Rolls-Royce

Annual report 2005

Company profile

Rolls-Royce is a global business providing power systems for use on land, at sea and in the air. The Group has a balanced business portfolio with leading positions in the civil and defence aerospace, marine and energy markets.

There are some 54,000 Rolls-Royce gas turbines in service and they generate a demand for high-value services throughout their operational lives.

Rolls-Royce is a technology leader, employing 36,200 people in offices, manufacturing and service facilities in 50 countries.

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Group financial highlights

Note: for background to the change from UK GAAP accounting to IFRS in 2005, and the retrospective adjustments made to the 2004 accounts, see the relevant section on IFRS in the Finance Director's review on page 29 and note 33 to the financial statements on page 96. 2003 and earlier figures are as reported under UK GAAP.

£24.4bn

Order book – firm and announced £bn

1996	7.7
1997	10.1
1998	12.6
1999	13.2
2000	14.5
2001	16.7
2002	17.1
2003	18.7
2004	21.3
2005	**24.4**

£6.6bn

Sales £bn

1996	3.9
1997	4.3
1998	4.5
1999	4.6
2000	5.9
2001	6.3
2002	5.8
2003	5.6
2004	5.9
2005	**6.6**

£546m

Cash flow before acquisitions and disposals £m

1996	-9
1997	9
1998	2
1999	2
2000	57
2001	110
2002	-22
2003	255
2004	235
2005	**546**

£282m

Net research and development £m

1996	217
1997	268
1998	310
1999	337
2000	371
2001	358
2002	297
2003	281
2004	288
2005	**282**

£248m

Capital investment – property, plant and equipment additions at cost £m

1996	143
1997	229
1998	368
1999	412
2000	253
2001	221
2002	344
2003	186
2004	191
2005	**248**

£877m

Profit before financing costs £m

1996	-21
1997	289
1998	342
1999	413
2000	289
2001	311
2002	212
2003	270
2004	417
2005	**877**

£679m

Underlying profit before financing costs* £m

1996	237
1997	289
1998	333
1999	421
2000	559
2001	594
2002	362
2003	375
2004	417
2005	**679**

* see note 2

20.11p

Earnings per share p

1996	-3.19
1997	13.53
1998	16.51
1999	15.60
2000	5.07
2001	6.67
2002	3.29
2003	7.04
2004	15.56
2005	**20.11**

24.14p

Underlying earnings per share* p

1996	12.70
1997	13.53
1998	16.18
1999	16.47
2000	19.38
2001	20.20
2002	11.10
2003	12.20
2004	15.56
2005	**24.14**

* see note 7

Rolls-Royce derives its revenues from original equipment sales and high value-added, product-related services in broadly equal measure.

Our four business sectors are all focused on power systems and they share a common technology base.

Civil aerospace

2005 highlights

Orders for 246 Trent engines worth approximately US$3 billion were announced.

The Airbus A380, powered by the Trent 900 engine, made a successful maiden flight and good progress through its comprehensive flight-test programme.

Agreement was reached with Airbus for Rolls-Royce to supply the Trent 1700 to power the new A350 airliner.

The 1,000th BR710 engine was delivered to Gulfstream to power its G550 long-range business jet.

International Aero Engines (IAE) achieved a record order intake of approximately 600 engines worth over US$1.5 billion to Rolls-Royce.

Sales

£3,510m

53% of Group sales

Marine

2005 highlights

A £137 million service and support contract was secured for ships in service with the Royal Navy and the French, Belgian and Royal Netherlands navies.

The first MT30 marine gas turbine was delivered to power land-based test runs of the US Navy's DD(X) destroyer.

Lockheed Martin installed two MT30 marine gas turbines on the first prototype Littoral Combat Ship for the US Navy.

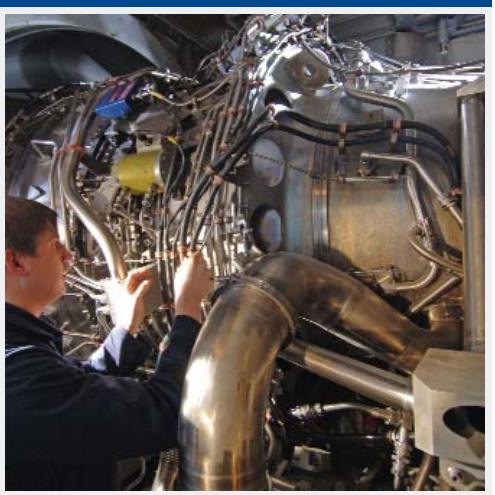
A University Technology Centre (UTC) was established by the Group in Norway to conduct research programmes in the marine sector.

A new marine facility in Shanghai was formally opened.

Sales

£1,097m

17% of Group sales



Group

Group sales

£6.6bn
Turnover

150
Customer countries

36,200
Employees

Overview

Rolls-Royce is a global power-systems business with offices, manufacturing and service facilities in 50 countries. The Group invests in technology and capabilities that can be exploited across all of its market sectors: civil aerospace, defence aerospace, marine and energy.

Breakdown of sales

46% Original equipment

54% Aftermarket services

2005 highlights

- Record firm order book at £22.9 billion
- Sales increased to £6,603 million
- Services revenues, including 100 per cent of repair and overhaul joint ventures, increased by 12 per cent, on an underlying basis
- Underlying profit before taxation increased to £584 million
- Average net debt fell to £260 million

Note: Sales analysis excludes Financial Services, £78 million (2004 £81 million) equivalent to one per cent of sales.

Defence aerospace

2005 highlights

- Good progress was made with the Group's development work for the US Department of Defense's (DoD's) Joint Strike Fighter programme.
- AirTanker was awarded preferred bidder status for the UK's Future Strategic Tanker Aircraft programme.
- The first series of tests was completed for the TP400-D6 engine for the Airbus A400M military transport aircraft.
- Mission Ready Management Solutions services contracts were signed with the UK Ministry of Defence (MoD) and the US DoD covering combat, transport and trainer aircraft engines.
- A new Operations Centre was opened in Bristol as part of the growing in-service support business for military engines.

Sales

£1,413m

21% of Group sales

Energy

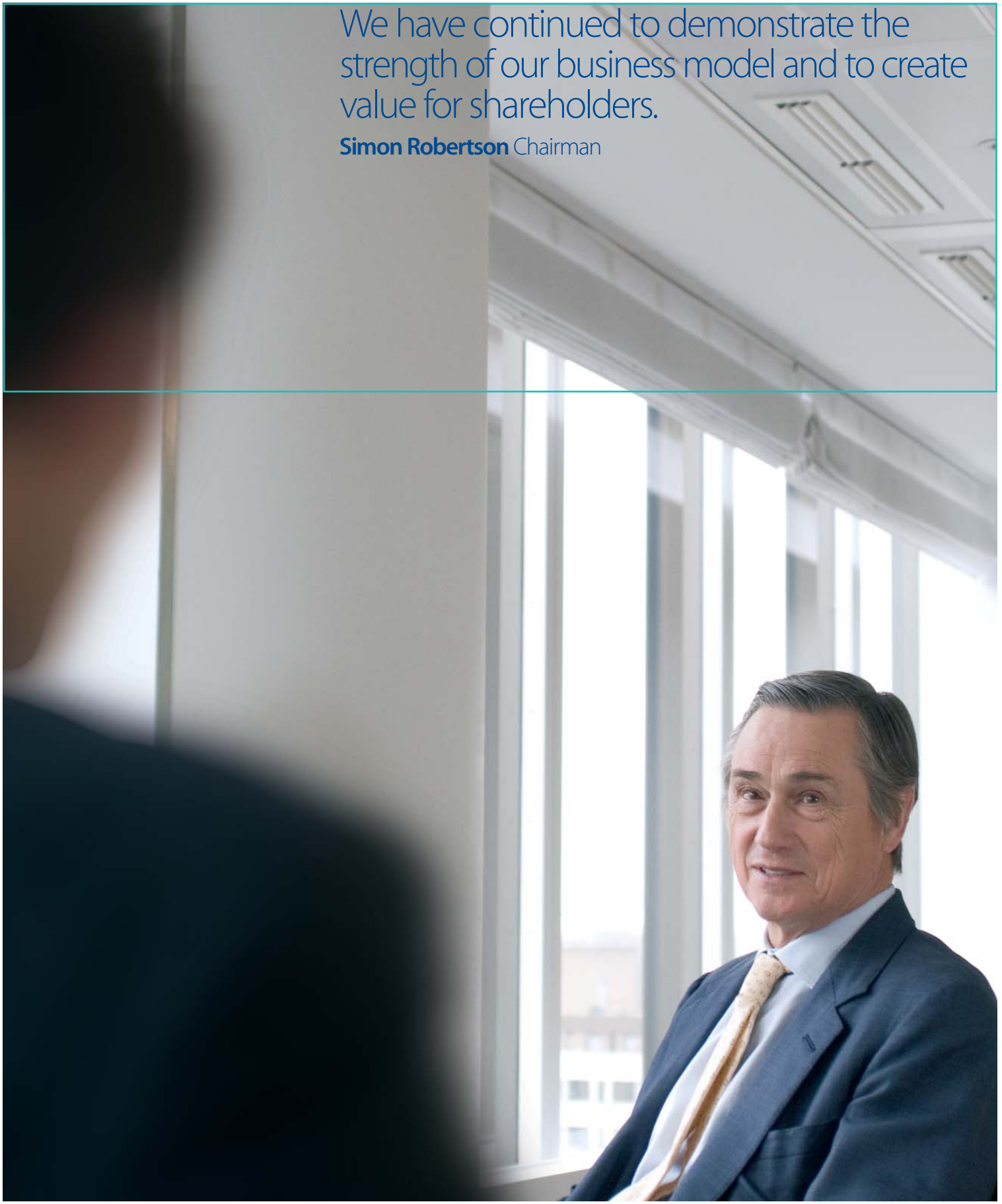
2005 highlights

- The first 12 industrial RB211-based compression packages were installed and commissioned for the West-East Pipeline Project in China, four months ahead of schedule. An additional three gas turbine units were ordered for the expansion of the pipeline's capacity.
- Six industrial Trent-based compression packages were delivered to Qatar for the Middle East Dolphin project. This is the first mechanical drive application of the Trent 60, the most powerful and efficient aero-derived gas turbine on the market.
- Sharjah Electricity and Water Authority chose two Trent 60 power-generation sets for the latest phase of the Wasit power-plant expansion, and the first Trent 60 for Asia was ordered by a major electricity producer in Yinchuan, China.
- Ten RB211 industrial gas turbine power-generation units were ordered to provide electrical power for floating production, storage and offloading vessels operated by Total off the coast of Nigeria and by Petrobras, off the coast of Brazil.
- The 500th industrial RB211 was shipped from the Rolls-Royce assembly and test facility in Montreal.
- A joint venture was established with a Singaporean consortium to continue development work on solid-oxide fuel cell technology.

Sales

£505m

8% of Group sales



We have continued to demonstrate the strength of our business model and to create value for shareholders.

Simon Robertson Chairman

Having completed my first 12 months as Chairman, I am delighted to be able to report another year of strong progress for the Group.

We have continued to demonstrate the strength of our business model and to create value for shareholders.

Our financial results for 2005 reflect the value of past investment and of the Group's consistent strategy. Underlying profits rose by 49 per cent, earnings per share by 55 per cent and debt levels were significantly reduced. We are therefore proposing an increase in the payment to shareholders.

Rolls-Royce is continuing to invest in new technologies, products and programmes. The long-term nature of these investments and the increasing numbers of our engines in service should enable the Group to generate growth and improving returns over many years.

The Group attaches a particular priority to the environment by investing in technologies which minimise the environmental impact of our operations and products.

We also take seriously our obligations to all our stakeholders as we believe that excellence in corporate responsibility delivers competitive advantage and long-term success.

There have been a number of Board changes over the year. After nearly 40 years with the Group, Mike Howse retired from the Board in June as Director of Engineering and Technology and has been succeeded by Colin Smith. I would like to thank Mike for the outstanding contribution he has made. Colin Smith has been with the Group for over 30 years and brings to the Board a similar wealth of engineering expertise.

We announced in January of this year that Colin Green is to retire from the Group and the Board in April. Again, I would like to thank Colin for the huge contribution he has made to the Company and to the aerospace industry, which was publicly recognised last year when he received a well deserved CBE.

As foreshadowed in last year's report, Iain Conn has joined the Board as a non-executive director and has brought to our discussions his extensive international business experience.

I would like to thank the management and all our employees very much for another successful year. Their commitment has been outstanding. I should also pay tribute to my fellow directors for the considerable contribution they have made in support of the Group.

Our past investments have enabled us to build strong positions in markets which offer long-term growth. Looking forward, we continue to lay the foundations for long-term success and value creation in a demanding international business environment. I expect the Group to continue to make progress in 2006, as the returns from past investments grow while we continue to invest in new technologies and products.

Simon Robertson Chairman
February 8, 2006

Rolls-Royce continued to make good financial progress in 2005.

Sir John Rose Chief Executive

Rolls-Royce continued to make good financial progress in 2005, with a substantial increase in our profitability and cash flow. By cutting costs and working more efficiently, we were able to counter the impact of higher commodity prices and an adverse trend in our achieved US dollar exchange rate. It was good to see the results reflected in a rising share price.

We continue to grow organically and our sales increased in 2005 by 11 per cent to £6,603 million, with growth achieved in each of the Group's market sectors. Our underlying profit, on a like-for-like basis, increased by 49 per cent and a strong cash inflow of £552 million resulted in positive net funds of £335 million on the balance sheet at the year-end. Average net debt was reduced by a further 59 per cent, to £260 million.

Underlying earnings per share rose 55 per cent to 24.14p and basic earnings per share rose 29 per cent to 20.11p. A final payment to shareholders has been proposed of 5.38p per share, making a total payment for the year of 8.72p per share, a 6.6 per cent increase compared to the payment in 2004.

We attach great importance to minimising the impact on our finances of volatility in the global currency markets. We continued in 2005 to pursue our strategy of hedging future net dollar revenues and at the end of the year we had approximately US$10.5 billion of forward cover, at an average exchange rate of 1.67 dollars to the pound. The achieved rate in 2005 deteriorated by four cents relative to 2004.

We will use this hedge book – in conjunction with cost-reduction initiatives and further 'dollarisation' of our cost base – to manage our future foreign exchange exposure.

We believe it desirable to continue to increase the strength of the balance sheet, reflecting the long-term nature of the business. This will also stand us in good stead as we manage pension obligations over the coming years.

New orders in 2005 reached a record level of £11.3 billion, and brought the year-end firm order book to a record £22.9 billion, an increase of 21 per cent over 2004. Over the past ten years, the order book has grown at an annual compound rate of 14 per cent. Over the past five years, Asia has been a significant source of new business and it now represents 33 per cent of the order book.

Progress in Asia

Growth in Asia is prompting more air travel, both for business and for pleasure, increasing the energy requirements to support industrial development and larger numbers of affluent homes. It is stimulating investment in oil and gas exploration and transmission and it is boosting orders for marine propulsion systems from Asia's ship building industries, now the largest and fastest growing in the world. These are all target markets for Rolls-Royce and we are benefiting accordingly. In 2005 sales to the region increased by 18 per cent and the order book for the region increased by 70 per cent.

Our physical presence in Asia is also growing. We incorporated a new subsidiary in Bangalore, in order to expand engineering capacity over a range of new programmes. We established a joint venture in Singapore, to develop a commercially viable power system based on solid oxide fuel cell technology. We opened a new marine factory in Shanghai, from which the Group's £300 million turnover merchant business will be managed. And we established new sources of supply in markets such as China, Indonesia, Malaysia, Singapore and Taiwan.

All this added to the increasingly international nature of the Group. Today 40 per cent of our employees work outside the UK, 87 per cent of our sales are to destinations outside the UK and we have offices, manufacturing and locally-supported service facilities in 50 countries.

Priorities

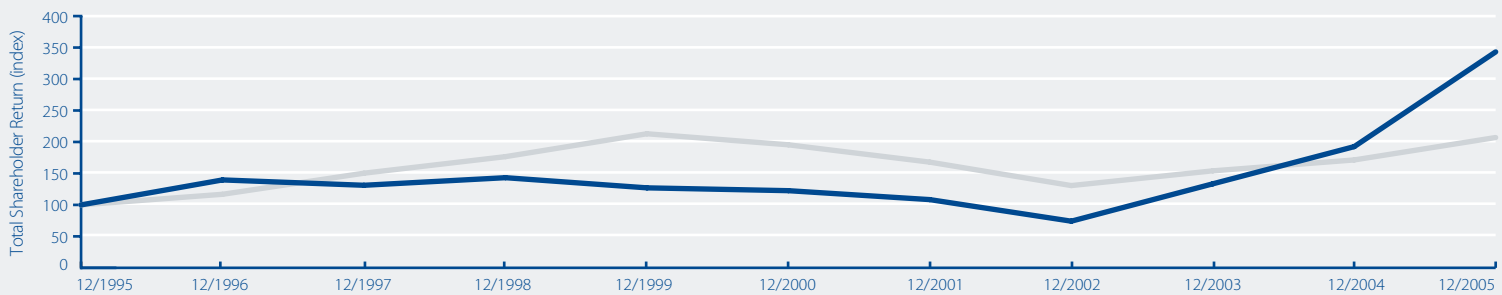
We focused on three priority areas in 2005.

– Investment in technology and products
  Acquisition of new technologies is conducted very methodically. We aim to have 'on-the-shelf' innovations ready to incorporate into our next generation of products, whilst at the same time exploring what might be possible further into the future. We see no shortage of market opportunities and expect the level of self-funded investment in our research and development work to remain at approximately five per cent of Group sales.

  The impact of this investment on our income in any one year will reflect the mix and maturity of our current development programmes. During 2005 we launched a number of new programmes, notably the Trent 1700 for the Airbus A350 and the Avon 200, an upgrade of the existing Avon engine that has been so successful in the energy sector.

