-qualified. He accrues a retirement lump sum benefit in both of these plans. The aggregate value of the retirement lump sums accrued in these two plans, and the transfer values of these benefits, are shown in the second table. In addition, James Guyette is a member of two 401(K) Savings Plans in the US, one qualified and one non-qualified, to which both he and his employer, Rolls-Royce North America Inc., contribute. James Guyette is also a member of an unfunded non-qualified deferred compensation plan in the US, to which his employer makes notional contributions. Employer contributions to these three plans during 2009 have been added to the increase in transfer value over 2009 for the defined benefit plans and are therefore included in the figures shown in the right hand column of the second table.

Directors' share interests

The directors who held office at December 31, 2009 and their connected persons had the following interests in the ordinary shares and C Shares[1] of the Company in respect of which transactions are notifiable to the Company under DTR 3.1.2R of the Disclosure Rules and Transparency Rules as shown in the following table:

	Ordinary shares			C Shares		
	January 1, 2009	Changes in 2009	December 31, 2009	January 1, 2009	Changes in 2009	December 31, 2009
James Guyette	350,881	72,311	423,192	–	–	–
Sir John Rose[2]	1,086,318	130,836	1,217,154	–	–	–
Andrew Shilston	363,737	79,163	442,900	–	–	–
Colin Smith	103,765	49,529	153,294	–	–	–
Mike Terrett	372,817	71,174	433,991	–	–	–
Helen Alexander CBE	1,021	22	1,043	–	–	–
Peter Byrom	203,959	7,993	211,952	–	–	–
Iain Conn	11,741	3,638	15,379	–	–	–
Professor Peter Gregson	1,219	1,292	2,511	–	–	–
Dr John McAdam	–	619	619	–	13,899	13,899
John Neill CBE	–	22,521	22,521	–	–	–
John Rishton	3,397	3,310	6,707	–	–	–
Simon Robertson	38,225	1,485	39,710	–	–	–
Ian Strachan	11,500	–	11,500	–	–	–

1 Non-cumulative redeemable preference shares of 0.1p each.
2 Sir John Rose had a non-beneficial interest in 45,191 (2008: 45,191) ordinary shares.

Directors' interests in the Company's share plans are shown separately on pages: 88 (Share Incentive Plan); 89 (share options and Annual Performance Related Award plan); and page 90 (Performance Share Plan). No director had any other interests, beneficial or otherwise, in the share capital of the Company or any of its subsidiaries as at December 31, 2009.

Changes in the interests of the directors between December 31, 2009 and February 10, 2010 are listed below and in the notes to the table on page 88 Share Incentive Plan:

- On January 4, 2010, Helen Alexander CBE was allotted 62,850 C Shares and Dr John McAdam was allotted 31,320 C Shares.
- On January 8, 2010, the following directors purchased ordinary shares under the C Share Reinvestment Plan: Andrew Shilston 5,364; Colin Smith 1,233; Mike Terrett 5,256; Peter Byrom 2,566; Iain Conn 181; Professor Peter Gregson 28; John Rishton 76 and Simon Robertson 507.
- The following directors purchased ordinary shares under arrangements made for non-executive directors to purchase shares on a monthly basis using a percentage of their after tax fees: On January 7, 2010: Iain Conn 196; Professor Peter Gregson 77; Dr John McAdam 47; John Neill CBE 196 and John Rishton 196 and on February 8, 2010: Iain Conn 204; Professor Peter Gregson 80; Dr John McAdam 49; John Neill CBE 204 and John Rishton 204.

'Partnership Shares' held in trust under the Share Incentive Plan[1]

	Ordinary shares			C Shares		
	January 1, 2009	Changes in 2009	December 31, 2009	January 1, 2009	Changes in 2009	December 31, 2009
Sir John Rose[2,3]	2,339	(330)	2,009	–	–	–
Andrew Shilston[2,3]	2,341	(330)	2,011	–	239,096	239,096
Colin Smith[2,3]	2,339	(330)	2,009	–	232,566	232,566
Mike Terrett[2,3]	2,342	(334)	2,008	–	232,363	232,363

'Free Shares' held in trust under the Share Incentive Plan[1]

	Ordinary shares			C Shares		
	January 1, 2009	Changes in 2009	December 31, 2009	January 1, 2009	Changes in 2009	December 31, 2009
Sir John Rose[4]	2,687	(1,434)	1,253	–	–	–
Andrew Shilston[4]	4,670	(527)	4,143	–	540,454	540,454
Colin Smith[4]	3,103	909	4,012	–	521,722	521,722
Mike Terrett[4]	1,436	(1,436)	–	–	–	–

'Unrestricted Shares' held under the Share Incentive Plan[1]

	Ordinary shares			C Shares		
	January 1, 2009	Changes in 2009	December 31, 2009	January 1, 2009	Changes in 2009	December 31, 2009
Sir John Rose[3,5]	5,678	2,166	7,844	–	–	–
Andrew Shilston[3,5]	2,235	2,169	4,404	–	64,779	64,779
Colin Smith[3,5]	1,583	732	2,315	–	337,345	337,345
Mike Terrett[3,5]	1,473	2,172	3,645	–	527,595	527,595

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

2 On January 4, 2010, C Shares were allotted under the 'Partnership Shares' element of the SIP to Sir John Rose 123,780; Andrew Shilston 123,780; Colin Smith 123,780 and Mike Terrett 123,780. Sir John Rose elected to redeem the C Shares he was allotted.

3 Sir John Rose, Andrew Shilston, Colin Smith and Mike Terrett purchased 25 ordinary shares each on January 7, 2010 and 26 ordinary shares each on February 8, 2010 under the HM Revenue & Customs approved Share Incentive Plan. On January 7, 2010 and February 7, 2010 the ordinary shares held as Partnership Shares by Sir John Rose 54 and 52; Andrew Shilston 55 and 51; Colin Smith 54 and 52 and Mike Terrett 53 and 52 were classified as Unrestricted Shares.

4 On January 4, 2010, C Shares were allotted under the 'Free Shares' element of the SIP to Sir John Rose 75,180; Andrew Shilston 248,580 and Colin Smith 240,720. Sir John Rose elected to redeem the C Shares he was allotted.

5 On January 4, 2010, C Shares were allotted under the 'Unrestricted Shares' element of the SIP to Sir John Rose 464,340; Andrew Shilston 258,000; Colin Smith 132,600 and Mike Terrett 212,340. Sir John Rose and Andrew Shilston elected to redeem the C Shares they were allotted.

Share options

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

All employees were eligible for options under the International ShareSave plan. The 2001 (seven-year) plan and the 2005 (three-year) plan matured on February 1, 2009.

	January 1, 2009	Granted in 2009	Lapsed in 2009	Exercised in 2009	December 31, 2009	Exercise price	Market price at date exercised	Aggregate gains 2009 £000	Aggregate gains 2008 £000	Exercisable dates
James Guyette	1,397	–	–	1,397	–	298p[1]	321.25p	–	–	–
	683	–	–	–	683	416p[1]	–	–	–	2011
	2,080	–	–	1,397	683	416p[2]	–	–	–	
Colin Smith	15,444	–	–	15,444	–	194p[3]	485.00p	45	–	2009-2010
	2,396	–	–	2,396	–	108p[1]	332.00p	6	–	2009
	1,233	–	–	–	1,233	298p[1]	–	–	–	2011
	19,073	–	–	17,840	1,233	298p[2]	–	51	9	
Mike Terrett	180,556	–	–	–	180,556	216p[4]	–	–	–	2009-2011
	6,900	–	6,900	–	–	141p[1]	–	–	–	2009
	187,456	–	6,900	–	180,556	216p[2]	–	–	–	

1 ShareSave plans.
2 Weighted average exercise price of December 31, 2009 balance.
3 Granted under the Rolls-Royce 1999 Executive Share Option Plan. The only performance criteria was that the growth in EPS must exceed UK RPI over a rolling three-year period.
4 Granted in 2001 under the Rolls-Royce 1999 Executive Share Option Plan with additional performance and personal shareholding requirements. Vesting of these Supplementary options was subject to attainment of significant personal shareholding targets and the requirement that the growth in EPS exceeds an average of six per cent year on year as well as exceeding the UK RPI by three per cent per year over a rolling three-year period. The increases are measured from the year 2000 or the base year of the rolling three-year period, whichever is the more stringent. All options were granted at the market value on the date of issue and no discount was applied. No options were varied during the year and no consideration was paid for the grant of options. The market price of the Company's ordinary shares ranged between 258.50p and 500.00p during 2009. The closing price on December 31, 2009 was 483.50p.

Long-term incentive awards

The directors as at December 31, 2009 had the following deferred share awards arising out of the operation of the Annual Performance Related Award[1] plan:

	January 1, 2009	Vested during 2009	Granted during 2009	December 31, 2009
James Guyette	31,657	18,852	26,125	38,930
Sir John Rose	76,862	42,091	44,019	78,790
Andrew Shilston	43,550	23,237	24,211	44,524
Colin Smith	28,432	16,387	17,336	29,381
Mike Terrett	30,471	15,583	22,441	37,329

1 Under the Annual Performance Related Award plan (APRA), shares vest after two years. Shares went into trust in 2007, 2008 and 2009 at prices of 447.60p, 501.62p and 289.65p respectively. At December 31, 2009, the amounts stated in the emoluments table representing the 2009 APRA deferred shares had not yet been applied by the Trustee to purchase shares. An investment is expected to be made by March 31, 2010 when the trustee will acquire the required number of shares at the prevailing market price. The market value per share which vested under APRA during 2009 was 281.80p

Conditional awards, granted under the Rolls-Royce Group plc Performance Share Plan (PSP) to executive directors, are set out below. The number of shares released will be dependent upon the achievement of the EPS and CPS targets over the three-year performance period. In respect of awards made up to and including 2008, the number of shares released will be increased by 25 per cent if the Company's TSR exceeds the median for the FTSE 100 index over the three-year performance period. From the 2009 grant, if the Company's TSR is above the median of the FTSE 100 index, the number of shares due to be released to an executive will be increased by between 25 per cent and 50 per cent. This increase is on a straight-line basis between the median and upper-quartile TSR performance in the performance period.

	January 1, 2009	Granted during 2009	TSR uplift at vesting[1]	Total vested during 2009[2]	December 31, 2009	Performance period	Date of grant	Market price at date of grant
James Guyette	72,670	–	–	72,670	–	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	60,669	–	–	–	60,669	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	70,672	–	–	–	70,672	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	–	207,845	–	–	207,845	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	204,011	207,845	–	72,670	339,186			
Sir John Rose	177,240	–	–	177,240	–	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	175,649	–	–	–	175,649	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	212,888	–	–	–	212,888	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	–	391,675	–	–	391,675	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	565,777	391,675	–	177,240	780,212			
Andrew Shilston	82,930	–	–	82,930	–	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	81,438	–	–	–	81,438	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	100,183	–	–	–	100,183	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	–	211,198	–	–	211,198	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	264,551	211,198	–	82,930	392,819			
Colin Smith	54,085	–	–	54,085	–	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	59,881	–	–	–	59,881	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	70,356	–	–	–	70,356	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	–	148,319	–	–	148,319	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	184,322	148,319	–	54,085	278,556			
Mike Terrett	60,638	–	–	60,638	–	Jan 1, 2006 to Dec 31, 2008	March 1, 2006	443.75p
	61,693	–	–	–	61,693	Jan 1, 2007 to Dec 31, 2009	March 1, 2007	501.00p
	91,075	–	–	–	91,075	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	–	191,998	–	–	191,998	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	213,406	191,998	–	60,638	344,766			

[1] There was no increase in the shares vesting as the TSR did not exceed the median of the FTSE 100 index during the three-year performance period to December 31, 2008.
[2] The market value per share, which vested under the PSP during 2009, was 281.80p.

Approval of the Directors' remuneration report

The Directors' remuneration report above was approved by the Board of directors on February 10, 2010 and signed on its behalf by

Helen Alexander CBE
Chairman of the remuneration committee

Financial statements

Consolidated financial statements

Company financial statements

Other matters

Consolidated income statement

For the year ended December 31, 2009

	Notes	2009 £m	Restated* 2008 £m
Revenue	2	**10,414**	9,082
Cost of sales		**(8,303)**	(7,278)
Gross profit		**2,111**	1,804
Other operating income		**89**	79
Commercial and administrative costs		**(740)**	(699)
Research and development costs		**(379)**	(403)
Share of profit of joint ventures and associates	10	**93**	74
Operating profit		**1,174**	855
(Loss)/profit on sale or termination of businesses	24	**(2)**	7
Profit before financing	2	**1,172**	862
Financing income	3	**2,276**	432
Financing costs	3	**(491)**	(3,186)
Net financing		**1,785**	(2,754)
Profit/(loss) before taxation[1]		**2,957**	(1,892)
Taxation	4	**(740)**	547
Profit/(loss) for the year		**2,217**	(1,345)
Attributable to:			
Equity holders of the parent		**2,221**	(1,340)
Minority interests		**(4)**	(5)
Profit/(loss) for the year		**2,217**	(1,345)
Earnings per ordinary share:			
Basic	5	**120.38p**	(73.63p)
Diluted	5	**119.09p**	(73.63p)
Payments to shareholders in respect of the year			
Pence per share	16	**15.00p**	14.30p
Total (£m)	16	**278**	263
[1] Underlying profit before taxation	2	**915**	880

* During the year, the Group has reviewed the allocation of costs. As a result, costs of £33m classified as cost of sales in 2008 have been reclassified as commercial and administrative costs.

Consolidated statement of comprehensive income

For the year ended December 31, 2009

	Notes	2009 £m	Restated* 2008 £m
Profit/(loss) for the year		**2,217**	(1,345)
Other comprehensive income			
Foreign exchange translation differences on foreign operations		**(158)**	603
Net actuarial (losses)/gains	18	**(1,148)**	944
Movement in unrecognised post-retirement surplus	18	**707**	(928)
Movement in post-retirement minimum funding liability	18	**40**	66
Transfers from transition hedging reserve		**(27)**	(80)
Net movements on cash flow hedging reserve in respect of joint ventures and associates	10	**22**	(41)
Related tax movements	4	**141**	(4)
Total comprehensive income/(expense) for the year		**1,794**	(785)
Attributable to:			
Equity holders of the parent		**1,799**	(782)
Minority interests		**(5)**	(3)
Total comprehensive income/(expense) for the year		**1,794**	(785)

* 2008 figures have been restated to reflect the adoption of IFRIC 14 with effect from January 1, 2008 – see note 18.

Consolidated balance sheet

At December 31, 2009

	Notes	2009 £m	December 31, 2008 £m	Restated* January 1, 2008 £m
ASSETS				
Non-current assets				
Intangible assets	8	**2,472**	2,286	1,761
Property, plant and equipment	9	**2,009**	1,995	1,813
Investments – joint ventures and associates	10	**437**	345	284
Other investments	10	**58**	53	57
Other financial assets	16	**637**	366	343
Deferred tax assets	4	**360**	804	132
Post-retirement scheme surpluses	18	**75**	453	210
		6,048	6,302	4,600
Current assets				
Inventory	11	**2,432**	2,600	2,203
Trade and other receivables	12	**3,877**	3,929	2,585
Taxation recoverable		**12**	9	7
Other financial assets	16	**80**	24	171
Short-term investments		**2**	1	40
Cash and cash equivalents	13	**2,962**	2,471	1,897
Assets held for sale		**9**	12	7
		9,374	9,046	6,910
Total assets		**15,422**	15,348	11,510
LIABILITIES				
Current liabilities				
Borrowings	14	**(126)**	(23)	(34)
Other financial liabilities	16	**(181)**	(316)	(33)
Trade and other payables	15	**(5,628)**	(5,735)	(4,326)
Current tax liabilities		**(167)**	(184)	(188)
Provisions	17	**(210)**	(181)	(121)
		(6,312)	(6,439)	(4,702)
Non-current liabilities				
Borrowings	14	**(1,787)**	(1,325)	(1,030)
Other financial liabilities	16	**(868)**	(2,525)	(355)
Trade and other payables	15	**(1,145)**	(1,318)	(965)
Non-current tax liabilities		**–**	(1)	–
Deferred tax liabilities	4	**(366)**	(307)	(258)
Provisions	17	**(232)**	(188)	(180)
Post-retirement scheme deficits	18	**(930)**	(1,020)	(824)
		(5,328)	(6,684)	(3,612)
Total liabilities		**(11,640)**	(13,123)	(8,314)
Net assets		**3,782**	2,225	3,196
EQUITY				
Capital and reserves				
Called-up share capital	19	**371**	369	364
Share premium account		**98**	82	67
Capital redemption reserves		**191**	204	191
Hedging reserves		**(19)**	(22)	77
Other reserves		**506**	663	62
Retained earnings		**2,635**	920	2,423
Equity attributable to equity holders of the parent		**3,782**	2,216	3,184
Minority interests		**–**	9	12
Total equity		**3,782**	2,225	3,196

* 2008 figures have been restated to reflect the adoption of IFRIC 14 with effect from January 1, 2008 (see note 18) and the adoption of Amendments to IAS 1 *Presentation of Financial Statements* relating to the classification of derivative financial instruments as current or non-current (see note 16).

The financial statements on pages 92 to 142 were approved by the Board on February 10, 2010 and signed on its behalf by:

Simon Robertson Chairman

Andrew Shilston Finance Director

Consolidated cash flow statement

For the year ended December 31, 2009

	Notes	2009 £m	2008 £m
Reconciliation of cash flows from operating activities			
Profit/(loss) before taxation		**2,957**	(1,892)
Share of profit of joint ventures and associates	10	**(93)**	(74)
Loss/(profit) on sale or termination of businesses	24	**2**	(7)
Profit on sale of property, plant and equipment		**(40)**	(11)
Net financing	3	**(1,785)**	2,754
Taxation paid		**(119)**	(117)
Amortisation of intangible assets	8	**121**	107
Depreciation and impairment of property, plant and equipment	9	**194**	208
Increase in provisions		**81**	39
Decrease/(increase) in inventories		**119**	(208)
Increase in trade and other receivables		**(14)**	(1,072)
(Decrease)/increase in trade and other payables		**(183)**	1,242
(Increase)/decrease in other financial assets and liabilities		**(303)**	144
Additional cash funding of post-retirement schemes		**(159)**	(117)
Share-based payments charge	20	**31**	40
Transfers of hedge reserves to income statement	16	**(27)**	(80)
Dividends received from joint ventures and associates	10	**77**	59
Net cash inflow from operating activities		**859**	1,015
Cash flows from investing activities			
Additions of unlisted investments		**(2)**	(1)
Disposals of unlisted investments		**–**	6
Additions of intangible assets		**(339)**	(389)
Disposals of intangible assets		**2**	–
Purchases of property, plant and equipment		**(258)**	(286)
Disposals of property, plant and equipment		**82**	68
Acquisitions of businesses	24	**(7)**	(47)
Disposals of businesses	24	**3**	6
Investments in joint ventures and associates		**(87)**	(32)
Disposals of joint ventures and associates		**–**	30
Net cash outflow from investing activities		**(606)**	(645)
Cash flows from financing activities			
Current borrowings – repayment of loans		**(10)**	(1)
Non-current borrowings – repayment of loans		**–**	(22)
– increase in loans		**693**	–
Capital element of finance lease payments		**(3)**	(4)
Net cash inflow/(outflow) from increase/(decrease) in borrowings		**680**	(27)
Interest received		**24**	52
Interest paid		**(66)**	(53)
Interest element of finance lease payments		**(1)**	(1)
(Increase)/decrease in government securities and corporate bonds		**(1)**	39
Issue of ordinary shares		**18**	17
Purchase of ordinary shares		**(17)**	(44)
Other transactions in ordinary shares		**(3)**	(4)
Redemption of B/C Shares		**(250)**	(200)
Net cash inflow/(outflow) from financing activities		**384**	(221)
Increase in cash and cash equivalents		**637**	149
Cash and cash equivalents at January 1		**2,462**	1,872
Foreign exchange		**(141)**	441
Cash and cash equivalents at December 31		**2,958**	2,462

Business review
Corporate governance
Financial statements

Consolidated cash flow statement (continued)

For the year ended December 31, 2009

	2009 £m	2008 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Increase in cash and cash equivalents	**637**	149
Net cash (inflow)/outflow from (increase)/decrease in borrowings	**(680)**	27
Cash outflow/(inflow) from increase/(decrease) in government securities and corporate bonds	**1**	(39)
Change in net funds resulting from cash flows	**(42)**	137
Net funds (excluding cash and cash equivalents) of businesses acquired	**–**	(6)
Exchange adjustments	**(141)**	439
Fair value adjustments	**110**	(319)
Movement in net funds	**(73)**	251
Net funds at January 1 excluding the fair value of swaps	**1,124**	873
Net funds at December 31 excluding the fair value of swaps	**1,051**	1,124
Fair value of swaps hedging fixed rate borrowings	**224**	334
Net funds at December 31	**1,275**	1,458

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

	At January 1, 2009 £m	Funds flow £m	Exchange adjustments £m	Fair value adjustments £m	Reclassifi-cations £m	At December 31, 2009 £m
Cash at bank and in hand	940	358	(58)	–	–	1,240
Overdrafts	(9)	5	–	–	–	(4)
Short-term deposits	1,531	274	(83)	–	–	1,722
Cash and cash equivalents	2,462	637	(141)	–	–	2,958
Investments	1	1	–	–	–	2
Other current borrowings	(11)	10	–	–	(121)	(122)
Non-current borrowings	(1,324)	(693)	–	110	121	(1,786)
Finance leases	(4)	3	–	–	–	(1)
	1,124	(42)	(141)	110	–	1,051
Fair value of swaps hedging fixed rate borrowings	334			(110)		224
	1,458	(42)	(141)	–	–	1,275

Consolidated statement of changes in equity

For the year ended December 31, 2009

	Notes	Share capital £m	Share premium £m	Capital redemption reserves £m	Hedging reserves[1] £m	Other reserves[2] £m	Retained earnings[3] £m	Total £m	Minority interests £m	Total equity £m
		Attributable to equity holders of the parent								
At January 1, 2008		364	67	191	77	62	2,776	3,537	12	3,549
Adoption of IFRIC 14 (note 18)		–	–	–	–	–	(353)	(353)	–	(353)
At January 1, 2008 restated		**364**	**67**	**191**	**77**	**62**	**2,423**	**3,184**	**12**	**3,196**
Loss for the year		–	–	–	–	–	(1,340)	(1,340)	(5)	(1,345)
Foreign exchange translation differences on foreign operations		–	–	–	–	601	–	601	2	603
Net actuarial gains		–	–	–	–	–	944	944	–	944
Movement in unrecognised post-retirement surplus		–	–	–	–	–	(928)	(928)	–	(928)
Movement in post-retirement minimum funding liability		–	–	–	–	–	66	66	–	66
Transfers from transition hedging reserve		–	–	–	(80)	–	–	(80)	–	(80)
Transfers to cash flow hedging reserve		–	–	–	(41)	–	–	(41)	–	(41)
Related tax movements – deferred tax		–	–	–	22	–	(26)	(4)	–	(4)
Total comprehensive income for the year		**–**	**–**	**–**	**(99)**	**601**	**(1,284)**	**(782)**	**(3)**	**(785)**
Arising on issues of ordinary shares	19	2	15	–	–	–	–	17	–	17
Issue of B Shares	16	–	–	(237)	–	–	–	(237)	–	(237)
Redemption of B Shares	16	–	–	200	–	–	(200)	–	–	–
Conversion of B Shares into ordinary shares	16	3	–	50	–	–	–	53	–	53
Ordinary shares purchased		–	–	–	–	–	(44)	(44)	–	(44)
Share-based payments adjustments[4]		–	–	–	–	–	36	36	–	36
Related tax movements – deferred tax	4	–	–	–	–	–	(11)	(11)	–	(11)
Other changes in equity in the year		**5**	**15**	**13**	**–**	**–**	**(219)**	**(186)**	**–**	**(186)**
At January 1, 2009		**369**	**82**	**204**	**(22)**	**663**	**920**	**2,216**	**9**	**2,225**
Profit for the year		–	–	–	–	–	2,221	2,221	(4)	2,217
Foreign exchange translation differences on foreign operations		–	–	–	–	(157)	–	(157)	(1)	(158)
Net actuarial losses		–	–	–	–	–	(1,148)	(1,148)	–	(1,148)
Movement in unrecognised post-retirement surplus		–	–	–	–	–	707	707	–	707
Movement in post-retirement minimum funding liability		–	–	–	–	–	40	40	–	40
Transfers from transition hedging reserve		–	–	–	(27)	–	–	(27)	–	(27)
Transfers to cash flow hedging reserve		–	–	–	22	–	–	22	–	22
Related tax movements – deferred tax		–	–	–	8	–	133	141	–	141
Total comprehensive income for the year		**–**	**–**	**–**	**3**	**(157)**	**1,953**	**1,799**	**(5)**	**1,794**
Arising on issues of ordinary shares	19	2	16	–	–	–	–	18	–	18
Issue of C Shares	16	–	–	(264)	–	–	1	(263)	–	(263)
Redemption of C Shares	16	–	–	251	–	–	(251)	–	–	–
Ordinary shares purchased		–	–	–	–	–	(17)	(17)	–	(17)
Share-based payments adjustment[4]		–	–	–	–	–	28	28	–	28
Transactions with minority interests		–	–	–	–	–	–	–	(4)	(4)
Related tax movements – deferred tax	4	–	–	–	–	–	1	1	–	1
Other changes in equity in the year		**2**	**16**	**(13)**	**–**	**–**	**(238)**	**(233)**	**(4)**	**(237)**
At December 31, 2009		**371**	**98**	**191**	**(19)**	**506**	**2,635**	**3,782**	**–**	**3,782**

[1] See accounting policies note 1 – hedge accounting. Hedging reserves include £nil (2008 £19m) in respect of the transition hedging reserve and £(19)m (2008 £(41)m) in respect of the cash flow hedging reserve.

[2] Other reserves include a merger reserve of £3m (2008 £3m) and a translation reserve of £503m (2008 £660m).

[3] At December 31, 2009, the Group held 7,156,497 ordinary shares with a net book value of £25m (2008 8,017,635 ordinary shares with a net book value of £34m). These are included in retained earnings. During the year, 6,766,884 ordinary shares with a net book value of £25m (2008 8,782,658 shares with a net book value of £37m) vested in share-based payment plans.

[4] The share-based payment adjustment is the net of the credit to equity in respect of the share-based payment charge to the income statement and the actual cost of shares vesting, excluding those vesting from own shares.

Notes to the consolidated financial statements

1 Accounting policies

The Company

Rolls-Royce Group plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended December 31, 2009 comprise the Company and its subsidiaries (together referred to as the 'Group') and the Group's interest in jointly controlled and associated entities. The financial statements were authorised for issue by the directors on February 10, 2010.

Basis of preparation and statement of compliance

In accordance with European Union (EU) regulations, these financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), as adopted for use in the EU effective at December 31, 2009 (Adopted IFRS). The Company has elected to prepare its parent company accounts under UK Generally Accepted Accounting Practices (GAAP).

The financial statements have been prepared on the historical cost basis except where Adopted IFRS requires the revaluation of financial instruments to fair value and certain other assets and liabilities on an alternative basis – most significantly post-retirement scheme liabilities are valued on the basis required by IAS 19 *Employee Benefits*.

The Group's significant accounting policies are set out below. These accounting policies have been applied consistently to all periods presented in these consolidated financial statements and by all Group entities.

The preparation of financial statements in conformity with Adopted IFRS requires the use of certain critical accounting estimates and judgements. The directors consider the potential key areas of judgements required to be made in applying the Group's accounting policies to be:

- A large proportion of the Group's activities relate to long-term aftermarket contracts. The determination of appropriate accounting policies for recognising revenue and costs in respect of these contracts requires judgement, in particular (i) whether an aftermarket contract is linked, for accounting purposes, to the related sale of original equipment and (ii) the appropriate measure of stage of completion of the contract.
- Where the Group participates in the financing of original equipment, judgement is required to determine whether revenue should be recognised or whether the transaction results in the consolidation of a special purpose financing entity.
- As set out in note 8, the Group has significant intangible assets. The decision as to when to commence capitalisation of development costs and whether sales of original equipment give rise to recognisable recoverable engine costs is a key judgement.
- As set out in note 22, the Group has contingent liabilities in respect of financing support provided to customers. Judgement is required to assess the likelihood of these crystallising, in order to assess whether a provision should be recognised.

Key sources of estimation uncertainty in applying the Group's accounting policies are described on page 102.

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 and associates up to December 31.

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

A joint venture is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. An associate is an entity, being neither a subsidiary nor a joint venture, in which the Group holds a long-term interest and where the Group has a significant influence. The results of joint ventures and associates are accounted for using the equity method of accounting.

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

All intra-group transactions, balances, income and expenses are eliminated on consolidation. Adjustments are made to eliminate the profit or loss arising on transactions with joint ventures and associates to the extent of the Group's interest in the entity.

1 Accounting policies (continued)

Significant accounting policies

Revenue recognition

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

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured. On occasion, the Group may participate in the financing of engines in conjunction with airframe manufacturers, most commonly by the provision of guarantees as described in note 22. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing whether significant risks and rewards of ownership have been transferred to the customer. Where it is judged that sufficient risks and rewards are not transferred, the transaction is treated as a leasing transaction, resulting in an operating lease between the Group and the customer. No deliveries of engines were treated as operating leases during 2009. 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 Adopted IFRS. No such entities were consolidated at December 31, 2009.

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

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

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

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

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

Risk and revenue sharing partnerships (RRSPs)

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

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

Government investment

Where a government or similar body has previously invested in a development programme, the Group treats payments to that body as royalty payments, which are matched to related sales.

Government grants

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

Interest

Interest receivable/payable is credited/charged to the income statement using the effective interest method. Where borrowing costs are attributable to the acquisition, construction or production of a qualifying asset, such costs are capitalised as part of the specific asset.

1 Accounting policies (continued)

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

Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled. Deferred tax is charged or credited in the income statement or other comprehensive income (OCI) as appropriate, except when it relates to items credited or charged directly to equity in which case the deferred tax is also dealt with in equity.

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

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

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

Financial instruments
IAS 39 *Financial Instruments: Recognition and Measurement* requires the classification of financial instruments into separate categories for which the accounting requirements are different. The Group has classified its financial instruments as follows:

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

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

- Loans and receivables and other liabilities are held at amortised cost and not revalued (except for changes in exchange rates which are included in the income statement) unless they are included in a fair value hedge accounting relationship. Where such a relationship exists, the instruments are revalued in respect of the risk being hedged. If instruments held at amortised cost are hedged, generally by interest rate swaps, and the hedges are effective, the carrying values are adjusted for changes in fair value, which are included in the income statement.
- Available for sale assets are held at fair value. Changes in fair value arising from changes in exchange rates are included in the income statement. All other changes in fair value are recognised in OCI. On disposal, the accumulated changes in value recorded in OCI 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 recognised in OCI. When the hedged forecast transaction occurs, amounts previously recognised in OCI are recognised in the income statement.

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

1 Accounting policies (continued)

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. In 2009 and 2008, cash flow hedging was undertaken only by joint ventures.

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 in OCI. Any ineffectiveness in the hedging relationships is included in the income statement. The amounts deferred in OCI are recognised in the income statement to match the recognition of the hedged item.

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

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

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

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

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

Research and development
In accordance with IAS 38 *Intangible Assets*, expenditure incurred on research and development, excluding known recoverable amounts on contracts, and contributions to shared engineering programmes, is distinguished as relating either to a research phase or to a development phase.

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

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

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

1 Accounting policies (continued)

Recoverable engine costs

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

Software

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

Property, plant and equipment

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

Depreciation is provided on a straight-line basis to write off the cost, less the estimated residual value, of property, plant and equipment over their estimated useful lives. No depreciation is provided on assets in the course of construction. Estimated useful lives are as follows:

i) Land and buildings, as advised by the Group's professional advisors:
   a) Freehold buildings – five to 45 years (average 23 years).
   b) Leasehold buildings – lower of advisor's estimates or period of lease.
   c) No depreciation is provided on freehold land.
ii) Plant and equipment – five to 25 years (average 14 years).
iii) Aircraft and engines – five to 20 years (average 16 years).

Leases

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

Impairment of non-current assets

Impairment of non-current assets is considered in accordance with IAS 36 *Impairment of Assets*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the cash-generating unit to which the asset belongs.

Goodwill and intangible assets not yet available for use are tested for impairment annually. Other non-current assets are assessed for any indications of impairment annually. If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

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

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

Inventory

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

1 Accounting policies (continued)

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 OCI.

Surpluses in schemes are recognised as assets only if they represent economic benefits available to the Group in the future. A liability is recognised to the extent that the minimum funding requirements in respect of past service will give rise to an unrecognisable surplus. Movements in unrecognised surpluses and minimum funding liabilities are recognised in OCI.

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

Share-based payments

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

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

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

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

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

Contingent liabilities

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

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

Key sources of estimation uncertainty

In applying the above accounting policies, management has made appropriate estimates in many areas, and the actual outcome may differ from those calculated. The key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are set out on page 103. The estimation of the relevant assets and liabilities involves the combination of a number of assumptions. Where appropriate and practicable, sensitivities are disclosed in the relevant notes.

1 Accounting policies (continued)

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

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

- The assessment whether there are any indications of impairment of development, participation, certification and recoverable engine costs recognised as intangible assets are dependent on forecasts of cash flows generated by the relevant assets. (Carrying values at December 31, 2009 £1,290m; December 31, 2008 £1,072m.)
- The financial liabilities arising from financial risk and revenue sharing partnerships are valued at each reporting date using the amortised cost method. (Carrying values at December 31, 2009 £363m; December 31, 2008 £455m.) 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, 2009 £360m; December 31, 2008 £804m restated) recognised is dependent on the generation of sufficient future taxable profits. The Group recognises deferred tax assets where it is more likely than not that the benefit will be realised.