Delivering shareholder value

Total Shareholder Return over 10 years Rolls-Royce against FTSE 100



– Operational and unit cost reduction
We made further progress in improving efficiency, thereby offsetting the impact of higher commodity prices by cutting costs. We achieved this by increasing productivity in our plants, managing our supply chain better and buying more from low-cost sources. Where we had to carry higher inventories to facilitate our factory-modernisation programme, we more than offset their financial impact through a rigorous management of our working capital. Importantly, more efficient working practices were implemented as a pre-condition for new factory investment. A significantly higher work load, particularly in relation to our civil aerospace engines, has challenged the ability of our supply chain to match our needs and this remains an area for attention.

– Continued development of aftermarket services
Aftermarket service revenues, including 100 per cent of our repair and overhaul joint ventures, increased by 12 per cent in 2005 and have grown at 11 per cent per annum compound over the past ten years. Services now represent 54 per cent of our revenues. This is a consequence of the successful broadening of the Group's product range, the steady increase in the number of our engines in service and the investment we have made in a comprehensive range of aftermarket-service capabilities.

Increasingly, we are taking responsibility for the maintenance of our engines and systems under long-term service agreements. This aligns our commercial interests closely with those of our customers, and maximises the value that our skills and assets can add. During 2005 a number of innovative service agreements were announced in each of the Group's business sectors.

Technology and the environment

We continued to pay particular attention in 2005 to the environmental impact of our products and of our manufacturing operations. In civil aerospace, our strategy is to seek to maintain the benefits to society of the growth in air travel, whilst helping to rein back as much as possible the negative consequences of air travel for the global environment. We are accordingly pursuing new technologies that should enable us to meet a series of highly demanding environmental targets, described in more detail on pages 36 and 37.

We will succeed in this because our engineers and scientists have the skills and dedication to tackle some daunting technical challenges. Their talents are a timely reminder of the importance of attracting gifted individuals to a career in the sciences. As a Group, we are increasingly impressed by the commitment to science teaching in many countries, especially in Asia. The picture in the UK, though, is very different with increasing evidence that young people's enthusiasm for the physical sciences is in decline.

To help address this issue, in 2004 we introduced the Rolls-Royce Science Prize. It has been designed to reward imaginative science-teaching projects in the classrooms of the UK and Ireland each year, across all ages.

It offers substantial cash awards for the winning entrants. It gathered momentum encouragingly in 2005, with a 55 per cent increase in the number of schools taking part in the prize as compared with its inaugural year.

Community

The Group's other community activities in 2005 were far ranging. They involved the active participation and generosity of our employees. This was notably true of our response to the sad consequences of both the tsunami that struck in the Indian Ocean just before the start of the year and the Gulf of Mexico hurricanes that swept across the southern US in September. Employees added over £250,000 of their own money to our corporate donations of £500,000 for recovery projects in Asia. Several of these were supported by Rolls-Royce managers and engineers based in the region. In the US, where three sites with 136 employees were directly affected, Group assistance was similarly backed up by generous support from Rolls-Royce colleagues.

We received a Gold Award from the UK Institute of Fundraising in 2005 for our Payroll Giving Scheme. This provides and pays for the administration of employees' donations to charity, enabling them to be made regularly and in a tax-efficient way. Employees last year gave in excess of £396,000 to charities of their own choosing.

Employees

Our contribution to community activities reflects a strong corporate culture that remains one of the Group's most valuable assets. It owes much to the unusually long average tenure of our employees, many of whom spend their entire careers with Rolls-Royce. It is therefore especially pleasing that the rise in our share price will benefit a broad constituency of shareholders within the company, with a significant number of our employees participating in 'sharesave' schemes and a large number owning shares directly.

A consistent strategy, built around five objectives

All four of our market sectors are characterised by strong demand trends that stretch well into the future. Our business strategy is built around five key objectives:

Address four global markets

We are a leading power-systems company, operating in the civil and defence aerospace, marine and energy markets. We manufacture in 20 countries and serve customers in 150 countries.

Invest in technology, capability and infrastructure

Over the past five years we have invested more than £3 billion in research and development. We invest on average £30 million annually on training, and the Group invests £200 – £300 million every year in capital projects.

Our improved financial performance has also meant that, for the first time in many years, executive share options have vested. The vesting of this component of executive remuneration is tied to performance criteria designed with a view to securing and rewarding long-term success. It is worth noting that our executive directors all own, either directly or in trust, substantial shareholdings in Rolls-Royce. This demonstrates their commitment to the Group, and has the added benefit of aligning their personal interests with those of all other shareholders.

Future prospects

Rolls-Royce is addressing four long-term growth markets. Their aggregate demand for engines and services over the next 20 years is estimated to be worth approximately two trillion dollars. The Group's consistent investment in technology and in new products and services enables us to respond effectively to new developments, creating opportunities for organic growth in each of the four markets.

In civil aerospace, we see the market continuing to recover from the recession that began at the start of this decade, the impact of which was exacerbated by the events of 9/11, SARS and the Gulf War. We expect to benefit further from this recovery. The number of Rolls-Royce jet engines in service is increasing and flying hours across our fleet are accumulating steadily. This growth, combined with our broadening of the services we make available, is expected to lead to a steady increase in our service revenues.

In defence aerospace, we have developed a broad product portfolio that addresses all of the major market sectors, from combat and trainer aircraft to transport and tactical aircraft and helicopters. Our mix of mature programmes, new production programmes, development programmes and service revenues is expected to enable the Group to make good progress in spite of the volatility that may be experienced on individual programmes, as exemplified by the uncertainties surrounding the alternate engine for the Joint Strike Fighter in the wake of the US Quadrennial Defense Review.

Our marine business is benefiting from its broad access to naval and commercial markets. Here again, we are bringing new products to market, from gas turbines such as the MT30 to rim-driven tunnel thrusters, which we believe are likely to have a major impact on marine propulsion systems. Boosted by the rise in oil and gas prices, the commercial offshore market remains very strong – and we are confident that we can continue to capture a good share of the available business.

Our energy business is strengthening its presence in emerging oil and gas markets and is well positioned to secure a growing share of the power-generation market. Its profitability will be constrained for some time by the investments it is making in new technology – including the development of solid-oxide fuel cell systems.

In aggregate, we are expecting continued progress in 2006, underpinned by the rising order book, the growth in service revenues and sustained cost reduction. As a result, though we see no likelihood of any reduction in competitive intensity in our markets, we do expect increased profits and a positive cash flow for the year.

The proposed increase in the payment to shareholders for 2005 represents an increase of 6.6 per cent over the payment made in 2004. This reflects our confidence in the future prospects of the business. I would like here to acknowledge the hard work and dedication of all the people in Rolls-Royce around the world that have helped us establish this position.

Sir John Rose Chief Executive

Develop a competitive portfolio of products and services

Our strong product portfolio means that we are involved in many of the major future projects in the markets we serve. These key projects will shape the power-systems market for the next 50 years.

Grow market share and installed product base

Across the Group, the growing number of engines in service and their long service lives are expected to generate attractive returns over many decades.

Add value 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. This approach is fundamental to developing and sustaining collaborative long-term relationships in all our markets.

Innovation

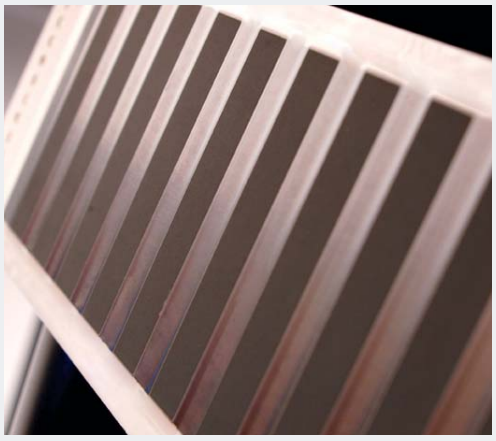
Focused investment in technology and products

Main image:
Trent 1000 for the Boeing 787
The image shows a close-up of compressor blades used in the Trent 1000 engine. This member of the Trent family is in development for the new Boeing 787 family of airliners. Rolls-Royce has secured important new customers on this programme, such as ANA of Japan and Northwest Airlines of the US.

Below:
Airbus A380
The first flight of the Airbus A380 took place on April 27, 2005, powered by four Trent 900 engines. As the next Trent to enter service, the Trent 900 features an advanced hollow swept fan, contra-rotating and 3-D computer-designed compressors and a low NOx combustor, all developed as a result of our investment in new technology.

Below:
Fuel cells
Rolls-Royce is developing this technology with a view to producing a new source of energy characterised by minimal noise and emission levels. Rolls-Royce Fuel Cell Systems is building a fuel cell that, if successful, will produce a commercially viable one-megawatt, stationary power system capable of servicing the energy needs of, for example, a business park or large hospital.

Below:
TP400
This large 11,000 shaft horsepower (shp) turboprop engine is being developed by Europrop International, a consortium in which Rolls-Royce is a major partner. The engine will power the Airbus A400M transport aircraft and is scheduled for certification in 2007. More than 750 engines will be required to meet the needs of the partners in the programme: Germany, France, the UK, Spain, Turkey, Belgium and Luxembourg.



Rolls-Royce programmes have long life-cycles, often lasting more than 50 years. Our technology-acquisition strategy is focused on both developing new products and enhancing their through-life performance.

We are investing in new facilities and the most efficient working practices, to manufacture high value-added components in our factories. We also work closely with a highly capable international supply chain.

Operational and unit cost reduction

Main image and below:

Derby

Two new facilities, each costing £50 million, have been built in Derby providing additional capacity for the production of compressor systems and for our aero-engine repair & overhaul (AR&O) business. A programme of investment in engine testbeds is also under way.

Below:

Shanghai

Our largest investment yet in China, the new marine facility in Shanghai, will produce a wide range of propulsion and steering systems and deck machinery for the fast-growing shipyards of north-east Asia.

Below:

Bristol

Bristol is a main centre for the Group's military engine activities and here £80 million is being invested in new facilities for the manufacture of turbine systems and components and their assembly into finished gas turbines.

Integrity

Rolls-Royce provides reliable products and a comprehensive range of product-related services. Our long-term support contracts enable us to add value for our customers by using our technology and skills to help them achieve their objectives.

Reliability

Continued development of aftermarket services

Main image:
Eurofighter Typhoon
Under a £57 million contract signed in 2005, Rolls-Royce will provide a complete support package that will ensure the RAF always has enough EJ200 engines available to meet its expanding flying programme for the new Eurofighter Typhoon aircraft, which has just entered service.

Below:
Marine
A long-term service contract worth £137 million has been agreed for our marine business to support Rolls-Royce gas turbines in service with the Royal Navy and the French, Belgian and Royal Netherlands navies. This service and support contract runs until 2017 and covers Olympus and Tyne engines powering 27 ships.

Below:
Customer care
Both the civil aerospace and defence aerospace businesses are now running Operations Centres – based at Derby and Bristol respectively – providing 24-hour in-service support for customers. The centres monitor engine operations in real time, co-ordinating and integrating data that allow Rolls-Royce to provide better predictive information and operational advice to customers.

Below:
Building relationships
Malaysian oil and gas giant PETRONAS and Rolls-Royce have been fostering stronger customer/supplier links through a successful technology-transfer programme. The programme has seen Rolls-Royce increase the knowledge and expertise in gas turbine technology of key PETRONAS personnel. It has involved training and hands-on experience for PETRONAS participants at Rolls-Royce facilities in Europe and North America.

The Group has four businesses: civil aerospace, defence aerospace, marine and energy.

We invest in technology and capabilities that can be applied to products and services in each of the global markets we serve. We aim to add value for our customers by providing innovative products and product-related services.

Civil aerospace

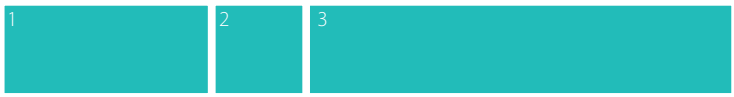
Mike Terrett
President – Civil Aerospace

	2005	2004	2003	2002	2001
Revenue £m	**3,510**	3,040	2,694	2,739	3,443
Underlying profit before financing costs* £m (see note 2)	**454**	194	131	150	347
Net assets £m	**1,278**	1,343	1,099	1,219	1,124
Order book – firm £bn	**17.6**	14.1	13.4	12.2	10.0
Engine deliveries	**881**	824	746	856	1,362
Installed engine base	**11,500**	10,970	10,450	9,910	9,212
Employees	**21,000**	20,100	19,800	21,100	23,900

Contribution to Group revenue 2005:

53%

Sales analysis 2005:



1 Original equipment – Airline
2 Original equipment – Corporate and regional
3 Services

Highlights of the year

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The Airbus A380, powered by the Trent 900 engine, made a successful maiden flight and good progress through its comprehensive flight-test programme.

Agreement was reached with Airbus for Rolls-Royce to supply the Trent 1700 to power the new A350 airliner.

The 1,000th BR710 engine was delivered to Gulfstream to power its G550 long-range business jet.

International Aero Engines (IAE) achieved a record order intake of approximately 600 engines worth over US$1.5 billion to Rolls-Royce.

Rolls-Royce has established a strong market position in civil aerospace through its portfolio of competitive aero engines, powering a broad range of aircraft from corporate jets to the largest airliners.

We made good progress with the development of our product range. The Trent 900 engine powered the Airbus A380 on its maiden flight and has now accumulated 4,000 hours of flying experience. The first Trent 1000 engine build, for the Boeing 787, was commenced on schedule in November and the Trent 1700 became the sixth member of the Trent engine family, following its selection by Airbus to power the A350. The Trent family celebrated the tenth anniversary of its entry into service and passed the milestone of 15 million flying hours during the year.

We extended our links with Japanese industry on the Trent 1000 programme by selecting Sumitomo Precision Products to supply the heat management system for the engine. Carlton, the US forging and machining specialist, also became a risk and revenue sharing partner on the Trent 1000 engine.

International Aero Engines (IAE), in which Rolls-Royce is a principal shareholder, took an increasing share of the strong single-aisle market, with a record order intake of approximately 600 engines worth over US$1.5 billion to Rolls-Royce. This included significant success in the rapidly growing Indian low-cost airline market where the V2500 engine was selected by a number of new operators.

IAE also launched V2500Select℠, a combined engine upgrade and aftermarket service programme, which improves fuel burn, reduces operating costs and offers time-on-wing improvements. By the end of 2005, contracts for aftermarket-service agreements with IAE were covering almost 1,000 engines.

Civil engine deliveries increased by seven per cent, to 881, reflecting strong growth in V2500 deliveries and continuing recovery in the corporate jet market, partially offset by a decline in regional airline engine deliveries. While the decline in regional deliveries is expected to continue, the Group expects total civil engine deliveries to grow in 2006 as the Trent 900 enters service, V2500 deliveries increase and the corporate sector remains strong.

The Rolls-Royce civil fleet flying hours increased by 11 per cent compared to 2004 as a result of a combination of world traffic growth and increased fleet size.

The installed base of civil jet engines grew to 11,500. This provides a significant aftermarket-services opportunity, which the Group is addressing with innovative long-term service arrangements for its customers. TotalCare contracts worth more than US$13 billion have now been signed, covering 80 per cent of new customers since 2001. The Group achieved record growth for its CorporateCare programme, signing 90 contracts in 2005. TotalCare contracts covered 77 per cent of all the engines ordered in 2005.

Services sales increased by 14 per cent to £2.1 billion, representing 59 per cent of civil aerospace sales. We expect services sales to continue growing at a double-digit rate.

* for background to the change from UK GAAP accounting to IFRS in 2005, and the retrospective adjustments made to the 2004 accounts, see the relevant section on IFRS in the Finance Director's review on page 29 and note 33 to the financial statements on page 96. 2003 and earlier figures are as reported under UK GAAP.

Defence aerospace

Colin Green
President – Defence Aerospace

	2005	2004	2003	2002	2001
Revenue £m	**1,413**	1,374	1,398	1,376	1,400
Underlying profit before financing costs £m	**180**	179	147	183	175
Net assets £m	**(59)**	51	69	25	179
Order book – firm £bn	**3.1**	3.0	2.4	2.1	2.6
Engine deliveries	**565**	548	510	505	472
Employees	**5,200**	5,100	4,900	5,100	6,700

Contribution to Group revenue 2005:

21%

Sales analysis 2005:

1 Original equipment
2 Development
3 Services

Highlights of the year

Good progress was made with the Group's development work for the US Department of Defense's (DoD's) Joint Strike Fighter programme.

AirTanker was awarded preferred bidder status for the UK's Future Strategic Tanker Aircraft programme.

The first series of tests was completed for the TP400-D6 engine for the Airbus A400M military transport aircraft.

Mission Ready Management Solutions services contracts were signed with the UK Ministry of Defence (MoD) and the US DoD covering combat, transport and trainer aircraft engines.

A new Operations Centre was opened in Bristol as part of the growing in-service support business for military engines.

The Group's defence aerospace business is broadly based, with a strong portfolio of products and services covering the key defence aerospace market sectors. This enables the Group to make good progress in spite of the volatility that may be experienced on individual programmes, as exemplified by the uncertainties surrounding the alternate engine for the Joint Strike Fighter, following the recent US Quadrennial Defense Review.

In 2005, Rolls-Royce continued to develop its range of engine programmes and customer services. More than 3,000 hours of testing were completed on the LiftFan® system for the US DoD's Joint Strike Fighter programme.

In December, an agreement was signed by the governments of the Kingdom of Saudi Arabia and the UK, under which the Royal Saudi Air Force will acquire Eurofighter Typhoon aircraft, powered by the EJ200 engine.