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

Post-retirement benefits
The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19. The accounting valuation, which was based on assumptions determined with independent actuarial advice, resulted in a net deficit of £855m before deferred taxation being recognised on the balance sheet at December 31, 2009 (December 31, 2008 £567m restated). The size of the net deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 18.

Provisions
As described in the accounting policy above, the Group measures provisions (carrying value at December 31, 2009 £442m; December 31, 2008 £369m) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates take 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.

Revisions to Adopted IFRS in 2009
The following revisions have been adopted in the Group's financial statements in 2009:

- Amendments to IAS 1 *Presentation of Financial Statements* – these amendments revise requirements for the presentation of the financial statements and do not affect the Group's overall reported results.
- Improvements to IFRSs (2008) – the amendments to IAS 1 clarify the classification of derivative financial instruments as current or non-current. Previously the Group has classified all derivative financial instruments within the IAS 39 category 'held for trading' as current. As a result of these amendments, they have now been classified according to their maturity dates. The impact is shown in note 16.
- Amendments to IFRS 2 *Share-based Payments: Vesting Conditions and Cancellations* – these amendments concern certain aspects of the valuation of share-based payments and the impact of a cancellation by a grantee. These amendments have not had a significant impact on the charges recognised to date for share-based payments.
- Amendments to IFRS 7 *Financial Instruments: Disclosure* – these amendments require additional disclosure of the basis of fair value measurements and liquidity risks. Note 16 reflects these additional disclosure requirements.
- IFRS 8 *Operating Segments* – this standard amends the requirements for disclosure of segmental performance and does not have any effect on the Group's overall reported results. Note 2 reflects the new requirements.

1 Accounting policies (continued)

- Amendment to IAS 23 *Borrowing Costs* – the amendment generally eliminates the option to expense borrowing costs attributable to the acquisition, construction or production of a qualifying asset as incurred, and instead requires the capitalisation of eligible borrowing costs as part of the cost of the specific asset. There is no significant impact, as the Group generally funds qualifying assets from gross cash resources and consequently does not have significant eligible borrowing costs.
- IFRIC 12 *Service Concession Arrangements* – this interpretation is applicable to the Group's investments in the joint ventures operating the Future Strategic Tanker Aircraft contract with the UK Ministry of Defence. This contract commenced in 2008 and the adoption of IFRIC 12 does not have any material transitional impact.
- IFRIC 14 *IAS 19 The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* – this interpretation applies where regulatory funding requirements will result in an unrecognisable surplus arising in the future. It has been adopted with effect from January 1, 2008. The impact of the adoption of this interpretation is set out in note 18.

Revisions to IFRS not applicable in 2009

Standards and interpretations issued by the IASB are only applicable if endorsed by the EU. The following revisions to IFRS will be applicable in future periods, subject to endorsement where applicable:

- Revised IFRS 3 *Business Combinations* and amendments to IAS 27 *Consolidated and Separate Financial Statements* are applicable for 2010. These standards will affect the future accounting for acquisitions and transactions with non-controlling interests. There will be no retrospective impact.
- IFRIC 18 *Transfers of Assets from Customers* is applicable for 2010. This interpretation confirms the Group's existing policies for the recognition of assets received from customers and will not have a significant impact.
- Amendments to IFRS 2 *Group Cash-settled Share-based Payment Transactions* are applicable from 2010. If endorsed, these amendments will apply to the International ShareSave Scheme, but the impact is not anticipated to be significant.
- IFRS 9 *Financial Instruments* is applicable from 2013. If endorsed, this standard will simplify the classification of financial assets for measurement purposes, but is not anticipated to have a significant impact on the financial statements.

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

2 Segmental analysis

The analysis by business segment is presented in accordance with the basis set out in IFRS 8 *Operating segments*, on the basis of those segments whose operating results are regularly reviewed by the Board (the Chief Operating Decision Maker as defined by IFRS 8), as follows:

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 oil and gas industry and electrical power generation and aftermarket services.

Engineering and Technology, Operations and Services discussed in the business review, operate on a Group-wide basis across all the above segments.

The operating results are prepared on an underlying basis that excludes items considered to be non-underlying in nature. The principles adopted are:

Underlying revenues – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these exclude the release of the foreign exchange transition hedging reserve and reflect the achieved exchange rates arising on settled derivative contracts. There is no inter-segment trading and hence all revenues are from external customers.

Underlying profit before financing – Where transactions are denominated in a currency other than the functional currency of the Group undertaking, this excludes the release of the foreign exchange transition hedging reserve and reflects the transactions at the achieved exchange rates on settled derivative contracts.

2 Segmental analysis (continued)

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

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

This analysis also includes a reconciliation of the underlying results to those reported in the consolidated income statement. The analysis for 2008 has been restated on a consistent basis.

Year ended December 31, 2009	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Total reportable segments £m
Underlying revenue from sale of original equipment	**1,855**	**964**	**1,804**	**558**	**5,181**
Underlying revenue from services	**2,626**	**1,046**	**785**	**470**	**4,927**
Total underlying revenue	**4,481**	**2,010**	**2,589**	**1,028**	**10,108**
Underlying operating profit excluding share of profit of joint ventures and associates	**409**	**247**	**263**	**23**	**942**
Share of profit of joint ventures and associates	**82**	**6**	**–**	**5**	**93**
Profit/(loss) on sale of businesses	**2**	**–**	**–**	**(4)**	**(2)**
Underlying profit before financing and taxation	**493**	**253**	**263**	**24**	**1,033**
Segment assets	**7,341**	**1,166**	**2,302**	**998**	**11,807**
Investments in joint ventures and associates	**271**	**62**	**77**	**27**	**437**
Segment liabilities	**(4,918)**	**(1,573)**	**(1,738)**	**(492)**	**(8,721)**
Net assets/(liabilities)	**2,694**	**(345)**	**641**	**533**	**3,523**
Investment in intangible assets, property plant and equipment, joint ventures and associates	**522**	**56**	**122**	**20**	**720**
Depreciation and amortisation	**209**	**34**	**46**	**26**	**315**
Year ended December 31, 2008					
Underlying revenue from sale of original equipment	1,776	739	1,492	385	4,392
Underlying revenue from services	2,726	947	712	370	4,755
Total underlying revenue	4,502	1,686	2,204	755	9,147
Underlying operating profit excluding share of profit of joint ventures	503	215	185	(10)	893
Share of profit of joint ventures	55	8	(2)	9	70
Profit/(loss) on sale of businesses	8	–	–	(1)	7
Underlying profit/(loss) before financing and taxation	566	223	183	(2)	970
Segment assets	7,223	1,044	2,334	807	11,408
Investments in joint ventures	320	(7)	5	27	345
Segment liabilities	(7,213)	(1,234)	(1,851)	(442)	(10,740)
Net assets/(liabilities)	330	(197)	488	392	1,013
Investment in intangible assets, property, plant and equipment and joint ventures	520	84	68	35	707
Depreciation and amortisation	212	42	32	29	315

2 Segmental analysis (continued)

Reconciliation to reported results

Year ended December 31, 2009	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Revenue from sale of original equipment	**5,181**	**–**	**5,181**	**128**	**5,309**
Revenue from services	**4,927**	**–**	**4,927**	**178**	**5,105**
Total revenue	**10,108**	**–**	**10,108**	**306**	**10,414**
Operating profit excluding share of profit of joint ventures and associates	**942**	**(50)**[1]	**892**	**189**	**1,081**
Share of profit of joint ventures and associates	**93**	**–**	**93**	**–**	**93**
Loss on sale of businesses	**(2)**	**–**	**(2)**	**–**	**(2)**
Profit before financing and taxation	**1,033**	**(50)**	**983**	**189**	**1,172**
Net financing		**(68)**	**(68)**	**1,853**	**1,785**
Profit before taxation		**(118)**	**915**	**2,042**	**2,957**
Taxation		**(187)**	**(187)**	**(553)**	**(740)**
Profit/(loss) for the year		**(305)**	**728**	**1,489**	**2,217**
Year ended December 31, 2008					
Revenue from sale of original equipment	4,392	–	4,392	(15)	4,377
Revenue from services	4,755	–	4,755	(50)	4,705
Total revenue	9,147	–	9,147	(65)	9,082
Operating profit excluding share of profit of joint ventures	893	(51)[1]	842	(61)	781
Share of profit of joint ventures	70	–	70	4	74
Profit on sale of businesses	7	–	7	–	7
Profit before financing and taxation	970	(51)	919	(57)	862
Net financing		(39)	(39)	(2,715)	(2,754)
Profit/(loss) before taxation		(90)	880	(2,772)	(1,892)
Taxation		(217)	(217)	764	547
Profit/(loss) for the year		(307)	663	(2,008)	(1,345)

[1] Central corporate costs

Underlying adjustments

	2009 Revenue £m	2009 Profit before financing £m	2009 Net financing £m	2009 Taxation £m	2008 Revenue £m	2008 Profit before financing £m	2008 Net financing £m	2008 Taxation £m
Underlying performance	**10,108**	**983**	**(68)**	**(187)**	9,147	919	(39)	(217)
Release of transition hedging reserve	**27**	**27**	**–**	**–**	80	80	–	–
Recognise revenue at exchange rate on date of transaction	**279**	**–**	**–**	**–**	(145)	–	–	–
Realised losses/(gains) on settled derivative contracts[1]	**–**	**274**	**60**	**–**	–	(185)	(107)	–
Net unrealised fair value changes to derivative contracts[2]	**–**	**14**	**1,835**	**–**	–	4	(2,479)	–
Effect of currency on contract accounting	**–**	**(126)**	**–**	**–**	–	44	–	–
Revaluation of trading assets and liabilities	**–**	**–**	**(17)**	**–**	–	–	14	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	**–**	**–**	**72**	**–**	–	–	(121)	–
Net post-retirement scheme financing	**–**	**–**	**(97)**	**–**	–	–	(22)	–
Related tax effect	**–**	**–**	**–**	**(553)**	–	–	–	764
Total underlying adjustments	**306**	**189**	**1,853**	**(553)**	(65)	(57)	(2,715)	764
Reported per consolidated income statement	**10,414**	**1,172**	**1,785**	**(740)**	9,082	862	(2,754)	547

[1] Realised (gains)/losses on settled derivative contracts included in profit before tax:
– includes £15m of realised losses (2008 £nil) deferred from prior years;
– excludes £6m of gains (2008 losses of £24m) realised in the year on derivative contracts settled in respect of trading cash flows that occurred after the year-end;
– excludes £14m of losses (2008 £nil) realised in respect of derivatives held in net investment hedges.

[2] The adjustment for unrealised fair value changes included in profit before financing includes the reversal of £5m of unrealised gains (2008 £4m) in respect of derivative contracts held by joint ventures and £9m (2008 £nil) of unrealised losses for which the related trading contracts have been cancelled and consequently the fair value loss has been recognised immediately in underlying profit.

2 Segmental analysis (continued)

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

	2009 £m	December 31, 2008 £m	Restated* January 1, 2008 £m
Reportable segment assets	**11,807**	11,408	9,359
Investments in joint ventures and associates	**437**	345	284
Eliminations	**(457)**	(477)	(461)
Cash and cash equivalents and short-term investments	**2,964**	2,472	1,937
Fair value of swaps hedging fixed rate borrowings	**224**	334	42
Income tax assets	**372**	813	139
Post-retirement scheme surpluses	**75**	453	210
Total assets	**15,422**	15,348	11,510
Reportable segment liabilities	**(8,721)**	(10,740)	(6,414)
Eliminations	**457**	477	461
Borrowings	**(1,913)**	(1,348)	(1,064)
Fair value of swaps hedging fixed rate borrowings	**–**	–	(27)
Income tax liabilities	**(533)**	(492)	(446)
Post-retirement scheme deficits	**(930)**	(1,020)	(824)
Total liabilities	**(11,640)**	(13,123)	(8,314)
Net assets	**3,782**	2,225	3,196

* See note 18

Geographical segments

The Group's revenue by destination is shown below:

	2009 £m	2008 £m
United Kingdom	**1,458**	1,462
Rest of Europe	**2,273**	1,890
USA	**2,895**	2,214
Canada	**275**	299
Asia	**2,856**	2,439
Africa	**144**	143
Australasia	**230**	255
Other	**283**	380
	10,414	9,082

The carrying amounts of the Group's non-current assets, excluding financial instruments, deferred tax assets and post-employment benefit surpluses, by the geographical area in which the assets are located, are as follows:

	2009 £m	2008 £m
United Kingdom	**2,764**	2,586
North America	**467**	463
Nordic countries	**824**	745
Germany	**574**	539
Other	**289**	293
	4,918	4,626

3 Net financing

	Note	2009 Per consolidated income statement £m	2009 *Underlying financing*[1] £m	2008 Per consolidated income statement £m	2008 *Underlying financing*[1] £m
Financing income					
Interest receivable		**21**	***21***	59	*59*
Fair value gains on foreign currency contracts[2]	16	**1,783**	**–**	–	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	16	**72**	**–**	–	–
Fair value gains on commodity derivatives[2]	16	**52**	**–**	–	–
Expected return on post-retirement scheme assets	18	**305**	**–**	373	–
Net foreign exchange gains		**43**	**–**	–	–
Other financing income		**–**	**–**	–	–
		2,276	***21***	432	*59*
Financing costs					
Interest payable		**(64)**	***(64)***	(69)	*(69)*
Fair value losses on foreign currency contracts[2]	16	**–**	**–**	(2,383)	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	16	**–**	**–**	*(121)*	–
Financial charge relating to financial RRSPs	16	**(25)**	***(25)***	(26)	*(26)*
Fair value losses on commodity derivatives[2]	16	**–**	**–**	(96)	–
Interest on post-retirement scheme liabilities	18	**(402)**	**–**	(395)	–
Net foreign exchange losses		**–**	**–**	(91)	–
Other financing charges		**–**	**–**	(5)	*(3)*
		(491)	***(89)***	(3,186)	*(98)*
Net financing		**1,785**	***(68)***	(2,754)	*(39)*
Analysed as:					
Net interest payable		**(43)**	***(43)***	(10)	*(10)*
Net post-retirement scheme financing		**(97)**	**–**	(22)	–
Net other financing		**1,925**	***(25)***	(2,722)	*(29)*
Net financing		**1,785**	***(68)***	(2,754)	*(39)*
[1] See note 2					
[2] Net gain/(loss) on items held for trading		**1,835**	**–**	(2,479)	–

4 Taxation

	UK 2009 £m	UK 2008 £m	Overseas 2009 £m	Overseas 2008 £m	Total 2009 £m	Total 2008 £m
Current tax						
Current tax charge for the year	**26**	7	**129**	88	**155**	95
Less double tax relief	**(29)**	(7)	**–**	–	**(29)**	(7)
	(3)	–	**129**	88	**126**	88
Adjustments in respect of prior years	**(4)**	(9)	**(23)**	14	**(27)**	5
	(7)	(9)	**106**	102	**99**	93
Deferred tax						
Deferred tax charge/(credit) for the year	**628**	(574)	**21**	(50)	**649**	(624)
Adjustments in respect of prior years	**(12)**	2	**4**	(18)	**(8)**	(16)
	616	(572)	**25**	(68)	**641**	(640)
Recognised in the income statement	**609**	(581)	**131**	34	**740**	(547)

Business review Corporate governance Financial statements

4 Taxation (continued)

Other tax (charges)/credits

	OCI 2009 £m	OCI Restated* 2008 £m	Equity 2009 £m	Equity 2008 £m
Deferred tax				
net actuarial losses/(gains)	**342**	(267)	**–**	–
movement in unrecognised surplus on post-retirement schemes	**(198)**	260	**–**	–
movement in minimum funding liability	**(11)**	(19)	**–**	–
release of hedge reserve	**8**	22	**–**	–
share-based payment plans	**–**	–	**1**	(11)
Total in respect of the year	**141**	(4)	**1**	(11)

* See note 18

Tax reconciliation

	2009 £m	2008 £m
Profit/(loss) before taxation	**2,957**	(1,892)
Less share of profits of joint ventures and associates (note 10)	**(93)**	(74)
Profit/(loss) before taxation excluding joint ventures and associates	**2,864**	(1,966)
Nominal tax charge/(credit) at UK corporation tax rate 28.0% (2008 28.5%)	**802**	(560)
UK R&D credit	**(26)**	(25)
Rate differences	**7**	16
Other permanent differences	**5**	15
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	**(21)**	(3)
Tax losses in year not recognised in deferred tax	**8**	21
Adjustments in respect of prior years	**(35)**	(11)
	740	(547)
Analysis of taxation charge:		
Underlying items (note 2)	**187**	217
Non-underlying items	**553**	(764)
	740	(547)

Deferred taxation assets and liabilities

	2009 £m	Restated* 2008 £m
At January 1	**497**	(126)
Amount (charged)/credited to income statement	**(641)**	640
Amount credited/(charged) to other comprehensive income	**141**	(4)
Amount credited/(charged) to equity	**1**	(11)
On acquisition of business	**–**	(5)
Exchange movements	**(4)**	3
At December 31	**(6)**	497