In the transport sector, Rolls-Royce is a member of the European consortium that successfully completed the first series of tests for the TP400-D6 turboprop engine being developed for the A400M military transport aircraft.

The US DoD approved full production for the V-22 Osprey aircraft, powered by Rolls-Royce AE 1107C-Liberty engines and placed equipment and services orders related to the engine worth more than US$64 million.

Rolls-Royce is a 20 per cent shareholder in the AirTanker consortium, which was awarded preferred bidder status for the Future Strategic Tanker Aircraft programme by the UK MoD.

Australia selected the Rolls-Royce Turbomeca RTM322 engine to power its NH90 helicopter fleet and the first RTM322 to be assembled under licence by KHI, in Japan, was delivered to the Japan Defense Agency and the Japan Maritime Self-Defense Force.

The provision of services contributed 55 per cent of the Group's defence sales. New services contracts announced during the year included: a £185 million service contract for the RB199 engines which power the MoD's fleet of Tornado aircraft; a renewal of the contract for the support of the F405 (Adour) engine in the US Navy's T-45 training aircraft worth US$63 million; a £57 million contract to support the EJ200 engines that power the UK's Typhoon fleet; and a £40 million contract to support the UK's fleet of AE 2100 engines that power the C-130J. A new Operations Centre was opened in Bristol as part of the growing in-service support business for military engines.

Marine

Dr Saul Lanyado
President – Marine

	2005	2004	2003	2002	2001
Revenue £m	**1,097**	963	1,003*	984	827
Underlying profit before financing costs £m	**89**	78	78*	82	73
Net assets £m	**592**	565	577*	550	513
Order book – firm £bn	**1.7**	1.4	1.2*	1.3	1.3
Employees	**7,200**	7,100	7,300*	6,500	6,500

*restated following the transfer of the diesel business from energy to marine.

Contribution to Group revenue 2005:

17%

Sales analysis 2005:

1 Commercial original equipment
2 Commercial services
3 Naval original equipment
4 Naval services

Highlights of the year

A £137 million service and support contract was secured for ships in service with the Royal Navy and the French, Belgian and Royal Netherlands navies.

The first MT30 marine gas turbine was delivered to power land-based test runs of the US Navy's DD(X) destroyer.

Lockheed Martin installed two MT30 marine gas turbines on the first prototype Littoral Combat Ship for the US Navy.

A University Technology Centre (UTC) was established by the Group in Norway to conduct research programmes in the marine sector.

A new marine facility in Shanghai was formally opened.

The Rolls-Royce marine business is a global leader in marine propulsion, engineering and hydrodynamics expertise, with a broad product range and a full systems-integration capability.

In 2005, the marine business made good progress, with higher sales and higher profit. The recovery of the offshore oil and gas support market continued and Rolls-Royce secured a good share of the available business. The 500th order was placed for a Rolls-Royce UT-Design vessel, one of the most successful designs in the history of commercial shipping. UT-Design ships are sold as complete systems and are fitted with a range of Rolls-Royce equipment.

The Group is developing rim-driven tunnel-thruster technology, which is likely to have a major impact on marine propulsion in the future. The first thrusters are to be fitted to an offshore support vessel but the technology will also be suitable for merchant and cruise ships.

Asia's ship building accounts for nearly 80 per cent of the world's commercial ship construction. During 2005 Rolls-Royce expanded its presence in Asia, opening a new factory in Shanghai, which, together with our existing factory in Korea, creates a north-east Asian production hub.

In the naval market sector, Rolls-Royce achieved a major development milestone when the MT30 gas turbine was awarded American Bureau of Shipping certification. In February 2005, the first MT30 marine gas turbine generator set was delivered to the US Navy to power land-based test runs for the DD(X) destroyer.

Lockheed Martin installed two MT30 gas turbines on the first prototype Littoral Combat Ship for the US Navy. These gas turbines are the largest ever installed on a naval ship.

The Group is working with the US Navy as prime contractor on the advanced electric ship demonstrator project that will be the proving ground for the Rolls-Royce AWJ-21 waterjet, the next generation of naval waterjet.

In 2005, 40 per cent of marine sales were derived from services and support activities. The Group announced a £137 million long-term service and support contract for Olympus and Tyne engines that power 27 ships in service with the Royal Navy and the French, Belgian and Royal Netherlands navies.

Energy

Tom Curley
President – Energy

	2005	2004	2003	2002	2001
Revenue £m	**505**	489	508*	639	608
Underlying profit before financing costs £m	**4**	14	23*	(41)	(64)
Net assets £m	**314**	324	346*	348	381
Order book – firm £bn	**0.4**	0.4	0.4*	0.6	0.4
Engine deliveries	**61**	47	54*	68	72
Employees	**2,700**	3,000	3,100*	4,500	4,900

*restated following the transfer of the diesel business from energy to marine.

Contribution to Group revenue 2005:

8%

Sales analysis 2005:

1 Oil & gas
2 Power generation
3 Services

Highlights of the year

The first 12 industrial RB211-based compression packages were installed and commissioned for the West-East Pipeline Project in China, four months ahead of schedule. An additional three gas turbine units were ordered for the expansion of the pipeline's capacity.

Six industrial Trent-based compression packages were delivered to Qatar for the Middle East Dolphin project. This is the first mechanical drive application of the Trent 60, the most powerful and efficient aero-derived gas turbine on the market.

Sharjah Electricity and Water Authority chose two Trent 60 power-generation sets for the latest phase of the Wasit power-plant expansion, and the first Trent 60 for Asia was ordered by a major electricity producer in Yinchuan, China.

Ten RB211 industrial gas turbine power-generation units were ordered to provide electrical power for floating production, storage and offloading vessels operated by Total off the coast of Nigeria and by Petrobras, off the coast of Brazil.

The 500th industrial RB211 was shipped from the Rolls-Royce assembly and test facility in Montreal.

A joint venture was established with a Singaporean consortium to continue development work on solid-oxide fuel cell technology.

The Rolls-Royce energy business supplies a wide range of gas turbine packages to the worldwide oil & gas and power-generation markets, with more than 4,000 industrial gas turbines sold and over 140 million hours of operating experience.

The financial results for 2005 reflect a strong performance by the oil & gas business, offset by the slow recovery of the power-generation market and continued investment in new product technologies.

In oil & gas, we continued to strengthen our presence in emerging markets, winning orders worth over US$120 million for projects in West Africa, over US$100 million from customers in Asia, and over US$70 million for gas turbine packages for Brazil.

The international power-generation market has shown signs of recovery and the Group won important new orders for the industrial Trent in the United Arab Emirates and China.

In 2005, the Group continued to invest in its fuel cell technology. Rolls-Royce and the Singaporean consortium, Enertek Singapore Pte Ltd, will between them invest a further US$100 million in the project. In addition, Rolls-Royce Fuel Cell Systems Limited opened a new Rolls-Royce facility in the UK that will pilot the production of ceramic components for use in fuel cell systems. This business is developing solid-oxide fuel cell systems for megawatt-scale, stationary power-generation applications with the goal of introducing a competitive product this decade.

The services sector enjoyed a record order intake in 2005 and contributed 38 per cent of energy sector sales. Strong growth in long-term service agreements was maintained, with a further £93 million of business secured during the year. This brings the backlog of energy business long-term service agreements to £220 million.

Focused investment in technology

Colin Smith
Director – Engineering and Technology

Highlights of the year

- First run of the TP400 engine for the Airbus A400M
- Following a successful concept-demonstrator phase, the JSF F136 System Development and Demonstration contract was awarded
- Successful Trent 1000 fan rig test for the Boeing 787
- First flight of the Trent 900 in the Airbus A380 aircraft achieved in April
- Two new University Technology Centres opened in Norway and Germany
- Completion of the ANTLE (Advanced Near-Term Low Emissions) demonstrator
- Record number of 306 patents filed

The ability to innovate is at the heart of our business and is the means by which we maintain our world-class position. We continue to invest significant amounts in research and development. These deliver new and improved technology, lower costs and better aftermarket services, on new and existing products across their lifecycle.

In 2005 we invested £663 million (gross) in research and development, an increase of 10 per cent on 2004. The net charge to the income statement was £282 million.

The markets in which we operate are exceptionally challenging. Customer expectations are increasing, which combined with growing environmental pressures, causes us to drive our technology forward.

In 2005 we made significant technological strides towards meeting the environmental challenge. One example is the completion of a 30-hour test programme in May for the ANTLE engine, successfully demonstrating a number of environmentally friendly technologies in a European collaborative project. The demonstrated technologies from ANTLE will be rolled out across our products in the coming years.

We have continued the product development of the high efficiency solid-oxide fuel cell programme for the energy business, with a number of successful rig tests forming the building blocks for sub-assembly demonstration in 2006.

For some years our University Technology Centre network has been key to our research work. In 2005 we further strengthened this global network by opening two new centres – one in Cottbus, Germany, researching structural mechanics and vibration, and the other in Trondheim, Norway, covering ship performance.

Amongst our many research achievements, we filed a record 306 patent applications.

We have continued to develop our engineering tools for use on all our projects. One key aspect to this work has been the progressive rollout of Product Lifecycle Management (PLM), a computer-system tool that significantly increases our design capabilities and then enables us to manage data cost effectively throughout the product lifecycle.

We have continued to build on the success of the Trent family. The Trent 900 is gaining maturity during the intensive Airbus A380 flight-test period and the Trent 1000 for the Boeing 787 is progressing towards its engine-test programme.

Our marine business saw the Trent 800-derived MT30 running in the land-based DD(X) demonstrator and a novel 50kW rim-driven tunnel thruster, which we believe will have a major impact on marine propulsion systems.

In the defence aerospace sector, the multi-partner TP400 engine for the Airbus A400M made a successful first run in October. Excellent progress continues to be made on our Joint Strike Fighter (JSF) programmes with the LiftFan® being developed to support the first STOVL aircraft flight in 2007 and the completion of the successful F136 concept-demonstrator phase leading to the award in August of the System Development and Demonstration contract worth around US$1 billion to Rolls-Royce.

In 2006, we will continue to build on our proven strategy of 'invest once and use many times' at both the technology and product level.

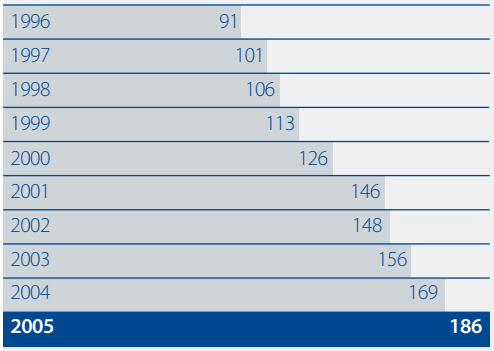
Gross research and development £m	
2001	636
2002	590
2003	619
2004	601
2005	**663**

Net research and development £m	
2001	358
2002	297
2003	281
2004	288
2005	**282**

Operational excellence

John Cheffins
Chief Operating Officer

Sales per employee £000



Highlights of the year

- Production load increased significantly
- Product cost improved slightly despite considerable commodity inflation
- Product quality continued to improve
- UK factory infrastructure construction advanced significantly
- IT operating costs reduced further: new IT investment increased
- Working capital utilisation improved again

2005 was a year of considerable change. Our loading increased by 17 per cent over 2004. Within this total, UK load increased whilst US load fell as the mix shifted away from regional jet engines towards smaller helicopter engines.

Operationally the year was significantly affected by raw material supply issues. The speciality metals industry struggled to meet our increased demand, which gave rise to some delivery disruption during the year. Notwithstanding this, we delivered a creditable result. As usual, I take this opportunity to thank all our employees and suppliers for their efforts in 2005 in this regard.

We made good progress in 2005 on our programme to restructure our supply chain. Our supplier base was reduced by 13 to 698 even though we added 38 new suppliers. Our sourcing in emerging low-cost markets increased from six per cent to nine per cent of purchases. Our newest civil aerospace product, the Trent 1000, was launched with an external supply chain of only 71 suppliers.

The prices of metals and of fuel rose throughout the year and closed at, or close to, new highs. We are accustomed to managing this through long-term supplier relationships that reduce volatility, together with long-term positions in the metals market for those that are traded.

We continued to drive for lower operating costs against a background of steeply rising volume. We increased our employee population by two per cent and delivered an improvement from £169,000 to £186,000 in sales per employee. In 2005 we were able to deliver a small reduction in product unit cost, effectively neutralising the effects of commodity-price inflation.

We completed construction of new factories at Derby and Hucknall and commenced commissioning. We completed all the remaining moves into our new factory at Inchinnan from Hillington. The latter site was closed and sold in its entirety in December. Construction of new factories at Barnoldswick and Bristol is proceeding satisfactorily towards completion in 2006 and full operation in 2007. We constructed a new factory for our commercial marine business in Shanghai and commenced operations in November.

More efficient working practices, which are a precondition for new factory investment, are now implemented in most UK locations and are under discussion elsewhere. Our new Global Council covering all our employees met successfully twice in 2005.

Our Process Excellence culture-change programme continued through 2005, delivering training to 27,000 employees and putting in place fully accredited six-sigma 'Black Belts' and 'Green Belts' at 0.6 per cent and 2.0 per cent of total employee population respectively.

In conjunction with our IT supply chain and our principal IT partner, EDS, further reductions in the operating cost of our IT estate provided the opportunity to increase our new investment in this area whilst maintaining total IT expenditure within 2.6 per cent of turnover. In 2005 we connected 70 per cent of our worldwide operations to a single wide-area-network, took important steps towards full global standardisation of our ERP systems and commenced the roll-out of the latest generation of Product Lifecycle Management software.

As forecast, our inventories increased in 2005 to respond to higher output volume and to buffer the moves associated with new factories. We offset this increase by tighter management of financial working capital to effect a further improvement of working capital utilisation.

In 2006 our priorities will be to complete our infrastructure-renewal projects in the UK and to advance our move into the new factories. We shall persist with operating and product unit-cost reduction, turning our focus towards overhead costs in particular, and we will continue our drive with Process Excellence to eliminate waste and achieve continuous improvement.

Services

Miles Cowdry
Director – Services

Services revenues £m

2001	2,723
2002	2,860
2003	3,081
2004	3,459
2005	**3,862**

Including 100 per cent of our repair and overhaul joint ventures.

We have been following a consistent strategy in services for a number of years, focused on generating value for our customers and ourselves by delivering high equipment availability at an affordable and predictable cost. These principles are fundamental to developing and sustaining the collaborative long-term relationships that underpin our success in the marketplace.

Under TotalCare, in the civil aerospace market, and similar contracts in defence aerospace, energy and marine, we provide services over the long term at fixed prices. We are well-qualified to manage the risks we assume in such contracts through our knowledge of the product and the data we capture in respect of its service life.

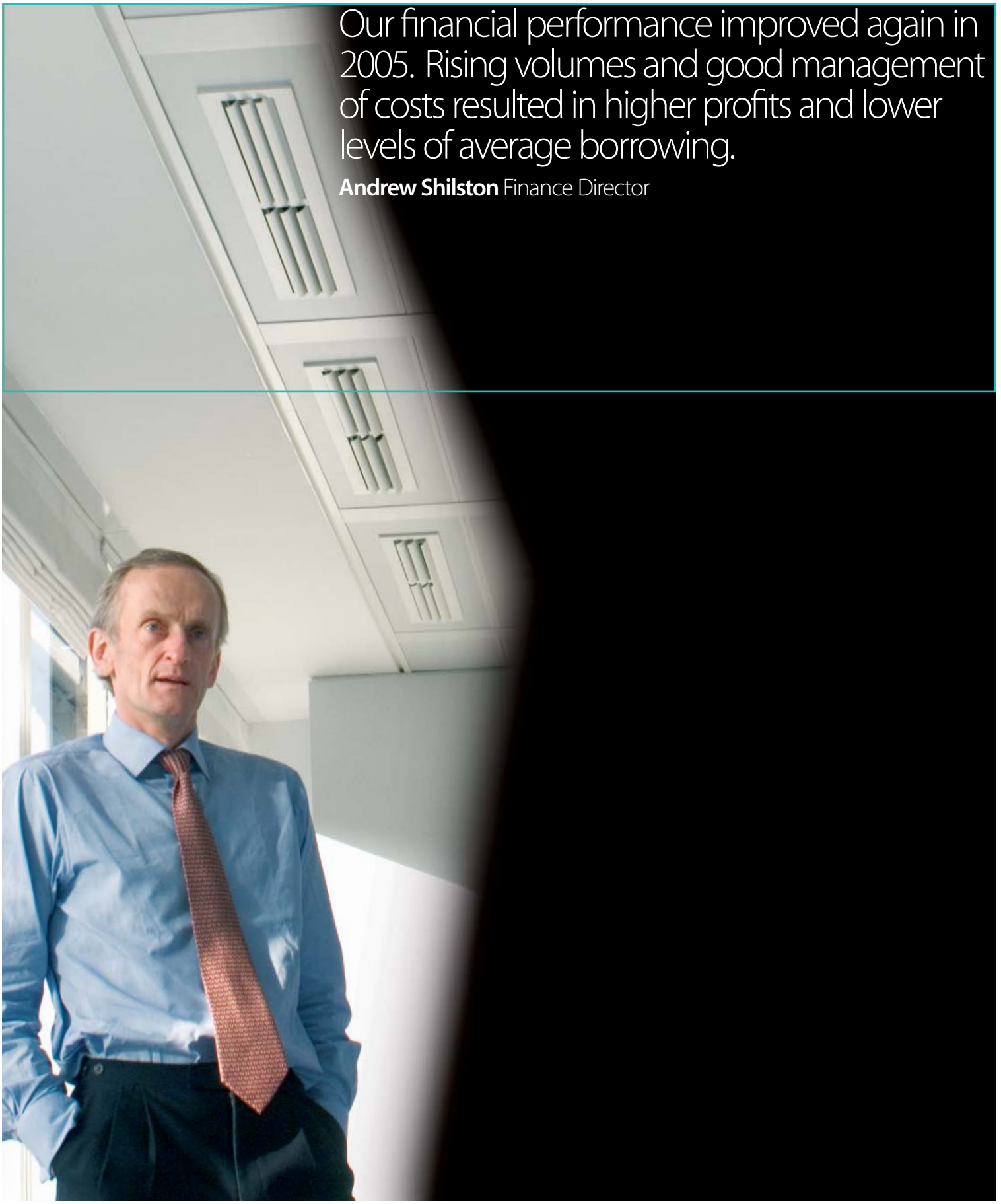
In the defence aerospace sector we provide these services under the banner Mission Ready Management Solutions. The UK Defence Industrial Strategy published in December 2005 cited our Spey and RB199 contracts as exemplars for the style of through-life support contract that will increasingly become the norm for the UK defence market.

In the civil aerospace market some 45 per cent, by value, of our fleet is now under our management. A notable contract was the TotalCare agreement signed by LCAL, allowing this leader in the leasing industry to provide an innovative, transferable engine-maintenance agreement with its aircraft.

Earlier investments to support our service business continue to deliver benefits: Aeromanager, our customer-care portal for the civil aerospace market, now provides access to our services for some 700 customers and over 10,000 users; Data Systems & Solutions retains a leadership position in the real-time equipment health-monitoring market, with a portfolio of more than 6,000 engines; and the Civil Operations Room is providing an around-the-clock-service to our customers. During 2005 we continued to invest, with the defence aerospace business opening its Operations Room in Bristol and the opening of our new repair and overhaul facility in Derby.

A feature of our engine repair and overhaul network is our partnership with customers and leading independent maintenance, repair and overhaul companies. The sharing of good practice across the network and the deployment of a common information-technology platform has enabled efficiency improvements and reduced turnaround times.

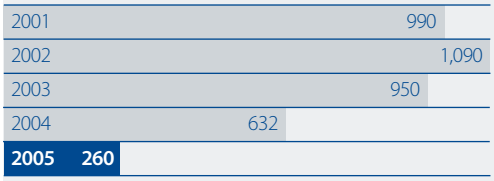
In 2006, our priorities for services will remain the same: innovation in service products to create value for customers and generate growth in our revenues; improvements in our service delivery capability; and further progress with the development of a responsive customer-focused service culture among our employees.



Our financial performance improved again in 2005. Rising volumes and good management of costs resulted in higher profits and lower levels of average borrowing.

Andrew Shilston Finance Director

Average net debt £m



***Derivation of 'like-for-like' results** £m

IAS 32 and IAS 39 were adopted prospectively from January 1, 2005. Accordingly, the 2004 results have not been restated in respect of these standards, including the revised treatment of financial RRSPs as financial liabilities and the consequent impact on the income statement (see note 33). The 'like-for-like' adjustments restate the 2004 results for the effect of the revised treatment of financial RRSPs as if this had applied in 2004.

	2005 £m	2004 £m	Year-on-year changes
Profit before finance costs:			
Underlying profit before finance costs (see note 2)	**679**	417	
2004 treatment of financial RRSP net charges	–	69	
Like-for-like profit before finance costs	**679**	486	40%
Profit before tax:			
Underlying profit before tax (see note 2)	**584**	364	
2004 treatment of financial RRSP net charges	–	69	
Equivalent notional finance charge	–	(41)	
Like-for-like profit before tax	**584**	392	49%

Our financial performance improved again in 2005. Rising volumes and good management of costs resulted in higher profits and lower levels of average borrowing.

Results for the year

Underlying profit before tax, on a 'like-for-like' basis* (see above) increased by 49 per cent to £584 million (2004 £392 million), and underlying earnings per share were 24.14p (2004 15.56p). Basic earnings per share were 20.11p (2004 15.56p).

The Group implemented International Financial Reporting Standards (IFRS) during the year. Comparative figures for 2004 are restated accordingly. A full analysis of the impact is provided in note 33 to the financial statements.

Sales growth in all market segments

Sales increased by 11 per cent.

- Civil aerospace engine deliveries increased by seven per cent to 881 engines. Civil aftermarket sales grew by 14 per cent.
- Defence aerospace sales increased slightly, with small increases in both original equipment sales and services revenues.
- Marine sales increased by 14 per cent, with strong growth in the offshore oil & gas support market sector.
- Energy sales increased by three per cent, with sales in the oil & gas sector offsetting the effects of the depressed power generation market.

Group aftermarket-services revenues including 100 per cent of repair and overhaul joint ventures grew by 12 per cent to £3.9 billion and have grown by 11 per cent per annum compound over the past ten years. Service revenues accounted for 54 per cent of total revenues.

87 per cent of sales were to customers outside the UK.

Margins benefited from some improvement in demand, continuing growth in services sales and our focus on cost reduction, which mitigated headwinds caused by commodity price inflation and an adverse trend in our achieved US dollar exchange rate.

Underlying financing costs amounted to £95 million, comprising principally net interest (£39 million), risk and revenue sharing partners' finance cost (£43 million) and net pension scheme finance cost (£9 million).

Group interest was covered 16.2 times (2004 7.6 times), based upon underlying profit before interest, excluding joint ventures. Restructuring charges of £48 million (2004 £37 million), which were incurred for ongoing operational improvements, were included within operating costs.

The Group made an underlying profit before tax of £584 million (2004 £364 million). The Group defines an underlying measure of profit to avoid the distortions caused primarily by the treatment of derivative foreign exchange and commodity contracts under IAS 39 (see note 28). The adjustments to reported profit are: a) reverse the impact of releasing the transition hedging reserve arising on the valuation of derivatives on January 1, 2005; b) eliminate the impact of unrealised gains and losses on derivatives and other financial assets and liabilities recognised during the year; and c) include the realised gains and losses of derivative contracts settled in the year. An adjustment is also made to eliminate the restructuring, re-measurement and foreign exchange gains and losses of financial RRSPs. Profit before tax was £477 million (2004 £364 million).

A final payment to ordinary shareholders of 5.38p is proposed making a total of 8.72p per ordinary share (2004 8.18p). The Company will continue to issue B Shares in place of dividends in order to accelerate the recovery of its advance corporation tax.

Order book

The order book, at constant exchange rates, was £22.9 billion (2004 £18.9 billion). Items are included in the order book when a firm, signed contract exists.

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 until they become firm, signed orders.

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

Aftermarket-services agreements, including TotalCare packages, represented 38 per cent of the order book. These are long-term contracts where only the first seven years' revenue is included in the order book.

Business which has been announced but for which contracts have not yet been signed is excluded from the order book. This amounted to a further £1.5 billion at the year end (2004 £2.4 billion).

Aftermarket services

The Group continues to be successful in developing its aftermarket-services activities. These accounted for 54 per cent of revenue in 2005.

In particular, TotalCare packages in the civil aerospace sector now cover 45 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 £367 million (2004 £389 million).

Cash

The Group cash flow statement is shown on pages 52 and 53 of the financial statements.

The Group generated a positive cash flow of £552 million during 2005 (2004 £251 million). The net cash balance at the year-end was £335 million (2004 net debt £217 million, after adjustment for the implementation of IFRS). Net working capital reduced year-on-year with the main items being increased inventories of £219 million, offset by an increase in customer advances of £181 million and an increase in payables of £294 million. The average net debt level reduced from £632 million to £260 million.

With positive cash flow expected again in 2006, there should be little if any average net debt and the balance sheet will strengthen further.

Net cash flow from operating activities was £1,060 million (2004 £610 million).

Taxation

The overall tax charge on the profit before tax was £130 million (2004 £100 million), a rate of 27.3 per cent (2004 27.5 per cent).

The tax charge was reduced by £18 million (2004 £13 million) in respect of the expected benefit of the UK research and development tax credit.

The tax charge on underlying profit was £167 million (2004 £100 million), a rate of 28.6 per cent (2004 27.5 per cent).

Pensions

As a result of the transition to IFRS, the charges for pensions are now calculated in accordance with the requirements of IAS 19 Employee Benefits; the amounts for 2004 have been restated accordingly. IAS 19 is broadly similar to FRS 17, the effects of which were disclosed in previous years. Its principal impact is to include the entire surplus or deficit of any defined benefit scheme on the balance sheet, based on defined valuation requirements.

Details of the pensions charge and the defined benefit schemes' assets and liabilities are shown in note 23 to the financial statements. This shows a net deficit, after taking account of deferred tax, of £1,154 million (2004 £984 million). Changes in this deficit are affected by the assumptions made in valuing the liabilities and the market performance of the assets. Most importantly, the discount rate used for measuring the UK defined benefit liabilities has fallen from 5.3 per cent in 2004 to 4.7 per cent in 2005. In addition, the mortality assumptions have been updated for the Rolls-Royce Pension Fund (the largest Scheme in the Group) based on the actual mortality experience within the scheme and also to allow for future mortality improvements. These factors more than offset the better than expected returns on the scheme assets.

During 2005, a revised benefit structure was agreed with the members of the Rolls-Royce Group Pension Scheme, similar to that implemented in the Rolls-Royce Pension Fund in 2003.

The next actuarial review is due in 2006 in respect of the Rolls-Royce Pension Fund.

Investments

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

The Group has a portfolio of projects at different stages of their life cycles. Discounted cash flow analysis of the remaining life of projects is performed on a regular basis. Sales of engines in production are assessed against criteria in the original development programme to ensure that overall value is enhanced.

Gross research and development investment amounted to £663 million (2004 £601 million). Net research and development was £282 million (2004 £288 million). The level of self-funded investment in research and development is expected to remain at approximately five per cent of sales in the future. The impact of this investment on the income statement will reflect the mix and maturity of individual development programmes and will result in a significantly lower level of capitalisation of costs in 2006. Investment in training was £30 million (2004 £30 million).

Capital expenditure on property, plant and equipment was £248 million (2004 £191 million) and is expected to increase over the next year.

Partnerships

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

Joint ventures

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

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

The Group's share of joint venture assets and liabilities is shown in the chart below.

Joint ventures: Rolls-Royce share £m

	Repair and overhaul	Financial services	Other	Total
Gross assets	131	499	604	1,234
Debt	(13)	(392)	(75)	(480)
Other liabilities	(50)	(66)	(391)	(507)
Gross liabilities	(63)	(458)	(466)	(987)
Net assets	68	41	138	247

Risk and revenue sharing partners (RRSPs)

RRSPs have enabled the Group to build a broad portfolio of engines, thereby reducing the exposure of the business to individual product risk. The primary financial benefit is a reduction of the burden of research and development (R&D) expenditure on new programmes. The related R&D expenditure is expensed through the income statement and the initial programme receipts from partners, which re-imburse the Group for past R&D expenditure, are also recorded in the income statement, as other operating income.

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

The sharing of risk is fundamental to RRSP agreements. In general, partners share financial investment in the programme; they share market risk as they receive their return from future sales; they share currency risk as their returns are denominated in US dollars; they share sales financing obligations; they share warranty costs; and, where they are manufacturing or development partners, they share technical and cost risk. Partners that do not undertake development work or supply components are referred to as financial RRSPs and, under IFRS from 2005, are accounted for as financial instruments as described below.

In 2005, the Group secured new partners for the Trent 1000 engine programme. However, as the number of new programmes has reduced and in particular as government launch investment was not sought for the Trent 1000 programme, receipts from partners have declined. In 2005, other operating income amounted to £60 million (2004 £73 million) and is expected to be at a similar level in 2006.

Payments to RRSPs are recorded within cost of sales and increase as the related programme sales increase. These payments amounted to £146 million (2004 £240 million, including £98 million in respect of financial RRSPs).

The classification of financial RRSPs as financial instrument has resulted in a liability of £423 million being incorporated in the balance sheet and an associated underlying financing cost of £43 million recorded in the income statement. In 2005 the restructuring of arrangements with a financial partner resulted in a reduction of the liability, of £86 million, with an associated gain within financing costs in the income statement. This gain has been excluded from the underlying profit calculation.

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

Financial services

The financial services businesses comprise: engine leasing (Rolls-Royce & Partners Finance), aircraft leasing (Pembroke), and electrical power project development (Rolls-Royce Power Ventures).

Rolls-Royce & Partners Finance, the Group's joint venture engine-leasing business, owns a portfolio of 281 engines with 35 customers. The proportion of engines on lease remains high, at 98 per cent, by value.

Pembroke, the Group's joint venture aircraft-leasing business, owns 19 aircraft all of which are on lease to 12 customers. A charge of £13 million was incorporated in the 2005 results to reflect the current market valuation of Pembroke's aircraft assets.

Rolls-Royce Power Ventures, the Group's power-project developer, has 11 power-generation projects under way. The business is being restructured and proceeds of £49 million were raised from asset sales.

Intangible assets

The Group carried forward £1,281 million (2004 £1,227 million) of intangible assets. This comprised purchased goodwill of £751 million, engine certification costs and participation fees of £146 million, development costs of £265 million and recoverable engine costs of £119 million. The recognition of development costs and recoverable engine costs has resulted from the transition to IFRS (see note 33).

Risk management

The Board has an established, structured approach to risk management. The risk committee (see Report of the directors) 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, in order 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 business, which are reviewed and updated on a regular basis, with risk mitigation plans identified for all significant risks.

Financial risk

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

The principal economic and market risks continue to be movements in foreign currency exchange rates, interest rates and commodity prices. The Board regularly reviews the 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 in the report of the directors.

Counterparty credit risk

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

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

Funding and liquidity

The Group finances its operations through a mixture of shareholders' funds, bank borrowings, bonds, notes and finance leases. The Group borrows in the major global markets in a range of currencies.

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

The Group took advantage of favourable market conditions during 2005 to extend the maturity profile of its main £250 million revolving credit facility from 2009 to 2012 on improved pricing and terms. As at December 31, 2005 the Group had total committed borrowing facilities of £1.7 billion on an IFRS basis (2004 £1.8 billion).

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

The Group holds financial investments and maintains undrawn committed facilities at a level sufficient to ensure the Group has available funds to meet its medium-term capital and funding obligations and to meet any unforeseen obligations and opportunities. The Group from time to time holds cash and short-term investments which, together with the undrawn committed facilities, enable the Group to manage its liquidity risk.

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

Credit rating

The Group subscribes to both Moody's Investors Service and Standard & Poor's for its official publicised credit ratings. As at December 31, 2005 the Group's assigned long-term credit ratings were:

Rating Agency	Rating	Outlook	Category
Moody's	Baa1	Stable	Investment grade
Standard & Poor's	BBB+	Stable	Investment grade

During the year the Group saw positive actions by Moody's and Standard & Poor's such that the ratings and outlook from both agencies are now equivalent.

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 medium-term objective is to achieve, through the normal course of business, 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 profit and loss accounts of foreign subsidiaries.

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

The Group is exposed to a number of foreign currencies. The most significant transactional currency exposure is the US dollar followed by the Euro. US dollar income, net of expenditure represented 27 per cent of Group turnover in 2005 (2004 26 per cent).

The Group operates a hedging policy using a variety of financial instruments with the objective of minimising the impact of fluctuations in exchange rates on future transactions and cash flows.

The permitted range of the amount of cover taken is determined by the written policies set by the Board, based on known and forecast income levels.

The forward cover is managed within the parameters of these policies in order to achieve the Group's objectives, having regard to the Group's view of long-term exchange rates. Forward cover is in the form of standard foreign exchange contracts and instruments on which the exchange rates achieved are dependent on future interest rates. The Group may also write currency options against a portion of the unhedged dollar income at a rate which is consistent with the Group's long-term target rate. At the end of 2005 the Group had approximately US$10.5 billion of forward cover (2004 US$9.0 billion).

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates. Note 20 includes the impact of revaluing forward currency contracts at market values on December 31, 2005, showing a value of £228 million (2004 £986 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 higher proportion of net debt at fixed rates of interest having regard to the prevailing interest-rate outlook. To implement this policy the Group may utilise a combination of interest-rate swaps, forward-rate agreements and interest-rate caps to manage the exposure.

Commodity risk

The Group has an ongoing exposure to the price of jet fuel and base metals arising from business operations. The Group's objective is to minimise the impact of price fluctuations. The exposure is hedged in accordance with parameters contained in a written policy set by the Board.

Sales financing

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

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

The Group uses Airclaims Limited as an independent appraiser to value its security portfolio at both the half-year and year-end. Airclaims provides specific values (both current and forecast future values) for each asset in the security portfolio. These values are then used to assess the 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 are divided approximately 60:40 between AVGs and credit guarantees. They are spread over many years and relate to a number of customers and a broad product portfolio.

The Board regularly reviews the 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 by the Chief Executive and the Finance Director.

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 re-insurance 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 30 to the accounts describes the Group's contingent liabilities as revised following the adoption of IFRS.

There were no material changes to the Group's gross and net contingent liabilities in this respect in 2005.

International Financial Reporting Standards

As we described last year, from 2005 all European Union listed companies are required to adopt International Financial Reporting Standards (IFRS) for their financial statements. Accordingly these are the first financial statements prepared on this basis. On April 14, 2005, we announced the impact on Rolls-Royce of the transition to IFRS. This is set out in note 33 to the financial statements and further details are available in the Investors section on the Group's website at www.rolls-royce.com

In summary, the key areas of impact for Rolls-Royce relate to:

- financial instruments accounting under IAS 32 and IAS 39;
- capitalisation of development expenditure under IAS 38;
- the impact of IAS 32 and IAS 39 on accounting for financial RRSP receipts and payments;
- pension-scheme accounting under IAS 19;
- fair valuing share-option schemes in accordance with IFRS 2; and
- the cessation of goodwill amortisation in accordance with IFRS 3.

During 2005, the International Accounting Standards Board has published further new standards and amendments to existing standards. Of these, the Group has chosen to adopt early the amendment to IAS 19 Employee Benefits allowing the recognition, in full, of actuarial gains and losses on post-retirement benefit schemes in the statement of recognised income and expense in 2005.