Analysed as:	2009 £m	December 31, 2008 £m	Restated* January 1, 2008 £m
Deferred tax assets	**360**	804	132
Deferred tax liabilities	**(366)**	(307)	(258)
	(6)	497	(126)

* See note 18

4 Taxation (continued)

The analysis of the deferred tax position is as follows:

	At January 1, 2009 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	On acquisition £m	Exchange movements £m	At December 31 2009 £m
Intangible assets	(200)	(53)	–	–	–	3	(250)
Property, plant and equipment	(146)	(17)	–	–	–	3	(160)
Other temporary differences	(31)	2	–	(2)	–	9	(22)
Amounts recoverable on contracts	(195)	(48)	–	–	–	–	(243)
Pensions and other post-retirement scheme benefits	168	(17)	133	–	–	(19)	265
Foreign exchange and commodity financial assets and liabilities	655	(609)	8	–	–	–	54
Losses	182	101	–	3	–	–	286
Advance corporation tax	64	–	–	–	–	–	64
	497	(641)	141	1	–	(4)	(6)

	At December 31, 2007 as previously reported £m	Adoption of IFRIC 14, recognised in OCI £m	At January 1, 2008 restated £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	On acquisition £m	Exchange movements £m	At December 31, 2008 restated £m
Intangible assets	(140)	–	(140)	(50)	–	–	(4)	(6)	(200)
Property, plant and equipment	(143)	–	(143)	3	–	–	–	(6)	(146)
Other temporary differences	62	–	62	(40)	–	(20)	–	(33)	(31)
Amounts recoverable on contracts	(145)	–	(145)	(50)	–	–	–	–	(195)
Pensions and other post-retirement scheme benefits	35	138	173	(26)	(26)	–	(1)	48	168
Foreign exchange and commodity financial assets and liabilities	(121)	–	(121)	754	22	–	–	–	655
Losses	124	–	124	49	–	9	–	–	182
Advance corporation tax	64	–	64	–	–	–	–	–	64
	(264)	138	(126)	640	(4)	(11)	(5)	3	497

	2009 £m	2008 £m
Advance corporation tax	118	118
Losses and other unrecognised deferred tax assets	59	67
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	177	185

Unprovided temporary differences relating to investments in subsidiaries and joint ventures are now £nil (2008 £946m). This is as a result of a recent change in UK legislation, intended to exempt the great majority of overseas dividends from UK tax. The 2008 comparative reflected undistributed profits of the relevant entities which, if paid up by way of dividend, would have given rise to taxable income in the UK. No deferred tax was provided in respect of the resultant temporary differences because the timing of any reversals (by way of dividend flow) could be controlled and it was considered unlikely that dividends would be paid if they resulted in additional UK taxable income.

5 Earnings per ordinary share

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

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

			2009			2008
	Basic	Potentially dilutive share options	Diluted	Basic	Potentially dilutive share options[1]	Diluted
Profit/(loss) (£m)	**2,221**	**–**	**2,221**	(1,340)	–	(1,340)
Weighted average number of shares (millions)	**1,845**	**20**	**1,865**	1,820	–	1,820
EPS (pence)	**120.38**	**(1.29)**	**119.09**	(73.63)	–	(73.63)

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

The reconciliation between underlying EPS and basic EPS is as follows:

		2009		2008
	Pence	£m	Pence	£m
Underlying EPS/Underlying profit attributable to equity holders of the parent	**39.67**	**732**	36.70	668
Total underlying adjustments to profit before tax (note 2)	**110.68**	**2,042**	(152.31)	(2,772)
Related tax effects	**(29.97)**	**(553)**	41.98	764
EPS/Profit attributable to equity holders of the parent	**120.38**	**2,221**	(73.63)	(1,340)
Diluted underlying EPS	**39.25**		36.70	

6 Employee information

	2009 Number	2008 Number
Average monthly number of Group employees during the year		
United Kingdom	**21,300**	22,500
Overseas	**17,200**	16,500
	38,500	39,000
Civil aerospace	**21,800**	22,700
Defence aerospace	**5,600**	5,700
Marine	**8,600**	8,100
Energy	**2,500**	2,500
	38,500	39,000
	£m	£m
Group employment costs[1]		
Wages and salaries	**1,725**	1,649
Social security costs	**194**	180
Share-based payments (note 20)	**31**	40
Pensions and other post-retirement scheme benefits (note 18)	**263**	218
	2,213	2,087

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

7 Auditors' remuneration

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

	2009 £m	2008 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements[1]	**0.1**	0.1
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**4.1**	3.6
Total fees payable for audit services	**4.2**	3.7
Fees payable to the Company's auditors and its associates for other services:		
Other services pursuant to legislation	**0.6**	0.5
Other services relating to taxation	**0.4**	0.4
	5.2	4.6
Fees payable in respect of the Group's pension schemes:		
Audit	**0.2**	0.2
Other services relating to taxation	**0.1**	–

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

8 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
Cost:						
At January 1, 2008	801	504	514	366	109	2,294
Exchange adjustments	173	9	5	–	7	194
Additions	–	55	113	97	128	393
On acquisitions of businesses	41	–	–	–	11	52
On disposals of businesses	(2)	–	–	–	–	(2)
Disposals	–	–	–	–	(1)	(1)
At January 1, 2009	**1,013**	**568**	**632**	**463**	**254**	**2,930**
Exchange adjustments	(28)	(3)	(2)	–	(2)	(35)
Additions	–	66	121	123	32	342
On acquisitions of businesses	6	–	–	–	–	6
Disposals	–	–	–	–	(11)	(11)
At December 31, 2009	**991**	**631**	**751**	**586**	**273**	**3,232**
Accumulated amortisation and impairment:						
At January 1, 2008	–	150	150	204	29	533
Exchange adjustments	–	3	–	–	2	5
Provided during the year[1]	5	12	26	46	18	107
Disposals	–	–	–	–	(1)	(1)
At January 1, 2009	**5**	**165**	**176**	**250**	**48**	**644**
Exchange adjustments	–	(1)	–	–	(1)	(2)
Provided during the year[1]	2	13	29	46	31	121
Disposals	–	–	–	–	(3)	(3)
At December 31, 2009	**7**	**177**	**205**	**296**	**75**	**760**
Net book value at December 31, 2009	**984**	**454**	**546**	**290**	**198**	**2,472**
Net book value at December 31, 2008	1,008	403	456	213	206	2,286
Net book value at January 1, 2008	801	354	364	162	80	1,761

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

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	Operating segment	2009 £m	2008 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**244**	266
Commercial marine – arising from the acquisitions of Vinters plc and Scandinavian Electric Holdings AS	Marine	**645**	641
Other	Various	**95**	101
		984	1,008

Business review

Corporate governance

Financial statements

8 Intangible assets (continued)

Goodwill (continued)

Goodwill has been tested for impairment during 2009 on the following basis:

- The carrying value of goodwill has been assessed by reference to values in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long term and established nature of many of the Group's products (product lives are often measured in decades), these typically forecast the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate.
- The key assumptions on which the cash flow projections for the most recent forecast are based are discount rates, growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs.
- The pre-tax cash flow projections have been discounted at 12.75 per cent (2008 12.75 per cent), based on the Group's weighted average cost of capital.

The principal value in use assumptions for goodwill balances considered to be individually significant are:

- Rolls-Royce Deutschland Ltd & Co KG – volume of engine deliveries, flying hours of installed fleet and cost escalation, these are based on current and known future programmes, estimates of customers' fleet requirements and long term economic forecasts. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at 2.5 per cent (2008 2.5 per cent). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. For example, the overall level of business would need to reduce by more that 30 per cent to cause an impairment of this balance.
- Vinters plc – volume of equipment deliveries, capture of aftermarket and cost escalation, these are based on current and known future programmes, estimates of customers' fleet requirements and long term economic forecasts. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at four per cent. The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. For example, it would require a doubling of the discount rate to cause an impairment of this balance.

Other intangible assets

Certification costs and participation fees, development costs and recoverable engine costs have been reviewed for impairment in accordance with the requirements of IAS 36 *Impairment of Assets*. Where an impairment test was considered necessary, it has been performed on the following basis:

- The carrying values have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions over the lives of the respective programmes.
- The key assumptions underlying cash flow projections are assumed market share, programme timings, unit cost assumptions, discount rates, and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at 11 per cent, based on the Group's weighted average cost of capital.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Group's control (discount rate, exchange rate and airframe delays), could result in impairment in future years.

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, 2008	699	2,110	174	176	3,159
Exchange adjustments	70	180	6	22	278
Additions	18	104	28	133	283
On acquisitions of businesses	18	–	–	–	18
On disposals of businesses	–	(13)	–	–	(13)
Reclassifications	17	69	–	(86)	–
Transferred to assets held for sale	(32)	(3)	–	–	(35)
Disposals/write-offs	(3)	(97)	(37)	–	(137)
At January 1, 2009	**787**	**2,350**	**171**	**245**	**3,553**
Exchange adjustments	(17)	(43)	(2)	(8)	(70)
Additions	22	94	20	155	291
Reclassifications	30	78	5	(113)	–
Transferred to assets held for sale	(12)	–	–	–	(12)
Disposals/write-offs	(4)	(92)	(31)	(3)	(130)
At December 31, 2009	**806**	**2,387**	**163**	**276**	**3,632**
Accumulated depreciation and impairment:					
At January 1, 2008	180	1,146	20	–	1,346
Exchange adjustments	18	106	3	–	127
Provided during the year[1]	44	155	9	–	208
On disposals of businesses	–	(11)	–	–	(11)
Transferred to assets held for sale	(22)	(3)	–	–	(25)
Disposals/write-offs	(2)	(85)	–	–	(87)
At January 1, 2009	**218**	**1,308**	**32**	**–**	**1,558**
Exchange adjustments	(2)	(25)	(1)	–	(28)
Provided during the year[1]	25	156	8	–	189
Impairment	4	1	–	–	5
Transferred to assets held for sale	(12)	–	–	–	(12)
Disposals/write-offs	(2)	(82)	(5)	–	(89)
At December 31, 2009	**231**	**1,358**	**34**	**–**	**1,623**
Net book value at December 31, 2009	**575**	**1,029**	**129**	**276**	**2,009**
Net book value at December 31, 2008	569	1,042	139	245	1,995
Net book value at January 1, 2008	519	964	154	176	1,813

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

9 Property, plant and equipment (continued)

Property, plant and equipment includes:

	2009 £m	2008 £m
Net book value of finance leased assets:		
Land and buildings	**9**	9
Plant and equipment	**6**	9
Aircraft and engines	**–**	–
Assets held for use in operating leases:		
Cost	**133**	141
Depreciation	**(31)**	(28)
Net book value	**102**	113
Non-depreciable land	**98**	113
Land and buildings at net book value comprise:		
Freehold	**559**	533
Long leasehold	**10**	12
Short leasehold	**6**	24
	575	569
Capital expenditure commitments – contracted but not provided for	**146**	122
Cost of fully depreciated assets	**473**	475

10 Investments

	Joint ventures				Associates[1]			Equity accounted	Other[2]
	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m	Shares at cost £m	Share of post acquisition reserves £m	Total £m	Total £m	Unlisted £m
At January 1, 2008	124	146	14	284	–	–	–	284	57
Exchange adjustments	14	71	–	85	–	–	–	85	1
Additions	30	–	1	31	–	–	–	31	1
Taxation paid by the Group	–	3	–	3	–	–	–	3	–
Share of retained profit	(8)	25	(2)	15	–	–	–	15	–
Transferred to 'Assets held for sale'	–	(2)	–	(2)	–	–	–	(2)	–
Disposals	(13)	(9)	(8)	(30)	–	–	–	(30)	(6)
Transfer to cash flow hedging reserve[3]	–	(41)	–	(41)	–	–	–	(41)	–
At January 1, 2009	**147**	**193**	**5**	**345**	**–**	**–**	**–**	**345**	**53**
Exchange adjustments	(7)	(28)	–	(35)	4	–	4	(31)	–
Additions	15	–	1	16	71	–	71	87	2
Taxation paid by the Group	–	2	–	2	–	–	–	2	–
Impairment	(1)	–	–	(1)	–	–	–	(1)	(1)
Share of retained profit	–	18	–	18	–	(1)	(1)	17	–
Transfer to other investments	(5)	2	(1)	(4)	–	–	–	(4)	4
Disposals	(1)	1	–	–	–	–	–	–	–
Transfer from cash flow hedging reserve[3]	–	22	–	22	–	–	–	22	–
At December 31, 2009	**148**	**210**	**5**	**363**	**75**	**(1)**	**74**	**437**	**58**

[1] During the year, the Group acquired 33 per cent of ODIM ASA, listed on the Oslo Stock Exchange. The market value of the shares at December 31, 2009 was £50m. The value of the investment has been assessed on a value in use basis and is not considered to be impaired.
[2] These primarily comprise floating rate convertible loan stock.
[3] Certain of the Group's joint ventures hold interest rate and inflation swaps for which cash flow hedge accounting has been adopted.

10 Investments (continued)

Investments in joint ventures and associates are represented by:

	Joint ventures		Associates		Total	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Share of aggregate assets:						
Non-current assets[4]	**1,143**	1,041	**69**	–	**1,212**	1,041
Current assets	**812**	940	**38**	–	**850**	940
Share of aggregate liabilities[5]:						
Current liabilities	**(709)**	(841)	**(20)**	–	**(729)**	(841)
Non-current liabilities	**(883)**	(795)	**(13)**	–	**(896)**	(795)
	363	345	**74**	–	**437**	345
[4] Non-current assets include goodwill of	**5**	10	**46**	–	**51**	10
[5] Liabilities include borrowings of	**(816)**	(655)	**(5)**	–	**(821)**	(655)
Share of income	**132**	104	**–**	–	**132**	104
Share of net financing	**(26)**	(16)	**(1)**	–	**(27)**	(16)
Share of taxation	**(12)**	(14)	**–**	–	**(12)**	(14)
Share of profit recognised in the income statement	**94**	74	**(1)**	–	**93**	74
Dividends received	**(77)**	(59)	**–**	–	**(77)**	(59)
Share of retained profit	**17**	15	**(1)**	–	**16**	15

The tax charge on joint venture profits represents an effective tax rate of 11 per cent (2008 16 per cent), a decrease of five per cent. This results from a change in profit mix between joint ventures taxed at different effective rates.

The principal joint ventures and associates are listed on pages 147 to 148.

11 Inventory

	2009 £m	2008 £m
Raw materials	**358**	328
Work in progress	**820**	1,008
Long-term contracts work in progress	**61**	34
Finished goods	**1,163**	1,192
Payments on account	**30**	38
	2,432	2,600
Inventories stated at net realisable value	**138**	144
Amount of inventory write-down	**83**	81
Reversal of inventory write-down	**5**	15

Business review

Corporate governance

Financial statements

Business review
Corporate governance
Financial statements

12 Trade and other receivables

	2009 £m	2008 £m
Trade receivables	**1,285**	1,421
Amounts recoverable on contracts[1]	**1,524**	1,448
Amounts owed by joint ventures and associates	**502**	451
Other receivables	**401**	404
Prepayments and accrued income	**165**	205
	3,877	3,929
Analysed as:		
Financial instruments (note 16):		
Trade receivables and similar items	**1,837**	1,939
Other non-derivative financial assets	**382**	369
Non-financial instruments	**1,658**	1,621
	3,877	3,929
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	**9**	24
Amounts recoverable on contracts	**1,178**	1,222
Amounts owed by joint ventures and associates	**14**	28
Other receivables	**35**	59
Prepayments and accrued income	**30**	38
	1,266	1,371

[1] The balance at December 31, 2009 includes a valuation allowance of £43m, being the directors' best estimate of the loss that will occur from the Group's contract with EPI Europrop International GmbH to participate in the development of the TP400 engine for the A400M military transport aircraft.

13 Cash and cash equivalents

	2009 £m	2008 £m
Cash at bank and in hand	**1,240**	940
Short-term deposits	**1,722**	1,531
	2,962	2,471
Overdrafts (note 14)	**(4)**	(9)
Cash and cash equivalents per cash flow statement (page 94)	**2,958**	2,462
Cash held as collateral against third party obligations	**77**	85

14 Borrowings

	Current		Non-current		Total	
	2009 £m	2008 £m	**2009 £m**	2008 £m	**2009 £m**	2008 £m
Unsecured						
Overdrafts	**4**	9	**–**	–	**4**	9
Bank loans	**2**	11	**204**	5	**206**	16
7 3/8% Notes 2016 £200m	**–**	–	**200**	200	**200**	200
5.84% Notes 2010 US$187m[1]	**120**	–	**–**	136	**120**	136
6.38% Notes 2013 US$230m[1]	**–**	–	**155**	178	**155**	178
6.55% Notes 2015 US$83m[1]	**–**	–	**57**	67	**57**	67
4 1/2% Notes 2011 €750m[2]	**–**	–	**677**	738	**677**	738
6.75% Notes 2019 £500m	**–**	–	**493**	–	**493**	–
Secured						
Obligations under finance leases[3]: (note 21)	**–**	3	**1**	1	**1**	4
	126	23	**1,787**	1,325	**1,913**	1,348

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

15 Trade and other payables

	Current		Non-current	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Payments received on account[1]	**1,550**	1,635	**544**	549
Trade payables	**863**	1,042	**–**	–
Amounts owed to joint ventures and associates	**276**	372	**2**	9
Other taxation and social security	**71**	55	**–**	–
Other payables	**1,086**	1,170	**71**	206
Accruals and deferred income	**1,782**	1,461	**528**	554
	5,628	5,735	**1,145**	1,318
[1] Includes payments received from joint ventures	**200**	209	**259**	107

Analysed as:

	2009 £m	2008 £m
Financial instruments: (note 16)		
Trade payables and similar items	**2,142**	2,264
Other non-derivative financial liabilities	**381**	430
Non-financial instruments	**4,250**	4,359
	6,773	7,053

Included within trade and other payables are government grants of £31m (2008 £25m). During 2009, £2m of government grants were released to the income statement.

16 Financial instruments

This note should be read in conjunction with the Finance Director's review on pages 58 to 65.

Carrying values and fair values of financial instruments

	Notes	Valuation basis	Assets Held for trading £m	Assets Loans and receivables £m	Assets Available for sale £m	Assets Cash £m	Liabilities Held for trading £m	Liabilities Other £m	Total £m
At December 31, 2009									
Unlisted non-current asset investments	10	A	**–**	**58**	**–**	**–**	**–**	**–**	**58**
Trade receivables and similar items	12	B	**–**	**1,837**	**–**	**–**	**–**	**–**	**1,837**
Other non-derivative financial assets	12	B	**–**	**382**	**–**	**–**	**–**	**–**	**382**
Derivative financial assets		C	**717**	**–**	**–**	**–**	**–**	**–**	**717**
Short-term investments		B	**–**	**–**	**2**	**–**	**–**	**–**	**2**
Cash at bank and in hand	13	B	**–**	**–**	**–**	**1,240**	**–**	**–**	**1,240**
Short-term deposits	13	B	**–**	**1,722**	**–**	**–**	**–**	**–**	**1,722**
Borrowings	14	D	**–**	**–**	**–**	**–**	**–**	**(1,913)**	**(1,913)**
Derivative financial liabilities		C	**–**	**–**	**–**	**–**	**(673)**	**–**	**(673)**
Financial RRSPs		D	**–**	**–**	**–**	**–**	**–**	**(363)**	**(363)**
C Shares		B	**–**	**–**	**–**	**–**	**–**	**(13)**	**(13)**
Trade payables and similar items	15	C	**–**	**–**	**–**	**–**	**–**	**(2,142)**	**(2,142)**
Other non-derivative financial liabilities	15	B	**–**	**–**	**–**	**–**	**–**	**(381)**	**(381)**
			717	**3,999**	**2**	**1,240**	**(673)**	**(4,812)**	**473**
At December 31, 2008									
Unlisted non-current asset investments	10	A	–	53	–	–	–	–	53
Trade receivables and similar items	12	B	–	1,939	–	–	–	–	1,939
Other non-derivative financial assets	12	B	–	369	–	–	–	–	369
Derivative financial assets		C	390	–	–	–	–	–	390
Short-term investments		B	–	–	1	–	–	–	1
Cash at bank and in hand	13	B	–	–	–	940	–	–	940
Short-term deposits	13	B	–	1,531	–	–	–	–	1,531
Borrowings	14	D	–	–	–	–	–	(1,348)	(1,348)
Derivative financial liabilities		C	–	–	–	–	(2,386)	–	(2,386)
Financial RRSPs		D	–	–	–	–	–	(455)	(455)
Trade payables and similar items	15	B	–	–	–	–	–	(2,264)	(2,264)
Other non-derivative financial liabilities	15	B	–	–	–	–	–	(430)	(430)
			390	3,892	1	940	(2,386)	(4,497)	(1,660)

Fair values equate to book values for both 2009 and 2008, with the following exceptions:

	2009 Book value £m	2009 Fair value £m	2008 Book value £m	2008 Fair value £m
Borrowings	**(1,913)**	**(2,012)**	(1,348)	(1,314)
Financial RRSPs	**(363)**	**(390)**	(455)	(487)

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 described below.

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

B 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.

C Fair values of derivative financial assets and liabilities are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. These financial instruments are included on the balance sheet at fair value, derived from observable market prices (Level 2 as defined by IFRS 7 *Financial Instruments: Disclosures*).

D Borrowing and financial RRSPs are carried at amortised cost. Fair values are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. For financial RRSPs, the contractual cash flows are based on future trading activity, which is estimated based on latest forecasts.

16 Financial instruments (continued)

Carrying values of other financial assets and liabilities

Further to the amendments to IAS 1 in the Improvements to IFRS (2008), derivative contracts are now classified as current or non-current based on their maturity dates. Previously all 'held for trading' items were deemed to be current. The effect is that: (i) financial assets comprising foreign exchange contracts (2008 £112m and 2007 £433m), commodity contracts (2007 £39m) and interest rate contracts (2008 £278m and 2007 £42m), previously reported as current assets; and (ii) financial liabilities comprising foreign exchange contracts (2008 £2,293m and 2007 £54m), commodity contracts (2008 £89m) and interest rate contracts (2008 £4m and 2007 £3m) previously reported as current liabilities, are presented as current or non-current as set out below.

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Financial RRSPs £m	B/C Shares £m	Total £m
At December 31, 2009							
Non-current assets	**429**	**11**	**197**	**637**	**–**	**–**	**637**
Current assets	**72**	**4**	**4**	**80**	**–**	**–**	**80**
Current liabilities	**(56)**	**(12)**	**–**	**(68)**	**(100)**	**(13)**	**(181)**
Non-current liabilities	**(589)**	**(14)**	**(2)**	**(605)**	**(263)**	**–**	**(868)**
	(144)	**(11)**	**199**	**44**	**(363)**	**(13)**	**(332)**
At December 31, 2008							
Non-current assets	88	–	278	366	–	–	366
Current assets	24	–	–	24	–	–	24
Current liabilities	(214)	(36)	(2)	(252)	(64)	–	(316)
Non-current liabilities	(2,079)	(53)	(2)	(2,134)	(391)	–	(2,525)
	(2,181)	(89)	274	(1,996)	(455)	–	(2,451)
At December 31, 2007							
Non-current assets	286	15	42	343	–	–	343
Current assets	147	24	–	171	–	–	171
Current liabilities	(4)	–	(1)	(5)	(12)	(16)	(33)
Non-current liabilities	(50)	–	(2)	(52)	(303)	–	(355)
	379	39	39	457	(315)	(16)	126

16 Financial instruments (continued)

Foreign exchange and commodity financial instruments

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

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

	Foreign exchange instruments £m	Commodity instruments £m
At January 1, 2008	379	39
Fair value gains to fair value hedges[1,2]	83	–
Fair value losses to other derivative contracts[1]	(2,383)	(96)
Fair value of contracts settled	(236)	(32)
Fair value of derivative contracts assumed on formation of joint venture	(24)	–
At January 1, 2009	**(2,181)**	**(89)**
Fair value losses to fair value hedges[1,2]	**(33)**	**–**
Fair value losses to net investment hedges	**(14)**	**–**
Fair value gains to other derivative contracts[1]	**1,783**	**52**
Fair value of contracts settled	**301**	**26**
At December 31, 2009	**(144)**	**(11)**

1 Included in financing
2 Profit on related hedged items £33m (2008 £83m loss).

Interest rate financial instruments

The Group uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates. Where the effectiveness of the hedge relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the hedging reserve and released to match actual payments on the hedged item. During 2008 and 2009, the Group did not have any cash flow hedges, other than in joint ventures, which are not included in this analysis.

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

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m
At January 1, 2008	39	42	(3)
Fair value changes[1,2]	235	236	(1)
At January 1, 2009	**274**	**278**	**(4)**
Fair value changes[1,2]	**(75)**	**(77)**	**2**
At December 31, 2009	**199**	**201**	**(2)**

1 Included in financing
2 Profit on related hedged items £77m (2008 £236m loss).

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.

16 Financial instruments (continued)

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

	2009 £m	2008 £m
At January 1	**(455)**	(315)
Cash paid to partners	**55**	53
Additions	**(15)**	(40)
Exchange adjustments direct to reserves	**6**	(6)
Financing charge[1]	**(26)**	(26)
Excluded from underlying profit:		
Exchange adjustments[1]	**45**	(118)
Restructuring of financial RRSP agreements and changes in forecast payments[1]	**27**	(3)
At December 31	**(363)**	(455)

[1] Included in financing, excluding £1m of finance charge capitalised in intangible assets.

Risk management policies and hedging activities

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

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

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

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

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

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

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

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

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

16 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:

	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
At December 31, 2009							
Foreign exchange contracts:							
Fair value hedges	**280**	**106**	**–**	**128**	**46**	**23**	**–**
Non-hedge accounted	**14,203**	**3,544**	**3,184**	**6,573**	**902**	**478**	**(645)**
Interest rate contracts:							
Fair value hedges	**809**	**116**	**500**	**142**	**51**	**201**	**–**
Non-hedge accounted	**35**	**20**	**–**	**–**	**15**	**–**	**(2)**
Commodity contracts:							
Non-hedge accounted	**169**	**62**	**59**	**48**	**–**	**15**	**(26)**
	15,496	**3,848**	**3,743**	**6,891**	**1,014**	**717**	**(673)**
At December 31, 2008							
Foreign exchange contracts:							
Fair value hedges	280	–	106	128	46	56	–
Non-hedge accounted	13,342	3,726	3,106	6,408	102	56	(2,293)
Interest rate contracts:							
Fair value hedges	848	–	130	660	58	278	–
Non-hedge accounted	65	25	22	–	18	–	(4)
Commodity contracts:							
Non-hedge accounted	271	106	73	92	–	–	(89)
	14,806	3,857	3,437	7,288	224	390	(2,386)

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.

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

	Currencies purchased forward: Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At December 31, 2009					
Currencies sold forward:					
Sterling	**–**	**280**	**–**	**77**	**357**
US dollar	**11,508**	**–**	**1,094**	**810**	**13,412**
Euro	**–**	**–**	**–**	**371**	**371**
Other	**54**	**116**	**129**	**44**	**343**
At December 31, 2008					
Currencies sold forward:					
Sterling	–	280	–	43	323
US dollar	10,096	–	1,189	1,097	12,382
Euro	–	–	–	614	614
Other	2	44	166	91	303

Other derivative financial instruments are denominated in the following currencies:

	2009 £m	2008 £m
Sterling	**15**	18
US dollar	**498**	666
Euro	**500**	500

16 Financial instruments (continued)

Non-derivative financial instruments

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

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At December 31, 2009					
Assets					
Unlisted non-current investments	**49**	**–**	**4**	**5**	**58**
Trade receivables and similar items	**242**	**1,175**	**225**	**195**	**1,837**
Other non-derivative financial assets	**130**	**54**	**40**	**158**	**382**
Short-term investments	**–**	**–**	**–**	**2**	**2**
Cash at bank and in hand	**490**	**366**	**129**	**255**	**1,240**
Short-term deposits	**1,517**	**1**	**192**	**12**	**1,722**
	2,428	**1,596**	**590**	**627**	**5,241**
Liabilities					
Borrowings	**(893)**	**(332)**	**(683)**	**(5)**	**(1,913)**
Financial RRSPs	**–**	**(303)**	**(60)**	**–**	**(363)**
C Shares	**(13)**	**–**	**–**	**–**	**(13)**
Trade payables and similar items	**(886)**	**(811)**	**(221)**	**(224)**	**(2,142)**
Other non-derivative financial liabilities	**(187)**	**(86)**	**(23)**	**(85)**	**(381)**
	(1,979)	**(1,532)**	**(987)**	**(314)**	**(4,812)**
	449	**64**	**(397)**	**313**	**429**
At December 31, 2008					
Assets					
Unlisted non-current investments	46	1	4	2	53
Trade receivables and similar items	249	1,228	211	251	1,939
Other non-derivative financial assets	91	110	85	83	369
Short-term investments	–	–	–	1	1
Cash at bank and in hand	99	552	129	160	940
Short-term deposits	479	287	744	21	1,531
	964	2,178	1,173	518	4,833
Liabilities					
Borrowings	(203)	(385)	(746)	(14)	(1,348)
Financial RRSPs	–	(406)	(49)	–	(455)
Trade payables and similar items	(763)	(979)	(250)	(272)	(2,264)
Other non-derivative financial liabilities	(144)	(151)	(58)	(77)	(430)
	(1,110)	(1,921)	(1,103)	(363)	(4,497)
	(146)	257	70	155	336

Currency exposures

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

Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At December 31, 2009					
Sterling	**–**	**2**	**–**	**(2)**	**–**
US dollar	**9**	**–**	**(6)**	**4**	**7**
Other	**–**	**4**	**(1)**	**4**	**7**
At December 31, 2008					
Sterling	–	11	(4)	1	8
US dollar	6	–	–	8	14
Other	–	–	(2)	5	3

16 Financial instruments (continued)

Ageing beyond contractual due date

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

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
At December 31, 2009					
Unlisted non-current asset investments	**58**	**–**	**–**	**–**	**58**
Trade receivables and similar items	**1,509**	**237**	**67**	**24**	**1,837**
Other non-derivative financial assets	**363**	**14**	**3**	**2**	**382**
Derivative financial assets	**717**	**–**	**–**	**–**	**717**
Short-term investments	**2**	**–**	**–**	**–**	**2**
Cash at bank and in hand	**1,240**	**–**	**–**	**–**	**1,240**
Short-term deposits	**1,722**	**–**	**–**	**–**	**1,722**
	5,611	**251**	**70**	**26**	**5,958**
At December 31, 2008					
Unlisted non-current asset investments	53	–	–	–	53
Trade receivables and similar items	1,516	322	93	8	1,939
Other non-derivative financial assets	354	9	4	2	369
Derivative financial assets	390	–	–	–	390
Short-term investments	1	–	–	–	1
Cash at bank and in hand	940	–	–	–	940
Short-term deposits	1,531	–	–	–	1,531
	4,785	331	97	10	5,223

Contractual maturity analysis

	Gross values					
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
At December 31, 2009						
Borrowings	**(112)**	**(903)**	**(366)**	**(1,183)**	**651**	**(1,913)**
Derivative financial liabilities	**(66)**	**(55)**	**(424)**	**(113)**	**(15)**	**(673)**
Financial RRSPs	**(118)**	**(45)**	**(109)**	**(179)**	**88**	**(363)**
C Shares	**(13)**	**–**	**–**	**–**	**–**	**(13)**
Trade payables and similar items	**(2,139)**	**(2)**	**(1)**	**–**	**–**	**(2,142)**
Other non-derivative financial liabilities	**(377)**	**(2)**	**(1)**	**(1)**	**–**	**(381)**
	(2,825)	**(1,007)**	**(901)**	**(1,476)**	**724**	**(5,485)**
At December 31, 2008						
Borrowings	(92)	(202)	(1,005)	(313)	264	(1,348)
Derivative financial liabilities	(252)	(225)	(817)	(963)	(129)	(2,386)
Financial RRSPs	(56)	(177)	(127)	(198)	103	(455)
Trade payables and similar items	(2,255)	(5)	(4)	–	–	(2,264)
Other non-derivative financial liabilities	(408)	(21)	(1)	–	–	(430)
	(3,063)	(630)	(1,954)	(1,474)	238	(6,883)

16 Financial instruments (continued)

Interest rate risk

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

			2009				
			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]	8.6744%	**2**	2	–	–	–	–
Cash at bank and in hand[2]		**1,240**	1,240	–	–	–	–
Short-term deposits[3]		**1,722**	1,722	–	–	–	–
Unsecured bank loans							
€2.5m floating rate loan	EURIBOR + 1.2	**(1)**	(1)	–	–	–	–
€5m floating rate loan	EURIBOR + 0.5	**(4)**	(4)	–	–	–	–
Overdrafts[4]		**(4)**	(4)	–	–	–	–
75m Indian Rupee Fixed Rate Loan	9.8167%	**(1)**	(1)	–	–	–	–
Effect of interest rate swaps	6.1814%	**–**	15	–	–	–	(15)
£200m floating rate	GBP LIBOR + 0.267	**(200)**	(200)	–	–	–	–
Unsecured bond issues							
7 3/8% Notes 2016 £200m	7.3750%	**(200)**	–	–	–	–	(200)
5.84% Notes 2010 US$187m	5.8400%	**(120)**	–	(120)	–	–	–
Effect of interest rate swaps	USD LIBOR + 1.159	**–**	(120)	120	–	–	–
6.38% Notes 2013 US$230m	6.3800%	**(155)**	–	–	–	(155)	–
Effect of interest rate swaps	USD LIBOR + 1.26	**–**	(155)	–	–	155	–
6.55% Notes 2015 US$83m	6.5500%	**(57)**	–	–	–	–	(57)
Effect of interest rate swaps	USD LIBOR + 1.24	**–**	(57)	–	–	–	57
4 1/2% Notes 2011 €750m	4.5000%	**(677)**	–	–	(677)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.911	**–**	(677)	–	677	–	–
6.75% Notes 2019 £500m	6.7500%	**(493)**	–	–	–	–	(493)
Other secured							
Obligations under finance leases	5.0000%	**(1)**	–	–	–	–	(1)
		1,051	**1,760**	**–**	**–**	**–**	**(709)**

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.