A summary of other changes, which have not been adopted in 2005, is included within the accounting policies in note 1 to the financial statements.

Share price

During the year the Rolls-Royce share price increased by 73 per cent from 247p to 427.5p per share, compared to a 55 per cent increase for the aerospace and defence sector and a 17 per cent increase for the FTSE 100. The Company's shares ranged in price from 236p in April to 430.5p in December.

The number of shares in issue at the end of the year was 1,759 million, an increase of 54 million of which 19 million related to share options and 35 million related to conversion of B Shares into ordinary shares.

The average number of shares in issue was 1,740 million (2004 1,690 million). Underlying earnings per share were 24.14p an increase of 55 per cent over 2004.

Andrew Shilston Finance Director

Board of directors

At February 8, 2006

Simon Robertson Non-executive Chairman
Appointed to the Board in 2004 and appointed non-executive Chairman in January 2005. He is the founder member of Simon Robertson Associates LLP and a non-executive director of HSBC Holdings plc, Berry Bros & Rudd Ltd and The Economist Newspaper Limited. He is Chairman of the Royal Academy Trust, a director of The Royal Opera House Covent Garden Limited and a trustee of the Eden Project and the Royal Opera House Endowment Fund. He is the former President of Goldman Sachs Europe Limited. Age 64.

Sir John Rose Chief Executive
Appointed to the Board in 1992. He joined Rolls-Royce in 1984 and was appointed Chief Executive in 1996. Age 53.

Hon Amy Bondurant Non-executive director
Appointed to the Board in 2003. Managing Director of Bozman Partners, a private investment fund based in Washington. A Board member of the American Hospital in Paris and a Member of the Council on Foreign Relations and of the Council of American Ambassadors. A former US Ambassador to the OECD from 1997 to 2001 and former senior member (partner) and Board member of the Washington DC law firm, Verner, Liipfert, Bernhard, McPherson and Hand and former Senior Counsel to the United States Senate Committee on Commerce, Science and Transportation and to the Consumer subcommittee. Age 54.

Peter Byrom BSc, FCA Non-executive director
Appointed to the Board in 1997. He is Chairman of Domino Printing Sciences plc and Molins PLC, and a non-executive director of both Wilson Bowden plc and AMEC plc. He is a Fellow of the Royal Aeronautical Society. He was a director of N M Rothschild & Sons Limited from 1977 to 1996. Age 61.

John Cheffins BSc, Ing, FREng, FRAeS Chief Operating Officer
Appointed to the Board in 2001. He joined Rolls-Royce in 1967, became President and Chief Executive Officer of Rolls-Royce Industries Canada Inc. in 1991, Director, Civil Engine Business in 1993, President – Civil Aerospace in 1998 and Chief Operating Officer in 2001. He is a Fellow of the Royal Academy of Engineering and of the Royal Aeronautical Society. He is a member of the Institution of Electrical Engineers and of the Order of Engineers of Quebec. Age 58.

Iain Conn Non-executive director
Appointed to the Board in January 2005. He is an executive director of BP p.l.c. having held a range of executive positions within the BP Group worldwide. He is Chairman of the Advisory Board of The Imperial College London Tanaka Business School. Age 43.

Carl-Peter Forster Non-executive director
Appointed to the Board in 2003. President of General Motors Europe and Chairman of the Supervisory Board of Adam Opel AG as well as Chairman of SAAB. He is Chairman of the Supervisory Boards of the Germany-based ASIC manufacturer, ZMD AG and the Austrian based private equity company, Lead Equities AG. Former Managing Director of BMW South Africa and former Executive Board Member for Manufacturing at BMW AG. Age 51.

Colin Green CBE, BSc, CEng, FREng, FIMechE, FRAeS President – Defence Aerospace
Appointed to the Board in 1996. He joined Rolls-Royce in 1968, became Director – Military Engines in 1989, Executive Vice President – Business Operations Allison Engine Company, Inc. in 1995, Managing Director – Aerospace Group in 1996, Director – Operations in 1998 and was appointed President – Defence Aerospace in 2001. He is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers. He is a former President of the Society of British Aerospace Companies. Age 57.

James Guyette BSc President and Chief Executive Officer of Rolls-Royce North America Inc.
Appointed to the Board in 1998. He became President and Chief Executive Officer of Rolls-Royce North America Inc., in October 1997. He is a director of the Private Bank and Trust Company of Chicago, Illinois and of priceline.com Inc. Until 1995 he was Executive Vice President, Marketing and Planning of United Airlines. Age 60.

Andrew Shilston MA, ACA, MCT Finance Director
Appointed to the Board as Finance Director in January 2003, having joined Rolls-Royce in 2002. He is a non-executive director of Cairn Energy PLC. He was Finance Director of Enterprise Oil plc from 1993 until 2002. Age 50.

Membership of principal Board committees:
Audit committee – Peter Byrom (Chairman), Iain Conn and Ian Strachan.
Remuneration committee – Carl Symon (Chairman), Hon Amy Bondurant, Peter Byrom, Carl-Peter Forster and Sir John Taylor.
Nominations committee – Simon Robertson (Chairman), Hon Amy Bondurant, Peter Byrom, Iain Conn, Carl-Peter Forster, Sir John Rose, Ian Strachan, Carl Symon and Sir John Taylor.

Colin Smith BSc Hons, FREng, FRAeS, FIMechE
Director – Engineering and Technology
Appointed to the Board in 2005. He joined Rolls-Royce in 1974 and 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 50.

Ian Strachan Non-executive director
Appointed to the Board in 2003. A non-executive director of Reuters Group plc, Johnson Matthey plc, Xstrata plc and Transocean Inc. He is the Former Chief Executive of BTR plc, former Deputy Chief Executive (1991 to 1995) and Chief Financial Officer (1987 to 1991) of Rio Tinto plc, former non-executive Chairman of Instinet Group Inc and former non-executive director of Commercial Union. Age 62.

Carl Symon BSc, MSc Non-executive director
Appointed to the Board in 1999. He is Chairman of HMV Group plc, the BT Group Equality of Access Board and a number of private companies. He is also a non-executive director of BT Group plc and Rexam plc. He was previously Chairman and Chief Executive Officer, IBM UK. He held numerous executive positions in IBM Corp. in Canada, USA, Latin America, Asia and Europe during a 32 year international career. Age 59.

Prof Sir John Taylor OBE, FRS, FREng Non-executive director
Appointed to the Board in 2004. He is currently Chairman of Roke Manor Research Ltd, and a member of Council of the Royal Academy of Engineering, an honorary fellow of Emmanuel College, Cambridge and a visiting professor at Oxford University. He is the former Director General of Research Councils and the former director of Hewlett Packard Laboratories Bristol. He was chair of the South West RDA's Shadow Science and Industry Council and director of the UK Foresight project on Cognitive Systems. He previously served as President of the Institution of Electrical Engineers and as Chairman of the UK Technology Foresight Panel in IT Electronics and Communications. Age 62.

Charles Blundell MA Company Secretary
He joined Rolls-Royce in 1993 and was appointed Company Secretary in 1995. Age 54.

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

Axel Arendt, Chairman Rolls-Royce Deutschland Ltd & Co KG
Brian Baker, Commercial Director and General Counsel
Charles Blundell, Company Secretary and Director of Government Relations
John Cheffins, Chief Operating Officer
Miles Cowdry, Director – Services
Tom Curley, President – Energy
Colin Green, President – Defence Aerospace
James Guyette, President and Chief Executive Officer of Rolls-Royce North America Inc.
Chris Hole, Director of Procurement
Dr Saul Lanyado, President – Marine
Dr Mike Lloyd, Director – Gas Turbine Operations
John Paterson, Managing Director Aero Repair and Overhaul
John Rivers, Director – Human Resources
Andrew Shilston, Finance Director
Colin Smith, Director – Engineering and Technology
Mike Terrett, President – Civil Aerospace

Report of the directors

The directors present their report and the audited financial statements of Rolls-Royce Group plc (the Company) and its subsidiaries (together referred to as the Group) for the year ended December 31, 2005.

Principal activities

Rolls-Royce is a global business providing power systems for use on land, at sea and in the air. The Group has a balanced business portfolio with leading positions in the civil and defence aerospace, marine and energy markets. There are some 54,000 Rolls-Royce gas turbines in service and they generate a demand for high-value services throughout their operational lives. Rolls-Royce is a technology leader employing 36,200 people in offices, manufacturing and service facilities in 50 countries.

Results for the year and the issue of B Shares

The Chairman's statement, the Chief Executive's review and the Finance Director's review describe the year's operations, research and development activities and prospects.

At the Annual General Meeting (AGM) on May 3, 2006, the directors will recommend an issue of 53.8 B Shares with a total nominal value of 5.38p for each ordinary share. Together with the interim issue on January 3, 2006 of 33.4 B Shares for each ordinary share with a total nominal value of 3.34p, this is the equivalent of a total annual payment to ordinary shareholders of 8.72p for each ordinary share.

Shareholders are given the opportunity to redeem their B Shares for cash or to convert them into additional ordinary shares in the Company. For those shareholders who have not elected to redeem or convert their B Shares, a B Share dividend at a rate of 75 per cent of the London Interbank Offered Rate (LIBOR) is payable half yearly in arrears.

The Board believes that there continues to be a significant benefit to be gained from the issue of B Shares. Payments to shareholders will, therefore, continue to be made through further issues of B Shares, generally in January and July each year.

Going concern

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

Share capital

The following shareholder has a notifiable interest in the Company's ordinary shares at February 8, 2006:

	% of issued ordinary share capital
BMW AG	9.02

Authority to purchase own shares

At the AGM in 2005 the Company was authorised by shareholders to purchase up to 173,313,853 of its own ordinary shares representing ten per cent of its issued ordinary share capital as at February 9, 2005. The Company did not make use of this authority during 2005.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2006 and a resolution to renew it will be proposed at that meeting.

Auditors

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

Political donations

In line with its established policy, the Group made no political donations during 2005.

Directors

The directors' biographical details, including their other significant commitments, are set out on pages 30 and 31. During the year there were a number of Board changes: Simon Robertson was appointed non-executive Chairman with effect from January 1, 2005; Iain Conn was appointed as an independent non-executive director with effect from January 20, 2005; Sir Robin Nicholson retired as the Company's senior independent director on February 9, 2005 and as a non-executive director, at the conclusion of the AGM on May 4, 2005; Peter Byrom succeeded him as the senior independent director; Dr Mike Howse retired as an executive director on June 30, 2005; and Colin Smith was appointed as an executive director of the Company on July 1, 2005. Colin Green will retire from the Board as an executive director on April 4, 2006.

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 re-election by the shareholders at the next AGM. The Board also requires any non-executive director who has served on the Board for more than nine years to be subject to annual re-election at the AGM. The directors retiring at this year's AGM are Peter Byrom, Sir John Rose, Colin Smith, Ian Strachan and Carl Symon. They all offer themselves for re-election.

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.

Corporate governance

Statement on corporate governance compliance

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 Board confirms that throughout 2005, the Company complied with the Combined Code on Corporate Governance (the Combined Code). This report and, where appropriate, the Directors' remuneration report, explain how the Company discharges its corporate governance responsibilities.

The Board's composition and directors' independence

Simon Robertson chairs the Board of the Company and Sir John Rose is the Chief Executive. The division of responsibilities between them is set down in writing and agreed by the Board. Peter Byrom is the Company's senior independent director.

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

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

Each executive director receives a service contract on appointment (see the Directors' remuneration report for further information) and each non-executive director receives a letter setting out the conditions of their appointment. Non-executive directors are appointed for an initial term of three years, which may be extended subsequently with the agreement of the Board. 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.

The Board applies a rigorous process in order to satisfy itself that its non-executive directors remain independent. 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 30. In the case of the non-executive directors, the Board reviews their independence every year, using its own judgement when applying the criteria in the Combined Code. Having undertaken this review in 2005, the Board confirms that all the non-executive directors are considered to be independent in character and judgement.

On January 1, 2006, Peter Byrom completed nine years service on the Board and therefore does not meet one of the criteria for independence contained in the Combined Code. Having conducted a thorough review, the Board has concluded that Peter Byrom remains independent in character and judgement, 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. 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. With his financial background, City experience and deep knowledge of the Group's business, Peter Byrom is particularly well qualified to serve as the Chairman of the audit committee and as the senior independent director. The Board therefore considers it to be in the interests of shareholders that he should continue to support the Company in both these roles, a judgement which has been endorsed by the independent consultancy, which undertook a review of the Board's effectiveness during 2005 (see below). In line with the policy adopted by the Board, Peter Byrom will in future be subject to annual re-election by shareholders.

Role of the Board

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

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

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

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

Primary goal

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

The Board's tasks

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

- ensure the development of the Company's strategy and keep it under rigorous review;
- monitor the implementation of the strategy, ensuring that the necessary financial and human resources are in place to deliver it and that effective controls exist to manage risk;
- safeguard the values of the Company, including its brand and corporate reputation and the safety of its products;
- oversee the quality and performance of management and ensure through effective succession planning and remuneration policies that it is maintained at world-class standards; and
- maintain an effective corporate governance framework that delivers 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. On-going training is available for all the directors, including presentations by the executive team on particular aspects of the business.

There is an agreed 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 Company Secretary and the General Counsel.

Board effectiveness

The Chairman meets at least once a year with the non-executive directors 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 their contribution to the Board. The senior independent director chairs an annual meeting with the non-executive directors to review the performance of the Chairman, the outcome of which is reported back to him.

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

The Board attaches considerable importance to ensuring that it performs effectively as a team. In 2005, an in-depth review of the effectiveness of the Board and its committees was undertaken by Consilium Associates, an independent consultancy. The review covered Board and committee structure, Board dynamics, the conduct of Board meetings, the information provided to directors and corporate governance. The report prepared by Consilium Associates was discussed by the Board in December 2005 and will be used by the directors in 2006 to implement a number of improvements in the way the Board operates. The audit, remuneration and nominations committees have separately undertaken reviews of their terms of reference and effectiveness during 2005.

Board committees

The Board is assisted by its committees. Details of their membership and principal terms of reference are set out below and on page 39. Their full terms of reference are available in the Investors section on the Group's website at www.rolls-royce.com

The following table shows the level of attendance by the directors at Board and principal committee meetings in 2005.

Attendance at meetings of the Board and its principal committees in 2005

	Board		Audit		Nominations		Remuneration	
Director	Held*	Attended	Held*	Attended	Held*	Attended	Held*	Attended
Hon Amy Bondurant	8	8			5	5	5	4
Peter Byrom	8	8	4	4	5	5	6	6
John Cheffins	8	8						
Iain Conn	8	7	4	3	1	1		
Carl-Peter Forster**	8	5			5	3	6	3
Colin Green	8	8						
James Guyette	8	8						
Dr Mike Howse	4	4						
Sir Robin Nicholson	3	3	2	2	1	1		
Simon Robertston	8	8			5	5		
Sir John Rose	8	8			5	5		
Andrew Shilston	8	8						
Colin Smith	4	4						
Ian Strachan	8	7	4	4	5	5		
Carl Symon	8	8			5	5	6	6
Sir John Taylor	8	8			1	1	5	5

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

** During 2005, Carl-Peter Forster was unable to attend the Board and committee meetings shown above as a result of the demands placed on him at short notice in his capacity as President of General Motors Europe. In all cases when he was unable to attend a meeting, he communicated his views to the Board or committee Chairman and in the Board's view, he continues to make a very strong contribution to the Company and to the work of the Board and its committees.

Nominations committee

In 2005 the nominations committee was chaired by Simon Robertson. Its other members were the Hon Amy Bondurant, Peter Byrom, Carl-Peter Forster, Sir John Rose, Ian Strachan, Carl Symon and Sir Robin Nicholson (until his retirement as a non-executive director on May 4, 2005). On November 17, 2005 Iain Conn and Sir John Taylor joined the committee, reflecting the Board's view that all the non-executive directors should serve as members of the committee. The committee met five times 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 for appointments to the Board and to other senior positions within the Group.

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.

Remuneration committee

The remuneration committee determines appropriate levels of remuneration for the executive directors and other 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 39.

Audit committee

The audit committee consists exclusively of independent, non-executive directors and is chaired by Peter Byrom who has recent and relevant financial experience. In 2005, its other members were Sir Robin Nicholson until May 4, 2005 and Ian Strachan. Iain Conn became a member of the committee with effect from January 20, 2005. The committee met four times during the year.

The committee has responsibility for recommending to the Board the published accounts and for reviewing the Group's financial reporting and accounting policies, including major announcements made to a regulatory information service. It is also responsible for the relationship with the external auditors and for 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 scope of the audit, approving the audit fee and, on an annual basis, satisfying itself that the auditors are independent. It keeps under review the Group's internal controls and systems for assessing and mitigating financial and non-financial risk. It also reviews and approves the Business Assurance work programmes and ensures that this function is adequately resourced and co-ordinated with the work of the external auditors.

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

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

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

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.

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 2005, membership of the committee comprised John Cheffins, Colin Green, James Guyette, Sir John Rose, and Andrew Shilston. Dr Mike Howse was a member of the committee until his retirement on June 30, 2005. Colin Smith became a member with effect from July 1, 2005. Colin Green will cease to be a member of the committee when he retires from the Company on April 4, 2006.

Internal controls and risk management

Directors' responsibilities

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

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

There is an ongoing process to identify, assess and manage risk, including those risks affecting the Group's reputation. This process is subject to continuous improvement and has been in place throughout the financial year to which these statements apply and up to the date of their approval. In 2005 the risk review framework has been enhanced at both programme and sector level and assurance activities more closely co-ordinated with the risk management process.

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 current Turnbull Committee Guidance on Internal Control and the Revised Guidance for Directors on the Combined Code issued in October 2005, which takes effect for financial years beginning on or after January 1, 2006.