16 Financial instruments (continued)

	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
			2008 Period in which interest rate reprices				
Short-term investments[1]	9.6769%	1	1	–	–	–	–
Cash at bank and in hand[2]		940	940	–	–	–	–
Short-term deposits[3]		1,531	1,531	–	–	–	–
Unsecured bank loans							
€2.5m floating rate loan	EURIBOR + 1.2	(2)	(2)	–	–	–	–
€5m floating rate loan	EURIBOR + 0.5	(5)	(5)	–	–	–	–
Overdrafts[4]		(9)	(9)	–	–	–	–
55m Indian Rupee Fixed Rate Loan	13.5455%	(1)	–	(1)	–	–	–
79.4m Norwegian Kroner Floating Rate Loan	NIBOR + 1.1	(8)	(8)	–	–	–	–
Effect of interest rate swaps	3.3521%	–	40	–	(22)	–	(18)
Unsecured bond issues							
$7^3/_8$% Notes 2016 £200m	7.3750%	(200)	–	–	–	–	(200)
5.84% Notes 2010 US$187m	5.8400%	(136)	–	–	(136)	–	–
Effect of interest rate swaps	USD LIBOR + 1.159	–	(136)	–	136	–	–
6.38% Notes 2013 US$230m	6.3800%	(178)	–	–	–	(178)	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(178)	–	–	178	–
6.55% Notes 2015 US$83m	6.5500%	(67)	–	–	–	–	(67)
Effect of interest rate swaps	USD LIBOR + 1.24	–	(67)	–	–	–	67
$4^1/_2$% Notes 2011 €750m	4.5000%	(738)	–	–	–	(738)	–
Effect of interest rate swaps	GBP LIBOR + 0.911	–	(738)	–	–	738	–
Other secured							
Obligations under finance leases	5.5226%	(4)	(3)	–	–	–	(1)
		1,124	1,366	(1)	(22)	–	(219)

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

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

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

	2009 £m	2008 £m
Expiring after two years	**450**	650

Business review
Corporate governance
Financial statements

16 Financial instruments (continued)

Sensitivity analysis

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

At December 31, 2009 if sterling had weakened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been £864m lower (2008 £890m). If sterling had strengthened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been £707m higher (2008 £728m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2009 if the euro had weakened ten per cent against the US dollar with all other variables held constant, profit after tax and equity for the year would have been £88m lower (2008 £102m). If the euro had strengthened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been £72m higher (2008 £84m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2009 if the price of commodities had been ten per cent lower, with all other variables remaining constant, profit after tax for the year and equity would have been £11m lower (2008 £13m). If the price of commodities had been ten per cent higher, with all other variables remaining constant, profit after tax and equity would have been £11m higher (2008 £13m), arising mainly as the result of higher fair value gains on derivatives. There would have been no change to the underlying results that exclude unrealised gains and losses on commodity derivatives.

At December 31, 2009 the Group had no material sensitivity to changes in interest rates on that date. The main interest rate sensitivity for the Group arises as a result of the gross up of net cash and this is mitigated as described under the interest rate risk management policies on page 64.

B Shares and C Shares and payments to shareholders

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. C Shares in respect of a year are issued in the following year. Shareholders are able to redeem any number of their C Shares for cash. Any C Shares retained attract a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. The Company has the option to compulsorily redeem the C Shares, at any time, if the aggregate number of C Shares in issue is less than ten per cent of the aggregate number of C Shares issued, or on the acquisition or capital restructuring of the Company.

From July 2004 to July 2008, the Company issued non-cumulative redeemable convertible preference shares (B Shares). The only significant difference was that B Shares, unlike C Shares, also carried the right to convert directly into ordinary shares. In September 2008, the Company exercised its option to compulsorily redeem all B Shares then in issue. The Company does not intend to issue B Shares in the future.

Movements in the B/C Shares during the year were as follows:

	2009		2008	
	C Shares of 0.1p each Millions	**C Shares Nominal value £m**	B Shares of 0.1p each Millions	B Shares Nominal value £m
Authorised				
At January 1, and December 31	**2,000,000**	**2,000**	1,000,000	1,000
Issued and fully paid				
At January 1	**–**	**–**	15,859	16
Issued	**263,776**	**264**	236,740	237
Converted into ordinary shares	**–**	**–**	(52,524)	(53)
Redeemed	**(251,199)**	**(251)**	(200,075)	(200)
At December 31	**12,577**	**13**	–	–

Payments to shareholders in respect of the year represent the value of C Shares to be issued in respect of the results for the year. Issues of C Shares were declared as follows:

	2009		2008	
	Pence per share	**£m**	Pence per share	£m
Interim	**6.00**	**111**	5.72	105
Final	**9.00**	**167**	8.58	158
	15.00	**278**	14.30	263

17 Provisions

	At December 31, 2008 £m	Exchange adjustments £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2009 £m
Warranty and guarantees	182	**(4)**	**(8)**	**87**	**(33)**	**224**
Contract loss	38	**(1)**	**–**	**39**	**(18)**	**58**
Restructuring	16	**–**	**(6)**	**8**	**(10)**	**8**
Customer financing	73	**(2)**	**–**	**14**	**(14)**	**71**
Insurance	38	**–**	**–**	**7**	**–**	**45**
Other	22	**(1)**	**–**	**17**	**(2)**	**36**
	369	**(8)**	**(14)**	**172**	**(77)**	**442**

Analysed as:

	2009 £m	2008 £m
Current liabilities	**210**	181
Non-current liabilities	**232**	188
	442	369

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 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 64. The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 22. It is estimated that the provision will be utilised as follows:

	2009 £m	2008 £m
Potential claims with specific claim dates:		
In one year or less	**3**	–
In more than one year but less than five years	**20**	6
In more than five years	**21**	27
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	**19**	31
Up to five years	**4**	4
Thereafter	**4**	5
	71	73

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.

18 Post-retirement benefits

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

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

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

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2009. The most recent funding valuations of the main UK schemes were:

Scheme	Valuation date
Rolls-Royce Pension Fund (RRPF)	March 31, 2009
Rolls-Royce Group Pension Scheme	April 5, 2007
Vickers Group Pension Scheme	March 31, 2007

Restatement

IFRIC 14 *IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* has been adopted in 2009. The interpretation requires that, where statutory funding requirements will result in an unrecognisable surplus arising in the future, a liability should be recognised. The rules of the RRPF are such that future contributions set out in the scheme's Recovery Plan will give rise to an unrecognisable surplus. In accordance with the transition rules of the interpretation, it has been applied from January 1, 2008, and the 2008 figures have been restated accordingly. The impact of adopting IFRIC 14 is as follows:

		Deferred tax (note 4)			
	Net post-retirement liability £m	Assets £m	Liabilities £m	Total £m	Retained earnings £m
At January 1, 2008, as previously reported	(123)	81	(345)	(264)	2,776
Adoption of IFRIC 14	(491)	51	87	138	(353)
At January 1, 2008, restated	(614)	132	(258)	(126)	2,423
At December 31, 2008, as previously reported	(142)	685	(307)	378	1,226
Adoption of IFRIC 14	(425)	119	–	119	(306)
At December 31, 2008, restated	(567)	804	(307)	497	920
Movements in 2008 recognised in other comprehensive income	66	68	(87)	(19)	

Amounts recognised in the income statement

	2009			2008		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost	**94**	**29**	**123**	127	27	154
Past service cost	**2**	**4**	**6**	5	3	8
Ex-gratia payment paid directly by the Group	**–**	**–**	**–**	8	–	8
	96	**33**	**129**	140	30	170
Defined contribution schemes	**8**	**29**	**37**	6	20	26
Operating cost	**104**	**62**	**166**	146	50	196
Financing (income)/costs in respect of defined benefit schemes:						
Expected return on assets	**(285)**	**(20)**	**(305)**	(352)	(21)	(373)
Interest on liabilities	**355**	**47**	**402**	358	37	395
	70	**27**	**97**	6	16	22
Total income statement charge	**174**	**89**	**263**	152	66	218

18 Post-retirement benefits (continued)

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2009 £m	2008 £m	2009 £m	2008 £m	2009 £m	2008 £m
Cost of sales	**94**	124	**27**	19	**121**	143
Commercial and administrative costs	**26**	33	**7**	5	**33**	38
Research and development	**9**	13	**3**	2	**12**	15
	129	170	**37**	26	**166**	196

The Group operates a PaySave scheme in the UK. This is a salary sacrifice scheme under which employees elect to stop making employee contributions and the Group makes additional contributions in return for a reduction in gross contractual pay. As a result, there is a decrease in wages and salaries and a corresponding increase in pension costs of £36m (2008 £38m) in the year.

Amounts recognised in other comprehensive income

	2009 £m	2008 £m
Actuarial gain on scheme assets	**(270)**	178
Experience gains on scheme liabilities	**(878)**	766
Movement in unrecognised surplus	**707**	(928)
Movement in minimum funding liability	**40**	66
	(401)	82

Defined benefit schemes

Assumptions

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

	2009		2008	
	UK schemes %	Overseas schemes %	UK schemes %	Overseas schemes %
Rate of increase in salaries	**4.7**	**4.0**	4.5	3.9
Rate of increase of pensions in payment	**3.3**	**2.2**	2.9	0.5
Discount rate	**5.7**	**5.9**	6.4	6.1
Expected rate of return on scheme assets	**5.4**	**7.4**	4.1	6.9
Inflation assumption	**3.6**	**2.6**	3.0	2.6

[1] Benefits accruing after April 5, 2005 are assumed to increase in payment at a rate of 1.9 per cent.

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

The overall expected rate of return is calculated by weighting the individual returns expected from each asset class (see page 134) in accordance with the actual asset balance in the schemes' investment portfolios.

The mortality assumptions adopted for the UK pension schemes are derived from the actuarial tables (PA92, other than RRPF which has adopted the SAPS tables in its 2009 valuation), with 80 per cent of long cohort, published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant scheme's actual experience. The resulting range of life expectancies in the principal UK schemes are as follows:

Life expectancy from age 65	
Current pensioner	19.6 years to 23.5 years
Future pensioner	20.7 years to 24.2 years

18 Post-retirement benefits (continued)

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

Amounts recognised in the balance sheet

	2009			December 31, 2008			January 1, 2008		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	**(6,714)**	**(406)**	**(7,120)**	(5,719)	(390)	(6,109)	(6,335)	(293)	(6,628)
Fair value of scheme assets	**7,048**	**354**	**7,402**	7,163	283	7,446	6,626	277	6,903
	334	**(52)**	**282**	1,444	(107)	1,337	291	(16)	275
Present value of unfunded obligations	**–**	**(417)**	**(417)**	–	(437)	(437)	–	(284)	(284)
Unrecognised surplus[1]	**(329)**	**(6)**	**(335)**	(1,036)	(6)	(1,042)	(110)	(4)	(114)
Minimum funding liability[2]	**(385)**	**–**	**(385)**	(425)	–	(425)	(491)	–	(491)
Net asset/(liability) recognised in the balance sheet	**(380)**	**(475)**	**(855)**	(17)	(550)	(567)	(310)	(304)	(614)
Analysed as:									
Post-retirement scheme surpluses	**75**	**–**	**75**	453	–	453	210	–	210
Post-retirement scheme deficits	**(455)**	**(475)**	**(930)**	(470)	(550)	(1,020)	(520)	(304)	(824)
	(380)	**(475)**	**(855)**	(17)	(550)	(567)	(310)	(304)	(614)

[1] Where a surplus has arisen on a scheme, in accordance with IAS 19 and IFRIC 14, the surplus is recognised as an asset only if it represents an unconditional economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet.

[2] A minimum funding liability arises where the statutory funding requirements are such that future contributions in respect of past service that will result in a future unrecognisable surplus.

Changes in present value of defined benefit obligations

	2009			2008		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
At January 1	**(5,719)**	**(827)**	**(6,546)**	(6,335)	(577)	(6,912)
Exchange adjustments	**–**	**67**	**67**	–	(196)	(196)
Current service cost	**(94)**	**(29)**	**(123)**	(127)	(27)	(154)
Past service cost	**(2)**	**(4)**	**(6)**	(5)	(3)	(8)
Finance cost	**(355)**	**(47)**	**(402)**	(358)	(37)	(395)
Contributions by employees	**(3)**	**(3)**	**(6)**	(4)	(2)	(6)
Net benefits paid out	**324**	**33**	**357**	331	25	356
Actuarial (losses)/gains	**(865)**	**(13)**	**(878)**	776	(10)	766
Transfers	**–**	**–**	**–**	3	–	3
At December 31	**(6,714)**	**(823)**	**(7,537)**	(5,719)	(827)	(6,546)
Funded schemes	**(6,714)**	**(406)**	**(7,120)**	(5,719)	(390)	(6,109)
Unfunded schemes	**–**	**(417)**	**(417)**	–	(437)	(437)

18 Post-retirement benefits (continued)

Changes in fair value of scheme assets

	2009 UK schemes £m	2009 Overseas schemes £m	2009 Total £m	2008 UK schemes £m	2008 Overseas schemes £m	2008 Total £m
At January 1	7,163	283	7,446	6,626	277	6,903
Exchange adjustments	–	(16)	(16)	–	63	63
Expected return on assets	285	20	305	352	21	373
Contributions by employer	232	56	288	248	31	279
Contributions by employees	3	3	6	4	2	6
Benefits paid out	(324)	(33)	(357)	(331)	(25)	(356)
Actuarial (losses)/gains	(311)	41	(270)	264	(86)	178
At December 31	7,048	354	7,402	7,163	283	7,446
Actual return on scheme assets			35			551

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

	2009 Expected rate of return %	2009 Market value £m	2008 Expected rate of return %	2008 Market value £m
UK schemes:				
LDI portfolios[1]	5.0	5,736	3.5	5,833
Equities	7.8	1,107	7.2	1,141
Sovereign debt	4.5	18	3.9	110
Corporate bonds	5.5	8	5.5	110
Other	4.6	179	1.9	(31)
	5.4	7,048	4.1	7,163
Overseas schemes:				
Equities	9.3	194	9.0	134
Corporate bonds	4.7	136	4.9	130
Other	6.5	24	5.9	19
	7.4	354	6.9	283

[1] A portfolio of gilt and swap contracts, backed by LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

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

The expected rate of return for LDI portfolios is determined by the implicit yield on the portfolio at the balance sheet date.
The expected rates of return on other individual categories of scheme assets are determined by reference to gilt yields. In the UK, equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25 per cent and 1.0 per cent per annum respectively.

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

Future contributions

The Group expects to contribute approximately £270m to its defined benefit schemes in 2010.

18 Post-retirement benefits (continued)

Sensitivities

The revised investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. A reduction of 0.25 per cent in the discount rate would increase the obligations of the principal UK defined benefit schemes by approximately £243m. An equivalent movement in interest rates would increase the fair value of the assets by approximately £290m. The difference arises largely due to differences in the methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is in excess of 80 per cent. The principal remaining risks relate to the assumptions for mortality and increases in salaries. If the age ratings in respect of the principal UK defined benefit schemes were increased by one year, the scheme liabilities would increase by £137m. If the rate of increase in salaries were 0.5 per cent higher, scheme liabilities would increase by £117m.

The defined benefit obligation relating to post-retirement medical benefits would increase by £47m if the healthcare trend rate increases by one per cent, and reduce by £38m if it decreases by one per cent. The pension expense relating to post-retirement medical benefits, comprising service cost and interest cost, would increase by £5m if the healthcare trend increases by one per cent, and reduce by £4m if it decreases by one per cent.

History of defined benefit schemes

The history of the schemes for the current and prior years is as follows:

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Balance sheet					
Present value of defined benefit obligation	**(7,537)**	(6,546)	(6,912)	(6,899)	(7,220)
Fair value of scheme assets	**7,402**	7,446	6,903	5,906	5,563
Unrecognised surplus	**(335)**	(1,042)	(114)	(2)	(2)
Minimum funding liability	**(385)**	(425)	–	–	–
Deficit	**(855)**	(567)	(123)	(995)	(1,659)
Experience gains/losses					
Actuarial (losses)/gains on scheme assets	**(270)**	178	161	132	588
Experience (losses)/gains on scheme liabilities	**(878)**	766	350	470	(868)
Movement in unrecognised surplus	**707**	(928)	(112)	–	(2)
Recognition of minimum funding liability on January 1, 2008	**–**	(491)	–	–	–
Movement in minimum funding liability	**40**	66	–	–	–
Total amount recognised in OCI	**(401)**	(409)	399	602	(282)
Cumulative amounts recognised in OCI since January 1, 2004	**(98)**	303	712	313	(289)

19 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Authorised					
At January 1, 2008 and December 31, 2009	**1**	**50,000**	**–**	**2,500**	**500**
Issued and fully paid					
At January 1, 2008	1	–	–	1,820	364
Exercise of share options	–	–	–	12	2
B Share conversion into ordinary shares	–	–	–	12	3
At January 1, 2009	**1**	**–**	**–**	**1,844**	**369**
Exercise of share options	–	–	–	10	2
At December 31, 2009	**1**	**–**	**–**	**1,854**	**371**

The rights attaching to each class of share are set out in the Directors' report on page 76.