Organisation

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

Rolls-Royce also has a code of business ethics which lays down the principles to be followed by employees in the course of conducting business. The code also gives guidance to support achievement of the required standards. Additionally, confidential reporting lines enable UK and US employees to report, outside the normal management chain, any concerns they may have with regard to business conduct.

The risk management system

The risk management system is an integral part of management's approach to delivering business objectives and is a systematic process designed to identify, assess, treat, manage and communicate risks. It also provides a method of escalation and delegation to the appropriate level within the organisation and ensures actions are owned, defined, resourced and effective.

Management is responsible for the ongoing identification and evaluation of significant risks within their areas of responsibility and, using a common process, for the operation of suitable controls or mitigation actions. Risks are recorded in regularly updated risk registers operating at all levels of the organisation and are continuously reviewed and monitored. During the review process, significant emphasis is placed on learning from and sharing prior experience. Risks may arise from a variety of internal and external sources. They may be associated with regulations, customer requirements and competitor actions or could result from the capability of the processes used to execute the business or from external and largely unpredictable events, such as terrorist activity or war.

Risks, irrespective of source, are managed through processes operated by project and functional teams. Management reports regularly to the risk committee on its view of risks and how they are managed so that the Board can then consider and review these risks in terms of their potential impact.

Management has continued to perform comprehensive risk reviews for all key projects, programmes and business change plans. In addition, all the processes operated by the Company are subject to continuous improvement, including the risk management process itself.

Systems of internal control

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

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

The activities of the Group are subject to review by the Department of Risk, including Business Assurance and Project Risk Assessment, and the assurance functions of Health, Safety and Environment, Quality and Engineering. These functions operate to work programmes agreed by the appropriate Board member.

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

Export controls

The Group attaches the highest priority to complying fully with export controls in all the jurisdictions in which it operates. Detailed processes have been put in place to ensure that the Group follows all applicable legal and regulatory requirements.

The Board has established an exports committee, chaired by the Chief Operating Officer, which has responsibility for the application of appropriate controls to the Group's export activity.

In the UK, the Group fully complies with the provisions of the UK Export Control Act on tangible and intangible exports and trade between third parties. Additionally, the Group complies with the relevant EU regulations regarding the export of dual use goods and technology. In other jurisdictions, most notably the USA, the Group vigorously enforces a policy of compliance with both the relevant national legislation and its underlying regulatory intent.

Communication with shareholders

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

In November 2005, the Company hosted a major investors' seminar in Derby, at which a number of Board directors and other senior executives described the Group's progress. 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, remuneration and nominations committees are available to answer any questions from shareholders on the work of their committees.

The Company confirms that it sends the AGM notice and relevant documentation to all shareholders at least 20 working days before the date of the AGM. For those shareholders who have elected to receive communications electronically, notice is given of the availability of documents on the Group's website.

Responsibility for maintaining regular communications with shareholders rests with the executive management team led by the Chief Executive. However, the Board is informed on a regular basis of key shareholder issues, including share price performance, the composition of the shareholder register and City expectations. Independent research is commissioned annually into institutional shareholder perceptions of the Group. The Chairman, the senior independent director and the non-executive directors make themselves available to meet with shareholders as required.

Corporate responsibility

The Group believes that excellence in corporate responsibility delivers competitive advantage and contributes to long-term success. It helps the Group attract and retain the best people and maintain successful working relationships with customers, suppliers and governments. It also enables the Group to build goodwill and to support the communities in which its employees live and work. The sustained wealth, created by providing thousands of highly skilled jobs, represents the Group's single greatest contribution to those communities.

Charitable donations and community involvement are encouraged within a global framework which assists local regeneration and promotes education in business and technology-based studies.

The Group supports its own employees with well-developed policies and practices in health, safety and environment, employment policy and employee learning and development. The Group also operates proactive policies to manage its supplier and customer relationships responsibly.

The Group's achievements during the year were recognised when it was ranked in 9th position in the 2004 UK Business in the Community Corporate Responsibility Index and retained its inclusion in the Dow Jones Sustainability Indices.

The following paragraphs describe in more detail how the Group addresses specific aspects of its policy and practice in the field of corporate responsibility.

Supply chain

The Group makes its approved suppliers aware of the expected business requirements and performance standards through its supplier quality system, 'Supplier Advanced Business Relationships' (SABRe). This includes a supplier code of conduct and a health, safety and environmental management system, which set minimum standards. Regular visits are made to suppliers to assess their performance and a supplier awareness programme is delivered through conferences and regular communications. The Rolls-Royce purchasing code of conduct for employees complements the supplier code of conduct and ensures that employees act consistently with suppliers.

In 2005, Rolls-Royce won a UK award from the Chartered Institute of Purchasing and Supply in recognition of its contribution to corporate responsibility through the recycling of material in its supply chain.

The Group's sourcing policies in the USA reflect US Government regulations on small and disadvantaged businesses and our performance is monitored regularly.

Health, Safety and Environment (HS&E)

Rolls-Royce recognises that exceptional HS&E performance makes sound business sense. Our strategy is to protect our employees, contractors and the wider community; attract and retain a motivated workforce; maintain business continuity; avoid asset damage; and reduce overall costs. We also aim to have zero injuries and environmental incidents and to minimise the environmental impact of our operations.

The Chief Executive chairs the HS&E committee which is responsible for defining strategy, the management system, Group objectives and all performance measures. The Group is supported by the Environmental Advisory Board (EAB), whose members include respected external authorities. The EAB reviews and makes independent recommendations on the environmental and sustainability aspects of the Group's activities.

The Chief Operating Officer chairs the Major Incident Board which reviews incidents to ensure that lessons learnt are effectively communicated throughout the Group. Incidents considered in 2005 were a fire in a magnesium cutting operation and an explosion in a hydrogen bell furnace. Fortunately, these regrettable incidents did not result in any injuries and the Group experienced no work-related fatalities in 2005.

Three-year targets were set across the Group in 2003 covering: lost time injury rate; number of working days lost; incident rate of occupational diseases and other work related ill health; 100 per cent health surveillance of any populations at risk; energy use; solid waste; solid waste recycling and hazardous liquid waste. Programmes are in place to improve performance in these areas and an update, with data for 2005, will be published on the Group's website in April 2006. Independent assurance is provided by Deloitte & Touche LLP.

The Group operates three sites in the UK which manufacture, test and support nuclear reactor cores for Royal Navy submarines. All these sites continue to maintain a strong health, safety and environmental record.

The Group's HS&E audit programme independently assesses the implementation of its HS&E management system. Several audits were completed in 2005, covering operations in the UK, USA, Finland and Norway. Good progress continues to be made in implementing the Group-wide standard for an integrated HS&E management system. HS&E reviews were also undertaken at joint venture operations in the UK and the USA and at selected suppliers in Bulgaria, Romania and Taiwan.

The Group recognises HS&E performance with annual awards presented by the Chief Executive. Recognition was given in 2005 to those sites achieving zero lost time injuries.

Environment

The Group operates environmental management systems which are third party certified to the international standard ISO 14001. In 2005 the Group's operations at Oberursel and Dahlewitz in Germany received certification and all the Group's major sites are now certified. Our aim is for newly acquired businesses to achieve certification within two years of acquisition.

The Group continues to make excellent progress in improving the environmental performance of its products, with environmental impacts reduced by sustained investment in technology. We work with industry groups to support these objectives and in 2005, we were a key participant in the development of the UK Sustainable Aviation initiative. This defines a long-term strategy to maintain the benefits of growth in air travel, whilst managing the environmental impacts within sustainable limits.

The Group also supports the long-term goals published by the Advisory Council for Aeronautics Research in Europe (ACARE). ACARE seeks, by 2020 from a 2000 baseline, to develop aero-engine technology to help reduce fuel burn and carbon dioxide emissions per passenger kilometre by 50 per cent, noise by 50 per cent and emissions of oxides of nitrogen by 80 per cent. Rolls-Royce engines for the Airbus A380 and the Boeing 787 show improvements in environmental performance which are fully consistent with achieving these goals. Similar programmes are being followed in the energy and marine businesses.

The Group continues to participate in the UK carbon dioxide emissions trading scheme and the Chicago Climate Exchange and has targets for reduced carbon dioxide emissions from its operations in the UK and North America. In 2005, the Group again exceeded its obligations to reduce emissions under the UK Emissions Trading Scheme and sold some emissions units, thereby enhancing the cost-saving benefits of energy reduction.

In 2005, the Group was again placed first in its business sector in the Business in the Environment index of corporate environmental management. Its environmental achievements have also been recognised by several UK awards, including Business in the Community's 'Big Tick,' Business Commitment to the Environment and the Energy Accreditation Scheme.

Occupational Health

The Group's strategy is to provide a progressive Occupational Health service recognised for delivering best practice based upon prevention and with processes fully integrated into the quality management system.

The Group recognises the link between physical and mental health and the need for employees to enjoy working effectively and successfully with proper regard for their personal well-being. To support the link between well-being and productivity, the HS&E committee in 2005 endorsed a preventative occupational health strategy, which concentrates on four key areas: screening and surveillance; rehabilitation; health promotion; and education.

In screening and surveillance, stringent targets are set for assessing fitness for work, reducing occupational disease and work-related ill health. A campaign continues to reduce noise-induced hearing loss and the Company played a significant part in 2005 in advising on the introduction of 'The Control of Vibration at Work Regulations' and their supporting guidance.

The priority in rehabilitation is early intervention and active case management of individuals. Training is provided to assist managers in managing absence and rehabilitation effectively.

Health promotion in 2005 included awareness campaigns on smoking and obesity. Employees are encouraged to stop smoking by highlighting the many benefits of not smoking and promoting the wide range of help and support in giving up. A three-month educational campaign called 'Reduce Hazardous Waist!' was launched with the aim of reducing health problems associated with obesity.

The Group's approach to managing workplace pressure has previously been recognised as an example of best practice by the UK's Health and Safety Executive (HSE) commissioned report on 'Beacons of Excellence'. Similarly its approach to absence management was cited by the HSE in its 'Better business' campaign.

Dr Ian Lawson, the Group's Chief Medical Officer, has recently completed a term of office as President of the Society of Occupational Medicine and has become a member of the International Commission on Occupational Health.

Employment policy

At the end of 2005, the Group employed 36,191 employees (2004 35,372).

The Group and employee representatives continue to work closely together to improve the quality of employee engagement and participation in the development of the business. This was reflected by the creation in April 2005 of a Global Council. It comprises employee representatives from countries worldwide and provides a structured approach to consultation and communication on international issues. The Global Council meets at least twice a year, supported by the Global Council's Executive Committee which progresses issues between the Council meetings.

In 2005, the Group consulted widely over changes to the Rolls-Royce Group Pension Scheme for UK employees. New arrangements took effect from July 1, 2005 after agreement with employee representatives and acceptance by employees. The changes introduced were similar to those made to the Rolls-Royce Pension Fund in 2004.

As part of its commitment to effective consultation with all employees, the Group carried out a worldwide Employee Engagement survey in 2004. In 2005 the results of this survey were shared with all employees. Each business identified an action programme to address the issues arising.

The Group's global policy on diversity and equality continues to develop in consultation with employee representatives. The Group is committed to equal opportunities and to developing a diverse and inclusive workforce. It continues to support initiatives to encourage more women and people from ethnic minorities to pursue careers in engineering. The Group recognises the need to promote its policies effectively and widely reflecting the international scope of its operations.

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

The Group actively encourages employee share ownership. All employees are regularly invited to participate in sharesave plans and the workforce has committed to save over £90 million to buy shares in the Company. In addition, statutory arrangements enable UK employees to receive part of their annual bonus in Company shares and make monthly share purchases from their salary.

Learning and development

To strengthen its competitive position, the Group has over many years invested in the training and development of its employees, customers and suppliers. In 2005, we spent £30 million on the education, training and professional development of employees.

Training programmes were delivered to support major change programmes. In particular, we have launched the 'Process Excellence' initiative to improve our management and operating processes and we have trained people to undertake specific projects to raise standards of performance and improve customer satisfaction.

Some 2,000 people were trained to support 'Product Lifecycle Management' which enables the Group and its supply chain to deliver products and services at a higher quality and with greater efficiency.

The Company offers employees access to wide-ranging courses on-line and over 5,000 employees have taken an on-line course over the past two years.

The Group continues to attract trainees into its skilled and professional workforce. In the UK, graduate applications totalled over 3,500 in 2005 and we recruited 183 graduates. We also recruited 136 apprentices and technicians. In addition, over 500 undergraduate students were employed for training periods of between two and 12 months. At the end of the year, worldwide there were 273 graduates and 370 apprentices and technicians in formal training programmes.

In 2005, the Group was ranked first in its business sector and 24th overall in the UK Times Newspaper Top 100 Graduate Employers list.

The Group continues to work closely with schools, colleges and universities to promote science, technology and enterprise. Our policy is to work with government, local and national bodies and educational institutions to widen pupils' and students' experience of industry and to promote careers in the aerospace, marine and energy sectors. In 2005, the Group progressed two flagship activities: Profitable Pursuit, a business simulation to stimulate enterprise education in schools, and the Rolls-Royce Science Prize which promotes and rewards science teaching in schools and colleges in the UK and the Republic of Ireland. In 2005 the first round finalists and special merit award winning teams were selected, representing a wide range of schools.

The Group supports educational projects and initiatives to promote engineering education in schools including Open Industry, Specialist Schools, Education Action Zones and Science and Engineering Ambassadors. In North America, Rolls-Royce supports 'Project Lead the Way,' a programme which creates partnerships with schools to encourage more students to consider careers in engineering and technology.

Some of the Group's training facilities are made available to local communities with free places being offered on internal training programmes. In addition, working on local community projects forms a key part in developing employees.

We continue to meet customer training needs with management and business education. We led the initiative to establish the British University in Dubai and developed executive programmes for China's aviation industry leaders. Under the UK Government's Chevening scheme, the Group sponsored students from Brazil, China, India, Indonesia, Malaysia and Taiwan. We also manage a company scheme for placing English language teachers in China, arranging 40 assignments for UK graduates.

Community investment

The Group community investment committee is responsible for the Group's policy on charitable donations. In 2005, total charitable donations amounted to £1,484,000. A list of the principal donations made in the year is available on written request to the Company Secretary.

The committee is supported by national committees and all operate within the following guidelines:

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

During 2005, charitable donations in the UK amounted to £671,000. They included support for The Prince's Trust, Community Foundations, SS Great Britain, The Industrial Trust and Duxford AirSpace.

The Group has made charitable donations of £563,000 in other major regions. In North America, this included support for the work of United Way, Habitat for Humanity, the Smithsonian National Air and Space Museum and Purdue University. In Germany, the Group supported a range of organisations including the Brandenburg Summer Festival, World Youth Day and the International Airport Race. In the Nordic countries, it supported a number of local sports and arts-based projects.

In response to the tsunami disaster in south east Asia, the Group contributed £250,000 in 2004 and an additional £250,000 in 2005 to match employee donations. Funding is being used to support a number of projects in the affected areas, including the construction of a primary care clinic in Aceh, Indonesia, the construction of a school in India and other projects in Thailand.

Our response to the hurricane Katrina disaster was very visible in the devastated communities affected. The Group provided housing, transportation and medical support, followed by a range of special support services. Employee groups mobilised their support through food and clothing drives and also raised over £35,000. The Rolls-Royce response was exemplary and was recognised as such both externally and internally.

In addition to our charitable donations, contributions of £1,700,000 were made by the Group's sponsorship committee and individual business groups, primarily to support arts and educational programmes.

The Group also finances the administration of the Payroll Giving Scheme for UK employees. In 2005, the scheme helped employees make donations of over £396,000 to over 200 charities of their choice. Sixteen per cent of employees participate, one of the highest levels in the UK. The scheme received a Gold Award from the UK Institute of Fundraising in 2005. In addition, 36 per cent of employees in North America have contributed over £200,000 to good causes through 'United Way' schemes, which are partly matched by the Company.

The Company also supports its commitment to being a good corporate citizen by supporting projects in which employees are encouraged to participate. Examples include:

- running successful mentoring and literacy programmes for school pupils through education business partnerships ;
- participating in the UK's Science and Engineering Ambassadors Scheme;
- undertaking community projects with trainees as part of their training;
- supporting employees who are school governors; and
- providing business mentors and advisers through The Prince's Trust and Young Enterprise.

The Group offers support in-kind to local initiatives including providing places on in-house training programmes; donating surplus computer equipment and furniture; and offering the free use of meeting rooms and premises.

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

Rolls-Royce has a long and successful history of community involvement which it is determined to maintain. We continue to attach particular priority to supporting education, the environment, the arts and economic and social regeneration. Our approach supports our values of reliability, integrity and innovation.

By order of the Board

Charles Blundell, Company Secretary

February 8, 2006

Directors' remuneration report

Information not subject to audit

Introduction

This report to shareholders covers:

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

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

The report was approved by the remuneration committee (the committee) on February 6, 2006 and was signed on the Board's behalf by Carl Symon as the Chairman of the committee. A resolution will be put to shareholders at the Annual General Meeting (AGM) on May 3, 2006 inviting them to approve this report.

The remuneration committee

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

The committee consists exclusively of independent, non-executive directors. At January 1, 2005, it was chaired by Carl Symon and its other members were Peter Byrom and Carl-Peter Forster. With effect from February 9, 2005, the Hon Amy Bondurant and Sir John Taylor joined the committee, with the chairmanship and other members of the committee remaining unchanged throughout the year.

In 2005, Simon Robertson, Chairman, Sir John Rose, Chief Executive, John Rivers, Director – Human Resources, and Charles Blundell, 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 2005 and details of members' attendance are set out on page 34.

Advice to the remuneration committee

The committee may call for information and advice from advisers inside and outside the Group. In 2005, Simon Robertson and Sir John Rose made recommendations to the committee relating to the performance of their direct reports. Internal support was provided primarily by John Rivers, advised by Deloitte & Touche LLP. Additional advice was provided by senior employees from Human Resources, Finance and Business Development.

The committee received advice on remuneration matters from Deloitte & Touche LLP and the Company's lawyers, Freshfields Bruckhaus Deringer. During 2005, Deloitte & Touche LLP also advised the Group on tax, assurance, pensions and corporate finance.

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 2006:

i) 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;

ii) a significant proportion of total remuneration should be based on Group and individual performance, both in the short and long term; and

iii) the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the acquisition of a significant shareholding 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, annual incentive arrangements, long-term share-based incentives and pension and life assurance benefits. Executive directors and senior executives are also entitled to a company car or car allowance, private medical insurance, financial counselling and, in the case of James Guyette, a housing allowance.

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

Base salaries

In determining the relative importance of these elements of remuneration, the committee believes that base salaries should be set at levels required to recruit and retain high quality senior executives.

The committee believes that base salaries should be set with reference to the median level of the relevant marketplace for companies of a similar size and complexity. 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.

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 2005, 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]
John Cheffins	48	80
Colin Green [2]	48	80
James Guyette	48	80
Dr Mike Howse	48	80
Sir John Rose	60	100
Andrew Shilston	48	80
Colin Smith [3]	37.5	62.5

[1] It is possible for a bonus award to be increased by a further 20 per cent to reflect exceptional personal performance.
[2] The award for Colin Green reflected the performance of the business sector for which he is responsible, in addition to Group and personal objectives.
[3] Colin Smith was appointed as an executive director on July 1, 2005. His maximum bonus award was increased from 45 per cent to 80 per cent from the date of his appointment as an executive director.

Performance measures

The APRA performance measures set by the committee are based on the Group's annual operating plans. For 2005, the measures for executive directors included underlying profit, average cash balance, cash flow and personal performance against specific personal objectives. Forty per cent of any APRA bonus depends on personal performance against these specific objectives.

In 2005, to emphasise the importance of the corporate result, the APRA bonus pool available for distribution to all participants was generated solely by the financial performance of the Group and no bonus would have been available to any participant unless the Group achieved predetermined performance targets. The performance of the business sector in which an executive is employed is also a factor in that it determines the extent to which an executive has access to the pool generated by corporate performance.

All executive directors have a high proportion of their annual remuneration at risk. For the Chief Executive, his 120 per cent maximum bonus opportunity means that 55 per cent of his combined basic pay and bonus opportunity is directly related to annual financial and personal performance. In 2005, the level of achievement against the financial measures was sufficient to generate 95 per cent of the bonus for individual participants.

Deferred APRA award

One third of the value of APRA is delivered in the form of a deferred award in the Company's shares. 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 full number of 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. The deferred share element operated for 2005 will result in share awards as described on page 43. The committee intends to maintain the deferred share element in respect of 2006. 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.

Other annual incentives

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

A Deferred Share Incentive Plan (DSIP) was operated for 2002, which was restricted to a small number of key executives, including executive directors. No awards under the DSIP were made in 2005 and it is not intended that the plan will be operated again. DSIP grants made in 2002 vest in April 2006.

Long-term incentives

In 2003 the committee completed a review of long-term incentive arrangements and concluded that the introduction of a new plan, the Rolls-Royce Group plc Performance Share Plan (PSP), would provide stronger incentives to improve Group performance than executive share options. Shareholders approved the introduction of the PSP at the 2004 AGM. As stated in the 2004 Annual report, the committee does not intend to make further grants under the Rolls-Royce 1999 Executive Share Option Plan.

Rolls-Royce Group plc Performance Share Plan

The 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 generation, earnings and total shareholder return. These measures are considered particularly important in generating shareholder value and are explained in more detail on page 41. There is no retesting of the performance criteria and no automatic vesting in the event of a take-over.

PSP award levels

The sizes of the awards under the PSP are aimed at the median of the marketplace for UK companies of a similar size and complexity to the Group. In 2005, Sir John Rose received an award of shares with a market value at the time of grant of 100 per cent of his annual salary. For other executive directors and business heads the grant was 66.6 per cent, and 50 per cent for other members of the Group Executive. During the year the committee reviewed the PSP award levels against market practice and for 2006 it is intended that the award level policy will be 110 per cent, 80 per cent and 65 per cent of annual salary respectively for the Chief Executive, executive directors and business heads, and other members of the Group Executive. The rules of the PSP permit grants of up to 200 per cent of annual salary. As described below, it is possible for the number of shares under an award to be increased by a further 25 per cent based on the Company's Total Shareholder Return (TSR) performance.

Performance measures

No shares will be released from the PSP unless the growth in the Company's Earnings Per Share (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 Cash Flow Per Share (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.

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 2006:

Aggregate CPS over three-year performance period	Percentage of maximum award released
52p	30%
69p	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.

Intermediate levels of performance attract pro rata releases. The shares released will be determined by the total CPS generated over the three-year period.

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 external independent agency. If the Company's TSR exceeds the median of that group of companies, the number of shares due to be released to an executive following achievement of the EPS and CPS targets will be increased by 25 per cent.

EPS and TSR performance measures are calculated from a base year, which is the year before grant.

In line with the committee's established policy, it is envisaged that existing shares will be used to satisfy awards, but in order to provide flexibility, the PSP rules permit the issue of new issue shares within standard limits.

Share retention policy

The committee requires participants in the PSP to retain at least one half of the number of after tax shares released from the PSP until their retirement, except that shares may be sold within one year before the normal or agreed retirement date or on leaving for any other reason once a committed date has been agreed. This exception is intended to ensure that participants are not disadvantaged under capital gains tax rules on leaving employment.

Executive share option plan

As mentioned on page 40, following the introduction of the PSP it is not intended to continue granting executive share options.

The exercise of existing options is subject to a performance condition that the Company's growth in underlying EPS must exceed the UK retail price index by an average of three per cent per year over a rolling three-year period. These performance conditions apply to all the executive directors. The committee reviews achievement of the EPS target annually.

In 2001, in order to help meet a series of demanding challenges, key members of the executive team, including the executive directors, received a larger than normal level of grant. As described in the Company's 2001 Annual report, this award had more demanding performance criteria and personal share ownership requirements (see pages 46 and 47).

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. This plan operates within specific tax legislation (including a requirement to finance the exercise of the option using the proceeds of a monthly savings contract). 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, under which UK employees receive shares of up to the equivalent of one week's pay as part of the Company component of any bonus paid for 2005; and

iii) the 'Partnership Share' element of the Share Incentive Plan under which UK employees may make regular purchases of shares from pre-tax income.

International Financial Reporting Standards

The committee is working closely with the audit committee to monitor and react appropriately to any impact which the introduction of International Financial Reporting Standards (IFRS) may have on the performance measures under annual and long-term incentive plans. In particular, since many of the performance targets were set based on UK GAAP, but will be measured under IFRS, appropriate adjustments will be made to ensure that performance is measured on a consistent basis.

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 such as age, length of service contract and the director's obligation to mitigate his or her own loss.

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

	Date of contract	Unexpired term	Notice period Company	Notice period individual
John Cheffins	4 May 2001	12 months	12 months	6 months
Colin Green	1 March 1991	12 months	12 months [1]	6 months
James Guyette	29 September 1997	Indefinite	30 days [2]	30 days
Sir John Rose	4 December 1992	12 months	12 months [1]	6 months
Andrew Shilston	5 November 2002	12 months	12 months	6 months
Colin Smith	1 July 2005	12 months	12 months	6 months

[1] In the event of the service contracts for Sir John Rose or Colin Green being terminated by the Company, other than in accordance with the contracts' terms, they are entitled to receive a liquidated sum calculated as 12 months' salary and benefits. Performance related payments are not covered under this arrangement, although an annual bonus may be paid if the executive is in post at the end of the year.

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

Executive directors' directorships of other companies

During 2005, Sir John Rose was a non-executive director of Eli Lilly and Company until his resignation on October 14, 2005. James Guyette was a director of the Private Bank and Trust Company of Chicago, Illinois and of priceline.com Inc. and Andrew Shilston was a non-executive director of Cairn Energy PLC.

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

External directorship fees

	Payment received £000
James Guyette [1,2]	48
Sir John Rose [1,3]	25
Andrew Shilston	45

[1] Sir John Rose and James Guyette were paid in US dollars translated at $1.82 = £1.
[2] In addition to an annual fee, James Guyette received 8,000 stock options in priceline.com at an option price of US$22.59 per share. He also received 3,000 stock options in Private Bank at an option price of US$30.59 per share.
[3] Following the resignation of Sir John Rose from the board of Eli Lilly and Company, he received 1,216 shares in respect of the release of shares from the Lilly Directors' Deferral Plan.

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 committee makes recommendations to the Board on the remuneration of the Chairman. The fees paid to the Chairman and non-executive directors are shown in the emoluments table on page 43.

Up to April 2005, each non-executive director received an annual fee of £30,000. In addition, fees of £6,000 per annum were paid to members of the audit, remuneration and nominations committees, with the chairmen of the audit and remuneration committees receiving a further £6,000 per annum.

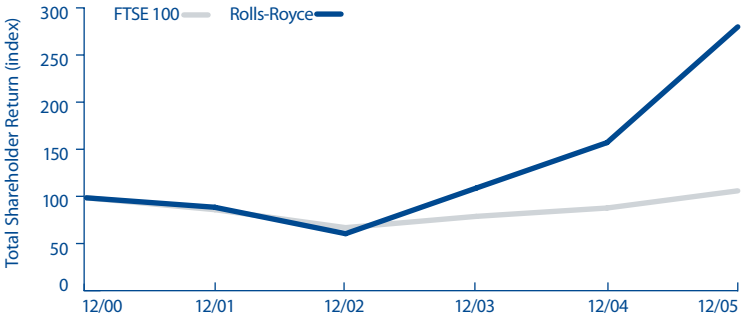
In February 2005 the Board reviewed the fees payable to non-executive directors as reported in the 2004 Annual report. It concluded that there was a strong case for increasing the non-executive directors' fees to more competitive levels in order to reflect the increased responsibilities and time commitments which changes in corporate governance were imposing on all non-executive directors. The Board therefore agreed that with effect from May 2005 a non-executive director would receive an annual fee of £50,000 covering his or her membership of the Board and of Board committees. The audit committee chairman and the remuneration committee chairman would receive additional fees of £15,000 and £12,000 per annum respectively. The senior independent director would receive an additional fee of £5,000 per annum for carrying out this role.

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

Total Shareholder Return – Rolls-Royce against the FTSE 100



Individual directors' emoluments and compensation

The individual directors' emoluments are analysed as follows:

								2005	2004
			Annual Performance Related Award plan (APRA)						
	Basic salaries £000	Board and committee fees £000	Cash bonus £000	Deferred shares [1] £000	Total APRA £000	SRS payments [2] £000	Taxable benefits [3] £000	Aggregate emoluments excluding pensions contributions [4] £000	Aggregate emoluments excluding pensions contributions [4] £000
John Cheffins	459	—	189	94	283	—	24	766	772
Colin Green	378	—	154	77	231	—	30	639	657
James Guyette [5]	371	—	209	104	313	—	38	722	648
Dr Mike Howse [6]	162	—	108	—	108	—	12	282	585
Sir John Rose	685	—	383	191	574	—	17	1,276	1,285
Andrew Shilston	422	—	211	106	317	51	13	803	775
Colin Smith [7]	125	—	68	34	102	—	6	233	—
Hon Amy Bondurant	—	45	—	—	—	—	—	45	36
Peter Byrom	—	65	—	—	—	—	—	65	52
Iain Conn [8]	—	43	—	—	—	—	—	43	—
Carl-Peter Forster	—	47	—	—	—	—	—	47	40
Simon Robertson	—	330	—	—	—	—	—	330	5
Ian Strachan	—	47	—	—	—	—	—	47	40
Carl Symon	—	57	—	—	—	—	—	57	46
Sir John Taylor	—	43	—	—	—	—	—	43	5
Euan Baird [9]	—	—	—	—	—	—	—	—	54
Lord Moore of Lower Marsh [10]	—	—	—	—	—	—	—	—	250
Sir Robin Nicholson [11]	—	14	—	—	—	—	—	14	42
Sir John Weston [12]	—	—	—	—	—	—	—	—	37
	2,602	691	1,322	606	1,928	51	140	5,412	5,329

1 Shares forming part of the bonus under APRA have been valued at date of award. An investment is expected to be made by March 31, 2006 when the trustee will acquire the required number of shares at the prevailing market price.
2 Payments made to Andrew Shilston in connection with his participation in the Rolls-Royce Supplementary Retirement Scheme (SRS) (see page 49) enabling him to discharge the income tax liability incurred by him on the contributions made by the Group into the SRS.
3 Taxable benefits include the following: company car or car allowance, private medical insurance and financial counselling, and in the case of James Guyette, a housing allowance and appropriate club membership fees.
4 Details of the directors' pensions are set out on pages 48 and 49.
5 James Guyette was paid in US dollars translated at $1.82 = £1.
6 Dr Mike Howse retired as a director with effect from June 30, 2005. The emoluments shown in the table above are the amounts paid up to his date of retirement from the Board.
7 Colin Smith was appointed to the Board as a director with effect from July 1, 2005. The emoluments shown in the table above are the amounts paid from his date of appointment to the Board.
8 Iain Conn was appointed to the Board as a non-executive director with effect from January 20, 2005.
9 Euan Baird resigned as Chairman with effect from June 21, 2004.
10 Lord Moore of Lower Marsh retired as interim Chairman with effect from December 31, 2004.
11 Sir Robin Nicholson retired as a non-executive director with effect from May 4, 2005.
12 Sir John Weston retired as a non-executive director with effect from December 1, 2004.

Payments made to former directors of the Company

Dr Mike Howse retired from the Board on June 30, 2005. The Board considered it to be in the interests of the Company to retain his expertise in engineering for a period following his retirement. He continued to be employed by the Group and received a salary totalling £49,000 and benefits of £12,000 between his date of retirement from the Board and the year end.

Lord Moore of Lower Marsh retired as interim Chairman on December 31, 2004. He has continued to chair the Trustees of the Rolls-Royce Pension Fund and the Investment Sub-Committee of the Trustees and attends meetings of the Trustees audit committee. Lord Moore received an annual fee of £35,000.

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

Phil Ruffles retired from the Board on October 18, 2001. He was retained by Rolls-Royce Fuel Cell Systems Limited to give general advice on the best contacts and direction for the business. Phil Ruffles received a fee of £1,270 for each day (or a pro rata amount for any part day) that he performed these services. It is expected that he will spend approximately five working days on this activity per year.

Directors' share interests

At December 31, 2005, the directors and their immediate families had beneficial interests in the ordinary shares and B Shares [1] of the Company, as shown in the following table:

	Ordinary shares			B Shares		
	January 1, 2005 *	Changes in 2005	December 31, 2005 §	January 1, 2005 *	Changes in 2005	December 31, 2005 §
John Cheffins [2]	164,748	65,868	230,616	123,850	(123,850)	—
Colin Green	196,796	56,199	252,995	—	—	—
James Guyette [2]	180,982	60,968	241,950	7,707,750	(7,707,750)	—
Dr Mike Howse [2,3]	90,088	47,260	137,348	3,696,750	(3,696,750)	—
Sir John Rose	300,618	97,533	398,151	—	—	—
Andrew Shilston	127,948	4,187	132,135	—	—	—
Colin Smith [4]	13,079	254	13,333	—	417,800	417,800
Hon Amy Bondurant	3,400	136	3,536	—	—	—
Peter Byrom	148,110	(1,110)	147,000	—	—	—
Iain Conn [5]	—	3,184	3,184	—	18,800	18,800
Carl-Peter Forster	1,967	3,764	5,731	—	—	—
Sir Robin Nicholson [6]	17,437	222	17,659	—	—	—
Simon Robertson	20,000	395	20,395	—	—	—
Ian Strachan	11,500	—	11,500	—	—	—
Carl Symon	6,551	215	6,766	—	—	—
Sir John Taylor	—	5,098	5,098	—	—	—

* or date of appointment if later.
§ or date of retirement if earlier.

1 Non-cumulative redeemable preference shares of 0.1p each.
2 On January 5, 2005 John Cheffins, James Guyette and Dr Mike Howse converted their B Share holdings into 50; 3,083 and 1,478 ordinary shares respectively.
3 Dr Mike Howse retired as a director with effect from June 30, 2005.
4 Colin Smith was appointed a director with effect from July 1, 2005.
5 Iain Conn was appointed a non-executive director with effect from January 20, 2005.
6 Sir Robin Nicholson retired as a non-executive director with effect from May 4, 2005.

On January 3, 2006, Iain Conn received 80,460 B Shares. On January 4, 2006 Colin Smith converted his B Shares holding into 117 ordinary shares. On January 4, 2006, pursuant to elections submitted, the following directors received ordinary shares in respect of the conversion of B Shares: John Cheffins 2,163; Colin Green 2,515; James Guyette 2,269; Sir John Rose 3,735; Andrew Shilston 1,240; Colin Smith 124; Hon Amy Bondurant 33; Peter Byrom 1,375; Carl-Peter Forster 55; Simon Robertson 191; Carl Symon 63 and Sir John Taylor 47. Iain Conn purchased 223 shares on January 9, 2006 and 222 shares on February 7, 2006 under arrangements made for non-executive directors to purchase shares on a monthly basis using a percentage of their after tax fees. Otherwise there have been no changes in the directors' interests between December 31, 2005 and February 8, 2006.

In addition the directors are, for Companies Act purposes, interested in the 68,536,712 Rolls-Royce Group plc shares held by the Rolls-Royce 2003 Employee Share Trust.