In accordance with IAS 32 *Financial Instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 16.

20 Share-based payments

Share-based payment plans in operation during the year

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

Performance Share Plan (PSP)

This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market based performance condition (TSR).

ShareSave share option plan

Based on a three- or five-year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into. Vesting of the options is not subject to the achievement of a performance target. In the UK, the plan is HM Revenue & Customs approved. Overseas, employees in 33 countries participate in ShareSave plans through arrangements which provide broadly comparable benefits to the UK plan. From 2007 onwards, the overseas schemes are cash-settled schemes.

Executive Share Option Plan (ESOP)

This plan involved the grant of market value share options to participants. It expired in 2009 and no further grants may be made. Remaining options under the plan are subject to a non-market based performance condition (growth in EPS) and have a maximum contractual life of ten years.

Annual Performance Related Award (APRA) plan deferred shares

Deferred shares are awarded as part of the APRA plan. One third of the value of any annual bonus is delivered in the form of a deferred share award. The release of deferred share awards is not dependent on the achievement of any further performance conditions other than that participants remain employed by the Group for two years from the date of the award in order to retain the full number of shares. During the two-year deferral period, participants are entitled to receive dividends, or equivalent, on the deferred shares. For deferred share awards made from 2010 onwards, 40 per cent of the value of any annual bonus will be delivered in the form of a deferred share award.

Share Incentive Plan (SIP)

This is the 'Free Share' element of the UK Share Incentive Plan. Eligible UK employees may receive shares as part of the Company component of any bonus paid. There are no conditions attached to the shares.

Further information regarding the operation of the plans can be found on pages 81 to 83 of the Directors' remuneration report.

During the year the Group recognised a total expense of £31m (2008 £40m), of which £1.0m (2008 £0.4m) related to cash-settled arrangements. At December 31, 2009, the Group had a liability of £1.5m (2008 £0.6m) relating to cash-settled arrangements.

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

	Number of shares	
PSP	**2009 Millions**	2008 Millions
Outstanding at January 1	**13.2**	14.0
Awarded during the year	**10.1**	5.1
Forfeited during the year	**(0.7)**	(0.7)
Additional entitlements arising from TSR performance	**–**	1.3
Vested during the year	**(4.2)**	(6.5)
Outstanding at December 31	**18.4**	13.2

		2009		2008
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	**29.7**	**303p**	43.3	260p
Granted during the year	**11.9**	**387p**	–	–
Forfeited during the year	**(2.3)**	**352p**	(1.7)	333p
Exercised during the year	**(11.9)**	**192p**	(11.9)	144p
Outstanding at December 31	**27.4**	**384p**	29.7	303p
Exercisable at December 31	**–**	**–**	1.6	141p

20 Share-based payments (continued)

ESOP	2009 Number of share options Millions	2009 Weighted average exercise price Pence	2008 Number of share options Millions	2008 Weighted average exercise price Pence
Outstanding at January 1	**2.1**	**177p**	2.3	175p
Forfeited during the year	**(0.2)**	**209p**	–	–
Exercised during the year	**(0.7)**	**213p**	(0.2)	156p
Outstanding at December 31	**1.2**	**154p**	2.1	177p
Exercisable at December 31	**1.2**	**154p**	2.1	177p

Deferred shares under APRA	Number of shares 2009 Millions	Number of shares 2008 Millions
Outstanding at January 1	**2.8**	3.4
Awarded during the year	**2.3**	1.5
Forfeited during the year	**(0.1)**	(0.1)
Additional shares accrued from conversion/reinvestment of B/C Shares	**0.1**	0.1
Vested during the year	**(1.7)**	(2.1)
Outstanding at December 31	**3.4**	2.8

Free Shares under SIP	Number of shares 2009 Millions	Number of shares 2008 Millions
Awarded during the year	**1.2**	1.2

Options were exercised on a regular basis during the year. The average share price during the year was 386p (2008 382p).

Fair values

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

	2009	2008	2007	2006	2005
PSP awards – 25% TSR uplift	**253p**	458p	557p	494p	282p
PSP awards – 50% TSR uplift	**282p**	n/a	n/a	n/a	n/a
ShareSave – 3 year grants	**144p**	–	230p	–	131p
ShareSave – 5 year grants	**167p**	–	264p	–	154p
APRA deferred share awards	**290p**	440p	502p	448p	260p
SIP Free Share awards	**330p**	439p	499p	462p	257p

Details of the assumptions used in the calculation of these fair values are set out below. Expected volatility is based on the historical volatility of the Company's share price over the seven years prior to the grant or award date. Until 2007, expected dividends were based on the Company's payments to shareholders over the five years prior to the grant or award date. From 2008, expected dividends are based on the Company's payments to shareholders in respect of the previous year.

PSP awards

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

	2009	2008	2007	2006	2005
Weighted average share price	**260p**	430p	501p	444p	262p
Expected dividends	**14.70p**	13.00p	8.30p	7.92p	7.81p
Volatility	**32%**	29%	29%	32%	34%
Correlation	**35%**	29%	26%	19%	19%
Expected life	**3 years**	3 years	3 years	3 years	3 years
Risk free interest rate	**1.9%**	4.1%	5.2%	4.3%	4.9%

20 Share-based payments (continued)

As explained on page 82 of the Directors' remuneration report, the PSP has a TSR market-based performance condition, such that the Company's TSR over the performance period will be compared with the TSR of the companies constituting the FTSE 100 index on the date of grant. If the Company's TSR exceeds the median TSR of the FTSE 100, the number of shares that vest will be increased by 25 per cent. For conditional awards made from 2009 onwards, a further stretch was incorporated for certain senior executives, such that if TSR performance exceeds the upper quartile of the FTSE 100 index, awards are increased by 50 per cent, with straight-line vesting between median and upper quartile performance. The fair values of the awards of shares under the PSP have 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 of the award 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:

	2009	2007	2005	2003
Weighted average share price	**462p**	553p	351p	173p
Exercise price	**387p**	416p	298p	142p
Volatility	**36%**	37%	40%	43%
Expected dividends	**14.30p**	8.80p	7.86p	7.61p
Expected life[1] – 3 year ShareSave	**3.3-3.8 years**	3.3-3.8 years	3.3-3.8 years	3.2-3.7 years
– 5 year ShareSave	**5.3-5.8 years**	5.3-5.8 years	5.3-5.8 years	5.2-5.7 years
Risk free interest rate	**2.4%**	5.0%	4.4%	4.6%

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

Deferred shares under APRA and Free Shares under SIP

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

Share options outstanding

At December 31, 2009, the following ordinary shares were subject to options:

	Date of grant	Number	Exercise price	Exercisable dates
Executive Share Option Plan	2000	61,638	194p	2010
	2001	500,440	216p	2010-2011
	2001	8,161	218p	2010-2012
	2002	157,061	188p	2010-2012
	2003	513,061	77p	2010-2013
ShareSave plans	2005	4,576,045	298p	2010/2011
	2007	10,949,312	416p	2011/2013
	2009	11,905,178	387p	2013/2015

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to 42 directors and senior executives were outstanding at December 31, 2009.

21 Operating and finance leases

Operating leases

Leases as lessee

		2009 £m	2008 £m
Rentals paid	– hire of plant and machinery	**68**	64
	– hire of other assets	**24**	25
Non-cancellable operating lease rentals are payable as follows:			
Within one year		**82**	104
Between one and five years		**182**	163
After five years		**123**	205
		387	472

Leases as lessor

	2009 £m	2008 £m
Rentals received – credited within revenue from aftermarket services	**22**	26
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	**5**	6
Between one and five years	**11**	13
After five years	**5**	3
	21	22

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

- Sublease payments of £18m (2008 £15m) and sublease receipts of £11m (2008 £11m) were recognised in the income statement in the year.
- Purchase options exist on aero engines, land and buildings and plant and equipment with the period to the purchase option date varying between one to five years.
- Renewal options exist on aero engines, land and buildings and plant and equipment with the period to the renewal option varying between one to 21 years at terms to be negotiated upon renewal.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total future minimum sublease payments expected to be made is £14m (2008 £88m) and sublease receipts expected to be received is £4m (2008 £6m).

Finance leases

Finance lease liabilities are payable as follows:

	2009 Payments £m	2009 Interest £m	2009 Principal £m	2008 Payments £m	2008 Interest £m	2008 Principal £m
Within one year	**–**	**–**	**–**	4	1	3
Between one and five years	**1**	**–**	**1**	–	–	–
After five years	**–**	**–**	**–**	1	–	1
	1	**–**	**1**	5	1	4

There were no contingent rents recognised as an expense in the year (2008 £nil). The future minimum sublease receipts expected under non-cancellable subleases is £4m (2008 £6m).

22 Contingent liabilities

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

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

The discounted values of contingent liabilities relating to delivered aircraft and other arrangements where financing is in place, less insurance arrangements and relevant provisions, were:

	2009		2008	
	£m	***$m***	£m	*$m*
Gross contingent liabilities	**704**	***1,137***	775	*1,086*
Contingent liabilities net of relevant security[1]	**134**	***217***	155	*222*
Contingent liabilities net of relevant security reduced by 20 per cent[2]	**233**	***376***	246	*354*
[1] Security includes unrestricted cash collateral	**77**	***124***	85	*123*

[2] Although sensitivity calculations are complex, the reduction of relevant security by 20 per cent illustrates the sensitivity of the contingent liability to changes in this assumption.

There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Group has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. These include claims, which are yet to be substantiated, received by EPI Europrop International GmbH (EPI) in which the Group is a partner, which is developing the TP400 engine for the Airbus A400M aircraft. 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.

There is continuing uncertainty about the A400M programme. Airbus is currently in negotiation with its customers to determine the future of the programme. The timing and outcome of these negotiations, and their possible impact on EPI and the Group, is uncertain. In the event that the programme were cancelled, at December 31, 2009, the Group's balance sheet included net assets of £17m in relation to the programme, which would require impairment.

23 Related party transactions

	2009 £m	2008 £m
Sales of goods and services to joint ventures and associates	**2,136**	1,555
Purchases of goods and services from joint ventures and associates	**(1,900)**	(1,482)
Operating lease payments to joint ventures and associates	**(45)**	(36)
Guarantees of joint ventures' and associates' borrowings	**15**	13
Dividends received from joint ventures and associates	**77**	59
RRSP receipts from joint ventures and associates	**7**	19
Interest received from joint ventures and associates	**–**	2
Other income received from joint ventures and associates	**52**	102

The aggregated balances with joint ventures are shown in notes 12 and 15. Transactions with Group pension schemes are shown in note 18.

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.

Key management personnel are deemed to be the directors and the members of the Group Executive as set out on pages 66 to 69. Remuneration for key management personnel is shown below:

	2009 £m	2008 £m
Salaries and short-term benefits	**11**	9
Post-retirement schemes	**2**	2
Share-based payments	**4**	6
	17	17

More detailed information regarding the directors' remuneration, shareholdings, pension entitlements, share options and other long-term incentive plans is shown in the Directors' remuneration report on pages 80 to 90.

24 Acquisitions and disposals

During the year, the Group acquired 58 per cent of the shares of Tidal Generation Limited (previously a joint venture with a Group interest of 42 per cent) and 49 per cent of shares in Europea Microfusioni Aerospaziali S.p.A. (previously a subsidiary with a Group interest of 51 per cent) as summarised below:

	Total £m
Trade and other receivables	2
Cash at bank and in hand	3
Trade and other payables	(1)
Net assets acquired	4
Goodwill arising	6
Acquisition cost	10
Less cash in acquired businesses	(3)
Cash outflow per cash flow statement	7

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

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

	Total £m
Trade and other receivables	2
Assets held for resale	2
Net assets	4
Profit on sale or termination of businesses	(2)
Disposal proceeds	2
Receipt of proceeds deferred at December 31, 2008	1
Cash inflow per cash flow statement	3

Company balance sheet

At December 31, 2009

	Notes	2009 £m	2008 £m
Fixed assets			
Investments in shares in subsidiary undertakings at cost	2	**2,261**	2,230
Current assets			
Amounts owed by subsidiary undertakings due within one year		**–**	165
Cash at bank		**2**	2
		2	167
Creditors – amounts falling due within one year			
Financial liabilities	3	**(13)**	–
Amounts owed to subsidiary undertakings due within one year		**(71)**	–
		(84)	–
Net current assets		**(82)**	167
Total assets less current liabilities		**2,179**	2,397
Net assets		**2,179**	2,397
Capital and reserves			
Called-up share capital	4	**371**	369
Share premium account	5	**98**	82
Merger reserve	5	**–**	214
Capital redemption reserves	5	**968**	767
Other reserve	5	**108**	77
Own shares reserve	5	**(27)**	(35)
Profit and loss account	5	**661**	923
Equity shareholders' funds		**2,179**	2,397

The financial statements on pages 143 to 145 were approved by the Board on February 10, 2010 and signed on its behalf by:

Simon Robertson Chairman

Andrew Shilston Finance Director

Reconciliation of movements in shareholders' funds

For the year ended December 31, 2009

	2009 £m	2008 £m
At January 1	**2,397**	2,607
Profit/(loss) for the year	**–**	(1)
Arising on issue of ordinary shares	**18**	17
Issues of B/C Shares	**(263)**	(237)
Conversion of B Shares into ordinary shares	**–**	53
Ordinary shares purchased	**(17)**	(71)
Share-based payment adjustments	**44**	29
At December 31	**2,179**	2,397

Notes to the Company financial statements

1 Accounting policies

Basis of accounting
The financial statements have been prepared in accordance with applicable UK Accounting Standards on the historical cost basis.

As permitted by section 408 of the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements. As permitted by the audit fee disclosure regulations, disclosure of non-audit fee information is not included in respect of the Company. As permitted by FRS 1 *Cash flow statements*, no cash flow statement for the Company has been included. As permitted by FRS 8 *Related party transactions*, no related party disclosures for the Company have been included.

Investments in subsidiary undertakings
Investments in subsidiary undertakings are reported at cost less any amounts written off.

Share-based payments
As described in the Directors' remuneration report on pages 80 to 90, the Company grants awards of its own shares to employees of its subsidiary undertakings, (see note 20 of the consolidated financial statements). The costs of share-based payments in respect of these awards are accounted for, by the Company, as an additional investment in its subsidiary undertakings. The costs are determined in accordance with FRS 20 *Share-based payment*. Any payments made by the subsidiary undertakings in respect of these arrangements are treated as a return of this investment.

Own shares for settlement of share-based payment plans
Where the Company acquires its own shares for the purpose of satisfying share-based payment plans, the cost in excess of any exercise price payable by the plan participants is written off to the profit and loss reserve.

Current assets
Amounts are recognised at the lower of cost and net realisable value.

Financial instruments
In accordance with FRS 25 *Financial instruments: Presentation*, the Company's C Shares are classified as financial liabilities and held at amortised cost from the date of issue until redeemed.

Taxation
Provision for taxation is made at the current rate and, in accordance with FRS 19 *Deferred tax*, for deferred taxation at the projected rate on timing differences that have originated, but not reversed at the balance sheet date.

2 Investments – subsidiary undertakings

	£m
Cost:	
At January 1, 2009	**2,230**
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	31
At December 31, 2009	**2,261**

3 Financial liabilities

C Shares
Movements in the C Shares during the year were as follows:

	C Shares of 0.1p Millions	Nominal value £m
Authorised		
At January 1, and December 31, 2009	**2,000,000**	**2,000**
Issued and fully paid		
At January 1, 2009	–	–
Shares issued	263,776	264
Shares redeemed	(251,199)	(251)
At December 31, 2009	**12,577**	**13**

Rights attaching to C Shares are described in the Directors' report on page 76.

4 Share capital

	Special Share of £1 (Non-equity)	Preference shares of £1 each (Non-equity)	Nominal value £m (Non-equity)	Ordinary shares of 20p each Millions (Equity)	Nominal value £m (Equity)
Authorised					
At January 1, 2008 and December 31, 2009	**1**	**50,000**	**–**	**2,500**	**500**
Issued and fully paid					
At January 1, 2008	1	–	–	1,820	364
Exercise of share options	–	–	–	12	2
B Share conversion into ordinary shares	–	–	–	12	3
At January 1, 2009	**1**	**–**	**–**	**1,844**	**369**
Exercise of share options	–	–	–	10	2
At December 31, 2009	**1**	**–**	**–**	**1,854**	**371**

The rights attaching to each class of share are set out in the Directors' report on page 76.

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 3.

5 Movements in capital and reserves

	Share capital £m	Share premium £m	Merger reserve £m (Non-distributable reserves)	Capital redemption reserves £m (Non-distributable reserves)	Other reserve[1] £m (Non-distributable reserves)	Own shares reserve[2] £m (Non-distributable reserves)	Profit and loss account £m	Total £m
At January 1, 2009	**369**	**82**	**214**	**767**	**77**	**(35)**	**923**	**2,397**
Result for the year	–	–	–	–	–	–	–	–
Arising on issue of ordinary shares	2	16	–	–	–	–	–	18
Issue of C Shares	–	–	(214)	(50)	–	–	1	(263)
Redemption of C Shares	–	–	–	251	–	–	(251)	–
Own shares purchased	–	–	–	–	–	(17)	–	(17)
Own shares vesting in share-based payment plans	–	–	–	–	–	25	(25)	–
Share-based payment adjustments	–	–	–	–	31	–	13	44
At December 31, 2009	**371**	**98**	**–**	**968**	**108**	**(27)**	**661**	**2,179**

[1] The 'Other reserve' represents the value of share-based payments in respect of employees of subsidiary undertakings for which payment has not been received.
[2] At December 31, 2009, the Company held 7,156,197 shares (2008 8,017,635) with a net book value of £27m (2008 £35m).

6 Contingent liabilities

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, 2009 these guarantees amounted to £1,876m (2008 £1,273m).

7 Other information

Emoluments of directors
The remuneration of the directors of the Company is shown in the Directors' remuneration report on pages 80 to 90.

Employees
The Company had no employees in 2009 and 2008.

Share-based payments
Shares in the Company have been granted to employees of the Group as part of share-based payment plans and are charged in the employing company.

Principal subsidiary undertakings

At December 31, 2009

Incorporated within the UK – held by Rolls-Royce Group plc

Rolls-Royce plc	Principal trading company

Incorporated within the UK – indirectly held

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

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

Incorporated overseas – indirectly held

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

The above companies operate principally in the country of their incorporation.
The effective Group interest is 100 per cent.

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

Principal joint ventures and associates

At December 31, 2009

Joint ventures

Incorporated within the UK – indirectly held

	Class	% of class held	% of total equity held
Airtanker Holdings Limited Strategic tanker aircraft PFI project	Ordinary	20	20
Airtanker Services Limited Provision of aftermarket services for strategic tanker aircraft	Ordinary	22	22
Alpha Partners Leasing Limited Aero engine leasing	A Ordinary B Ordinary	100 –	50
Composite Technology & Applications Limited Development of aero engine fan blades	A Ordinary B Ordinary	100 –	51
Genistics Holdings Limited Trailer-mounted field mobile generator sets	A Ordinary B Ordinary	100 –	50
Rolls-Royce Goodrich Engine Control Systems Limited Development and manufacture of aero engine controls	Ordinary	50	50
Rolls-Royce Snecma Limited (UK & France) Aero engine collaboration	A Shares B Shares	– 100	50
Rolls-Royce Turbomeca Limited (UK & France) Aero engine collaboration	A Shares B Shares	– 100	50
Rolls Wood Group (Repair and Overhauls) Limited Industrial gas turbine repair and overhaul	A Ordinary B Ordinary	100 –	50
TRT Limited Aero engine turbine blade repair services	A Ordinary B Ordinary	– 100	49.5
Turbine Surface Technologies Limited Aero engine turbine surface coatings	A Ordinary B Ordinary	– 100	50
Turbo-Union Limited (UK, Germany & Italy) RB199 engine collaboration	Ordinary A Shares	40 37.5	40

Business review
Corporate governance
Financial statements

Principal joint ventures and associates (continued)

At December 31, 2009

Joint ventures

Incorporated overseas – indirectly held

		Class	% of class held	% of total equity held
China	Xian XR Aero Components Co Limited Manufacturing facility for aero engine parts	Ordinary	49	49
Germany	EPI Europrop International GmbH (effective interest 35.5%) A400M engine collaboration	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) EJ200 engine collaboration	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) MTR390 engine collaboration	Ordinary	33.3	33.3
Germany	N3 Engine Overhaul Services Verwaltungsgesellschaft mbh Aero engine repair and overhaul	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited Aero engine repair and overhaul	Ordinary	45	45
Israel	Techjet Aerofoils Limited Manufacture of compressor aerofoils for gas turbines	A Ordinary B Ordinary	50 50	50
Malaysia	Advanced Gas Turbine Solutions Sdn Bhd Industrial gas turbine aftermarket services	Ordinary	49	49
Singapore	International Engine Component Overhaul Pte Limited Aero engine repair and overhaul	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%) Aero engine repair and overhaul	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA Aero engine component manufacture and maintenance	Ordinary	46.9	46.9
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & US) V2500 engine collaboration	A Shares B Shares C Shares D Shares	100 – – –	32.5
US	Alpha Leasing (US) LLC, Alpha Leasing (US) (No.2) LLC, Alpha Leasing (US) (No.4) LLC, Alpha Leasing (US) (No.5) LLC, Rolls-Royce & Partners Finance (US) LLC, Rolls-Royce & Partners Finance (US) (No.2) LLC Aero engine leasing	Partnerships	50	–
US	Exostar LLC Business to business internet exchange	Partnership	17.6	–
US	GE Rolls-Royce Fighter Engine Team LLC F136 development engine for the Joint Strike Fighter (JSF) Programme	Partnership	40	–
US	Texas Aero Engine Services, LLC Aero engine repair and overhaul	Partnership	50	–
US	Williams-Rolls Inc. (UK & US) Small aero engine collaboration	Common	15	15

Unincorporated overseas – held by subsidiary undertaking

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

Associate

Incorporated overseas – held by subsidiary undertaking

Norway	ODIM ASA Provider of specialist marine handling systems	Ordinary	33	33

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

Independent auditors' report

to the members of Rolls-Royce Group plc

We have audited the financial statements of Rolls-Royce Group plc for the year ended December 31, 2009 set out on pages 92 to 148. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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 auditors' 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

As explained more fully in the Directors' responsibilities statement set out on page 78, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's website at www.frc.org.uk/apb/scope/UKP.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at December 31, 2009 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice;
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' remuneration report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, set out on page 79, in relation to going concern; and
- the part of the Corporate governance statement on page 66 relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review.

A J Sykes (Senior Statutory Auditor)
for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
8 Salisbury Square
London
EC4Y 8BB
February 10, 2010

Group five-year review

For the years ended December 31

Income statement	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Revenue	**10,414**	9,082	7,435	7,156	6,603
Profit before net research and development and share of joint ventures and associates	**1,458**	1,191	827	1,016	1,113
Research and development (net) [1]	**(379)**	(403)	(381)	(370)	(282)
Share of profit of joint ventures and associates	**93**	74	66	47	46
Profit before financing	**1,172**	862	512	693	877
Net financing	**1,785**	(2,754)	221	698	(400)
Profit/(loss) before taxation [2]	**2,957**	(1,892)	733	1,391	477
Taxation	**(740)**	547	(133)	(397)	(130)
Profit/(loss) for the year	**2,217**	(1,345)	600	994	347
Attributable to:					
Equity holders of the parent	**2,221**	(1,340)	606	998	350
Minority interests	**(4)**	(5)	(6)	(4)	(3)
Profit/(loss) for the year	**2,217**	(1,345)	600	994	347
[1] Research and development (gross)	**(864)**	(885)	(824)	(747)	(663)
[2] Underlying profit before taxation	**915**	880	800	705	593
Earnings per ordinary share:					
Underlying	**39.67p**	36.70p	34.06p	29.81p	24.48p
Basic	**120.38p**	(73.63p)	33.67p	57.32p	20.11p
Payments to shareholders per ordinary share	**15.00p**	14.30p	13.00p	9.59p	8.72p

Balance Sheet	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Assets	**15,422**	15,348	11,459	10,798	9,627
Liabilities	**(11,640)**	(13,123)	(7,910)	(8,073)	(8,122)
	3,782	2,225	3,549	2,725	1,505
Called-up share capital	**371**	369	364	356	352
Reserves	**3,411**	1,847	2,815	2,362	1,147
Equity attributable to equity holders of the parent	**3,782**	2,216	3,179	2,718	1,499
Minority interests	**–**	9	12	7	6
	3,782	2,225	3,191	2,725	1,505

Cash flow	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Cash inflow from operating activities	**859**	1,015	705	1,072	1,060
Cash outflow from investing activities	**(606)**	(645)	(572)	(469)	(289)
Cash inflow/(outflow) from financing activities	**384**	(221)	(473)	(122)	(443)
Increase/(decrease) in cash and cash equivalents	**637**	149	(340)	481	328
Net funds	**1,275**	1,458	888	826	335

Shareholder information

to the members of Rolls-Royce Group plc

Financial calendar 2010-2011

Ex entitlement to C Shares	April 21, 2010
Record date for entitlement to C Shares	April 23, 2010
Annual General Meeting, Queen Elizabeth II Conference Centre, London	11.00am April 28, 2010
Deadline for receipt of C Share elections	5.00pm June 4, 2010
Record date for dividend payable on C Shares	June 4, 2010
Allotment of C Shares	July 1, 2010
Payment of C Share redemption monies	July 2, 2010
Purchase of ordinary shares for CRIP participants	By July 13, 2010
Announcement of interim results	July 29, 2010
Ex entitlement to C Shares	October 27, 2010
Record date for entitlement to C Shares	October 29, 2010
Deadline for receipt of C Share elections	5.00pm December 3, 2010
2010 Financial year end	December 31, 2010
Allotment of C Shares	January 4, 2011
Payment of C Share redemption monies	January 5, 2011
Purchase of ordinary shares for CRIP participants	By January 13, 2011
Preliminary announcement – 2010 full year results	February, 2011
2010 Annual report published	March, 2011

Registrar

Our Registrar is Computershare Investor Services PLC. When making contact with the Registrar please quote your Shareholder Reference Number (SRN). This is a 10-digit number, which usually starts with the letter 'C' and which can be found on the right hand side of your share certificate. You can speak to a member of the Registrar's Rolls-Royce team by calling +44 (0)870 703 0162 between 8.30am and 5.30pm Monday to Friday or you can write to them at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol, BS13 8AE.

Information available on the internet

You can access copies of the Annual report, Company announcements and much more at www.rolls-royce.com.

You can also visit our Registrar's website at www.investorcentre.co.uk to:

- view your account balance, values and history;
- view your payment history;
- update a record of your bank details;
- register to receive electronic shareholder communications;
- download forms;
- deal in Rolls-Royce shares online;
- vote online for forthcoming general meetings;
- view your holdings in all companies registered with Computershare and create a portfolio; and
- track the market value of your portfolio.

Share dealing service

Our Registrar offers both internet and telephone dealing services. You can deal over the telephone or on the internet from 8.00am to 4.30pm Monday to Friday excluding Bank holidays. Real-time trading is available on the internet during market hours and there is no need to open a trading account in order to deal. The fee for the service is 0.5 per cent of the value of each sale or purchase of shares subject to a minimum fee of £15. The maximum value of shares you can trade using the internet is £25,000 for purchases and £50,000 for sales. Please note that the internet dealing service is only available to existing shareholders at www-uk.computershare.com/investor/sharedealing.asp.

The fee for the Telephone Share Dealing Service is one per cent of the value of the transaction subject to a minimum fee of £25. If you would like to use this service please call +44 (0)870 703 0084. Stamp duty of 0.5 per cent is also payable on all purchases.

Share price

You can obtain the current market price of the Company's shares on our website at www.rolls-royce.com or from Teletext, Ceefax or similar services or on the London Stock Exchange website at www.londonstockexchange.com.

American Depositary Receipts Programme (ADR)

Rolls-Royce ordinary shares are traded in the US in the form of a sponsored ADR facility with The Bank of New York Mellon as the depositary. Each ADR represents five ordinary shares.

For further information about the US ADR programme, please contact your broker or write to:

BNY Mellon
Shareholder Services
PO Box 358516
Pittsburgh PA 15252-8516
Phone: +1 888 269 2377 or +1 888 BNY ADRS (toll free within the US)
Phone outside the US: +1 201 680 6825
Email: shrrelations@bnymellon.com
Website: www.adrbnymellon.com

Unsolicited mail

The Company is legally obliged to supply the names and addresses of its members to certain organisations on request. Because of this, you may receive mail you have not asked for. If you want to limit the amount of personally addressed unsolicited mail you receive, and you have a UK registered address, please write to the Mailing Preference Service (MPS), DMA House, 70 Margaret Street, London, W1W 8SS or register by telephoning +44 (0)845 703 4599 or online at www.mpsonline.org.uk.

Shareholder information (continued)
to the members of Rolls-Royce Group plc

ShareGift
The Orr Mackintosh Foundation operates a charity donation scheme for shareholders with small numbers of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at www.sharegift.org or you can write to Orr Mackintosh Foundation, 17 Carlton House Terrace, London SW1Y 5AH (telephone +44 (0)20 7930 3737).

Warning to shareholders
We are aware that some shareholders have received unsolicited phone calls or correspondence concerning investment matters. These are typically from overseas based 'brokers' who target UK shareholders, offering to sell them what often turn out to be worthless or high risk shares in US or UK investments. Such operations are commonly known as 'boiler rooms'. These 'brokers' can be very persistent and extremely persuasive and a 2006 survey by the Financial Services Authority (FSA) has reported that the average amount lost by each investor is around £20,000.

Shareholders are advised to be very wary of any unsolicited advice, offers to buy shares at a discount or offers of free company reports. If you receive any unsolicited investment advice:
- Make sure you get the correct name of the person and organisation.
- Check that they are properly authorised by the FSA before getting involved by visiting www.fsa.gov.uk/pages/register.
- Report the matter to the FSA. For UK callers telephone 0300 500 5000 and for overseas callers telephone +44 20 7066 1000 or visit www.moneymadeclear.fsa.gov.uk.
- If the calls persist, hang up.

If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme.

Dividends paid on C Shares held

C Share calculation period	Dividend rate (%)	Record date for C Share dividend	Payment date
July 1, 2009 – December 31, 2009	1.055	November 20, 2009	January 4, 2010
January 1, 2009 – June 30, 2009	1.110	June 5, 2009	July 1, 2009

Previous C Share Issues

				Apportionment values		CGT apportionment				
Issue date	No of C Shares issued per ordinary share	Record date for entitlement to C Shares	Latest date for receipt of election forms by Registrar	Price of ordinary shares on first day of trading (p)*	Value of C Share issues per ordinary share (p)**	Ordinary shares (%)	C Shares (%)	Date of redemption of C Shares	CRIP purchase date	CRIP purchase price (p)
January 4, 2010	60.0	October 30, 2009	December 4, 2009	486.250	6.00	98.78	1.22	January 5, 2010	January 8, 2010	491.970
July 2, 2009	85.8	April 24, 2009	June 5, 2009	366.500	8.58	97.71	2.29	July 2, 2009	July 3, 2009	367.628
January 2, 2009	57.2	October 31, 2008	December 5, 2008	343.125	5.72	98.36	1.64	January 5, 2009	January 6, 2009	362.240

Details of previous B Share issues can be found in the investors section on the Group's website at www.rolls-royce.com.

Analysis of ordinary shareholders at December 31, 2009

Type of holder:	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	226,717	97.52	130,632,130	7.05
Institutional and other investors	5,776	2.48	1,723,454,910	92.95
Total	232,493	100.00	1,854,087,040	100.00
Size of holding:				
1 – 150	69,016	29.69	7,043,918	0.38
151 – 500	121,350	52.20	31,407,665	1.69
501 – 10,000	40,068	17.23	67,226,364	3.63
10,001 – 100,000	1,430	0.61	37,527,196	2.02
100,001 – 1,000,000	438	0.19	155,217,055	8.37
1,000,001 and over	191	0.08	1,555,664,842	83.91
Total	232,493	100.00	1,854,087,040	100.00

Designed and produced by salterbaxter

Photography credits: Airbus Industrie, BAE Systems plc, The Boeing Company, United States Department of Defense, Gulfstream Aerospace Corporation, Lockheed Martin Corporation, Marcus Ginns, The Ministry of Defence, Peak Photographic.

This document is printed on Revive 50:50 Silk which has been independently certified according to the rules of the Forestry Stewardship Council (FSC). Revive 50:50 Silk contains 50 per cent recycled fibre bleached in an Elementally Chlorine Free (ECF) process. The manufacturing mill is accredited with the ISO 14001 Environmental Standard. This document has been printed using vegetable based inks and is recyclable.

Printed by St Ives Westerham Press Ltd. ISO 14001:2004,
FSC certified and CarbonNeutral®.

Rolls-Royce Group plc
Registered office:
65 Buckingham Gate
London
SW1E 6AT

T +44(0)20 7222 9020
www.rolls-royce.com

Company number 4706930