Shares held in trust

Shares held in trust under the Profit Sharing Share Scheme[1]

	Ordinary shares			B Shares[2]		
	January 1, 2005 *	Changes in 2005	December 31, 2005 §	January 1, 2005 *	Changes in 2005	December 31, 2005 §
John Cheffins[3]	3,830	(3,830)	—	191,500	(191,500)	—
Colin Green	3,660	(3,660)	—	—	—	—
Dr Mike Howse[4]	2,615	(2,615)	—	—	—	—
Sir John Rose	4,361	(4,361)	—	—	—	—

'Partnership Shares' held in trust under the Share Incentive Plan[5]

	Ordinary shares			B Shares[2]		
	January 1, 2005 *	Changes in 2005	December 31, 2005 §	January 1, 2005 *	Changes in 2005	December 31, 2005 §
Colin Green[6,7]	2,096	572	2,668	—	—	—
Sir John Rose[6,7]	2,096	572	2,668	—	—	—
Andrew Shilston[6,7]	1,652	557	2,209	—	—	—
Colin Smith[6,7,8]	2,409	259	2,668	—	—	—

'Free Shares' held in trust under the Share Incentive Plan[9]

	Ordinary shares			B Shares[2]		
	January 1, 2005 *	Changes in 2005	December 31, 2005 §	January 1, 2005 *	Changes in 2005	December 31, 2005 §
John Cheffins[10,11]	4,911	1,402	6,313	180,700	(180,700)	—
Colin Green[10]	4,996	1,332	6,328	—	—	—
Dr Mike Howse[4]	3,699	47	3,746	—	—	—
Sir John Rose[10]	4,996	1,332	6,328	—	—	—
Andrew Shilston[10]	2,332	1,246	3,578	—	—	—
Colin Smith[8,10]	1,046	—	1,046	—	—	—

* or date of appointment if later.
§ or date of retirement if earlier.

1 Under the Profit Sharing Share Scheme, shares vest after three years.
2 Non-cumulative redeemable convertible preference shares of 0.1p each.
3 On January 5, 2005, pursuant to an election submitted, John Cheffins converted his B Share holding and received 76 ordinary shares.
4 Dr Mike Howse retired as a director with effect from June 30, 2005.
5 Under the 'Partnership Share' element of the Share Incentive Plan, shares vest on the fifth anniversary of each monthly purchase.
6 On January 4, 2006, pursuant to elections submitted, Colin Green, Sir John Rose, Andrew Shilston and Colin Smith received 24, 24, 20 and 24 ordinary shares respectively following the conversion of B Shares.
7 Colin Green, Sir John Rose, Andrew Shilston and Colin Smith purchased 28 shares each respectively on January 9, 2006 and February 7, 2006 under the Inland Revenue approved Share Incentive Plan.
8 Colin Smith was appointed a director with effect from July 1, 2005.
9 Under the 'Free Share' element of the Share Incentive Plan, shares vest after five years.
10 On January 4, 2006, John Cheffins, Colin Green, Sir John Rose, Andrew Shilston and Colin Smith received 59, 59, 59, 33 and 10 ordinary shares respectively following the conversion of B Shares.
11 On January 5, 2005, pursuant to an election submitted, John Cheffins converted his B Share holding and received 72 ordinary shares.

Share options

The directors, at December 31, 2005, held the following options under the Rolls-Royce plc Executive Share Option Scheme, the Rolls-Royce 1999 Executive Share Option Plan and the Rolls-Royce International ShareSave Plan.

All employees were eligible for options under the International ShareSave plan, and the 1997 (7 year), 1999 (5 year) and 2001 (3 year) plans matured on February 1, 2005. Options awarded under the Rolls-Royce 1999 Executive Share Option Plan vest on February 9, 2006 and March 28, 2006.

	January 1, 2005 *	Granted in 2005	Lapsed in 2005	Exercised in 2005	December 31, 2005 §[1]	Exercise price	Market price at date exercised	Aggregate gains 2005 £000	Aggregate gains 2004 £000	Exercisable dates
John Cheffins	72,250			72,250	—	176p	358.50p	132		—
	15,444				15,444	194p				2006-2010
	118,405				118,405	194p				2006-2010
	173,612				173,612	216p				2006-2011
	4,398			4,398	—	108p	253.00p	6		—
	398,936				398,936	188p				2006-2012
	499,189				499,189	77p				2006-2013
	694,445				694,445 [2]	216p				2007-2011
	1,976,679			76,648	1,900,031	172p [3]		138		
Colin Green	4,756			4,756	—	205p	264.50p	3		—
	154,441				154,441	194p				2006-2010
	162,038				162,038	216p				2006-2011
	279,255				279,255	188p				2006-2012
	465,910				465,910	77p				2006-2013
	3,103				3,103 [4]	141p				2006
	648,149				648,149 [2]	216p				2007-2011
	4,053				4,053 [4]	194p				2007
	551				551 [4]	108p				2007
	1,722,256			4,756	1,717,500	172p [3]		3	38	
James Guyette	114,581				114,581 [5]	269p				2006-2009
	167,799				167,799	194p				2006-2010
	179,161				179,161	216p				2006-2011
	4,398			4,398	—	108p	267.50p	7		—
	450,140				450,140	188p				2006-2012
	506,084				506,084	77p				2006-2013
	3,122				3,122 [4]	141p				2006
	716,641				716,641 [2]	216p				2007-2011
	—	1,397			1,397 [4]	298p				2009
	2,141,926	1,397		4,398	2,138,925	178p [3]		7		
Dr Mike Howse [6]	63,836				63,836	194p				2006-2010
	69,445				69,445	216p				2006-2011
	1,407			1,407	—	108p	264.50p	2		—
	199,468				199,468	188p				2006-2012
	138,889				138,889 [2]	216p				2007-2011
	473,045			1,407	471,638	201p [3]		2	24	
Sir John Rose	116,750			116,750	—	176p	358.50p	213		—
	283,141				283,141	194p				2006-2010
	254,630				254,630	216p				2006-2011
	638,298				638,298	188p				2006-2012
	798,702				798,702	77p				2006-2013
	2,894				2,894 [4]	141p				2006
	1,018,519				1,018,519 [2]	216p				2007-2011
	7,662				7,662 [4]	108p				2007
	3,120,596			116,750	3,003,846	171p [3]		213		

Share options continued

	January 1, 2005 *	Granted in 2005	Lapsed in 2005	Exercised in 2005	December 31, 2005 §[1]	Exercise price	Market price at date exercised	Aggregate gains 2005 £000	Aggregate gains 2004 £000	Exercisable dates
Andrew Shilston	633,117				633,117	77p				2006-2013
	633,117				633,117	77p				
Colin Smith[7]	3,862				3,862	194p				2006-2010
	15,444				15,444	194p				2006-2010
	19,676				19,676	216p				2006-2011
	99,734				99,734	188p				2006-2012
	166,364				166,364	77p				2006-2013
	78,704				78,704[2]	216p				2007-2011
	1,780				1,780[4]	194p				2007
	6,362				6,362[4]	141p				2008-2009
	2,396				2,396[4]	108p				2009
	—	1,233			1,233[4]	298p				2011
	394,322	1,233			395,555	148p[3]				

* or date of appointment if later.
§ or date of retirement if earlier.

1 Unless otherwise indicated all the above options were granted under the Rolls-Royce plc Executive Share Option Scheme and the Rolls-Royce 1999 Executive Share Option Plan and are subject to the achievement of performance targets (see page 41). 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 236p and 430.50p during 2005. The closing price on December 31, 2005 was 427.50p.
2 Supplementary options – vesting of these options is subject to attainment of significant personal share holding 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 annum 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.
3 Weighted average exercise price of December 31, 2005 balance.
4 Sharesave plans.
5 Performance target achieved. Option capable of exercise.
6 Dr Mike Howse retired as a director with effect from June 30, 2005.
7 Colin Smith was appointed as a director with effect from July 1, 2005.

Long-term incentive awards

The directors as at December 31, 2005 had the following share awards in the Annual Performance Related Award plan:

	Shares held in trust under the Annual Performance Related Award plan[1]				Shares held in trust under the Deferred Share Incentive plan[2]			
	January 1, 2005 *	Vested during 2005	Granted during 2005	December 31, 2005 §	January 1, 2005 *	Vested during 2005	Granted during 2005	December 31, 2005 §
John Cheffins	119,671	(77,419)	43,107	85,359	171,928	—	—	171,928
Colin Green	120,983	(83,049)	33,165	71,099	160,467	—	—	160,467
James Guyette	106,740	(78,487)	32,764	61,017	174,303	—	—	174,303
Dr Mike Howse[3]	88,248	(60,424)	31,803	59,627	—	—	—	—
Sir John Rose	186,501	(123,869)	80,813	143,445	275,086	—	—	275,086
Andrew Shilston	36,824	—	46,633	83,457	—	—	—	—
Colin Smith[4]	14,712	—	—	14,712	43,058	—	—	43,058

* or date of appointment if later.
§ or date of retirement if earlier.

1 Under the Annual Performance Related Award plan, shares vest after two years (see page 40). Shares went into trust in 2003, 2004 and 2005 at prices of 76.46p, 220.00p and 260.19p. At December 31, 2005, the amounts stated in the emoluments table on page 43 representing the 2005 APRA deferred shares had not yet been applied by the Trustee to purchase shares. An investment is expected to be made by March 31, 2006 when the trustee will acquire the required number of shares at the prevailing market price. The market value per share which vested under the Annual Performance Related Award plan during 2005 was 245.75p.
2 Under the Deferred Share Incentive plan shares vest after three years. Shares went into Trust in 2003 at a price of 76.46p.
3 Dr Mike Howse retired as a director with effect from June 30, 2005.
4 Colin Smith was appointed as a director with effect from July 1, 2005.

Long-term incentive awards continued

Conditional awards, granted under the Rolls-Royce Group plc Performance Share Plan (PSP) to executive directors in 2004 and 2005, are set out below. The number of shares released will be dependent upon certain performance criteria being achieved over a three-year performance period (see page 41).

						PSP
	January 1, 2005 *	Granted during 2005	Vested during 2005	December 31, 2005 §	Performance period	Market price at date of grant
John Cheffins	112,777	—	—	112,777	Jan 1, 2004 to Dec 31, 2006	232.92p
	—	118,517	—	118,517	Jan 1, 2005 to Dec 31, 2007	261.58p
	112,777	118,517	—	231,294		
Colin Green	105,255	—	—	105,255	Jan 1, 2004 to Dec 31, 2006	232.92p
	—	97,006	—	97,006	Jan 1, 2005 to Dec 31, 2007	261.58p
	105,255	97,006	—	202,261		
James Guyette	101,654	—	—	101,654	Jan 1, 2004 to Dec 31, 2006	232.92p
	—	93,871	—	93,871	Jan 1, 2005 to Dec 31, 2007	261.58p
	101,654	93,871	—	195,525		
Dr Mike Howse [1]	88,017	—	—	88,017	Jan 1, 2004 to Dec 31, 2006	232.92p
	—	83,599	—	83,599	Jan 1, 2005 to Dec 31, 2007	261.58p
	88,017	83,599	—	171,616		
Sir John Rose	270,640	—	—	270,640	Jan 1, 2004 to Dec 31, 2006	232.92p
	—	263,782	—	263,782	Jan 1, 2005 to Dec 31, 2007	261.58p
	270,640	263,782	—	534,422		
Andrew Shilston	95,352	—	—	95,352	Jan 1, 2004 to Dec 31, 2006	232.92p
	—	109,596	—	109,596	Jan 1, 2005 to Dec 31, 2007	261.58p
	95,352	109,596	—	204,948		
Colin Smith [2]	24,043	—	—	24,043	Jan 1, 2004 to Dec 31, 2006	232.92p
	22,403	—	—	22,403	Jan 1, 2005 to Dec 31, 2007	261.58p
	46,446	—	—	46,446		

* or date of appointment if later.
§ or date of retirement if earlier.

[1] Dr Mike Howse retired as a director with effect from June 30, 2005.
[2] Colin Smith was appointed as a director with effect from July 1, 2005.

The number of shares released on the achievement of the EPS and CPS targets will be increased by 25 per cent if the Total Shareholder Return exceeds the median for the FTSE 100 companies over the three-year performance period.

Pensions

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

All other executive directors who are under their normal retirement ages are members of the Group's UK pension schemes. These schemes are funded and approved defined benefit pension schemes providing, at retirement, a pension of up to two thirds of final remuneration.

New HM Revenue and Customs (HMRC) pensions regulations are effective from April 2006. There is no intention to compensate directors or other senior executives for any additional tax they may be required to pay as a result of these regulations.

The committee has determined that where further pension accrual would exceed the new HMRC annual and/or lifetime allowances applicable from April 6, 2006, executives may choose to opt out of pension accrual and receive a cash allowance in lieu of pension provision. Alternatively, as permitted under the new pension regime, the committee will have the discretion to enable the drawing of pension benefits to commence while the executive is still in employment with the Group. In such circumstances the pension schemes provide for appropriate early retirement factors to reduce the pension payable.

Pensions continued

Details of the pension benefits, which accrued over the year in the Group's approved UK defined benefit pension schemes, are given below.[8]
The pension position of Dr Mike Howse, who passed his normal retirement age in 2004 and who is excluded from the table below, is described in note 5 below.

	Increase in accrued pension during the year ended Dec 31, 2005[1] £000pa		Total accrued pension entitlement at the year ended Dec 31, 2005[2] £000pa	Transfer value of accrued pension as at Dec 31, 2005[3] £000	Transfer value as at Dec 31, 2004 of accrued pension at that date[3] £000	Increase in transfer value over 2005 net of the member's own contributions[4] £000	
John Cheffins	40	(29)	387	6,378	5,091	1,259	(481)
Colin Green	33	(24)	342	5,749	4,505	1,221	(401)
Sir John Rose	52	(40)	436	7,916	5,683	2,192	(716)
Andrew Shilston[6]	2	(2)	5	134	64	138	(113)
Colin Smith[7]	12	(12)	97	1,840	1,110	725	(508)

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, 2005[1] £000		Total accrued retirement lump sum entitlement at the year ended Dec 31, 2005[10] £000	Transfer value of accrued retirement lump sum as at Dec 31, 2005[11] £000	Transfer value as at Dec 31, 2004 of accrued retirement lump sum at that date[11] £000	Increase in transfer value over 2005 net of the member's own contributions[4] £000	
James Guyette[9,12]	73	(62)	337	337	264	496	(485)

1 The figure in brackets is the increase in pension/retirement lump sum during the year ended December 31, 2005 but in this case excluding the effect of inflation.
2 The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year.
3 The transfer values stated represent liabilities of the Rolls-Royce sponsored pension schemes and not sums paid to the individuals. The transfer values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11 (GN11). GN11 covers individual transfer calculations and the above figures have been calculated using assumptions certified by the Actuaries as being consistent with GN11. Transfer values calculated on this basis will vary up or down from one year to the next due to changes in financial conditions, principally long-term interest rates from which the Actuary derives the assumptions used to place a capital value on the pension entitlement. Whilst fluctuating up or down in individual years, transfer values generally trend upwards over time as individuals complete more service and become older. A large part of the increase in transfer values over 2005 is attributable to falls in the market interest rates on which the transfer value calculations are based.
4 The figure in brackets is the transfer value of the increase in pension/retirement lump sum during the year ended December 31, 2005 excluding the effect of inflation, and net of the member's own contributions.
5 Dr Mike Howse ceased to accrue pension benefits after reaching his normal retirement age on July 1, 2004. He began receiving his pension benefits from this date, although he remained an executive director until he retired from the Board on June 30, 2005. No pension benefits were therefore earned by Dr Mike Howse over the six month period in 2005 while he remained a director.
6 The Group operates the Rolls-Royce Supplementary Retirement Scheme (SRS). The purpose of the SRS is to fund pension provision above the pensionable earnings cap which was imposed on approved pension schemes under the 1989 Finance Act. Membership of the SRS is restricted to executive directors and to a limited number of senior executives. The members of the SRS include Andrew Shilston. He joined the Group after the introduction of the earnings cap and his terms and conditions on joining the Group included a commitment to provide pension and life cover based on total salary, in line with other directors and senior executives. Employer contributions to the SRS during 2005 have been added to the increase in transfer value over 2005 for the approved defined benefit plans, and are therefore included in the figures shown in the right hand column of the first table. In addition, the employer has paid £51,000 to Andrew Shilston directly in order to meet the income tax liability that he will incur on these employer contributions to the unapproved plan.
7 Colin Smith was appointed as a director with effect from July 1, 2005. The additional pension earned and the corresponding transfer value relate only to the period for which he was a director ie to the period July 1, 2005 to December 31, 2005. For Colin Smith, the comparator transfer value figure at the start of the year is the value as at June 30, 2005, immediately before his date of appointment as a director.
8 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.
9 Benefits are translated at US$1.82 = £1.
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 James Guyette is a member of two defined benefit plans in the USA, one qualified and one non-qualified. He accrues a retirement lump sum benefit in both of these plans which, as cash balance arrangements, operate on the same basis as defined contribution except a guaranteed minimum rate of interest of four per cent is applied to investments. 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) defined benefit savings plans in the USA, one qualified and one non-qualified, to which both he and his employer, Rolls-Royce North America Inc., contribute. The aggregate employer contribution invested in the cash balance and 401(k) plans each year is calculated with reference to taxable basic and annual incentive compensation to reflect market practice in the USA. However, this is capped at no more than 26 per cent of basic salary. James Guyette is also a member of an unfunded non-qualified deferred compensation plan in the USA, to which his employer makes notional contributions calculated with reference to his basic salary. Employer contributions to the 401(k) and deferred compensation plans during 2005 have been added to the increase in transfer value over 2005 for the defined benefit plans, and are therefore included in the figures shown in the right hand column of the second table.

Approval of the directors' remuneration report

The directors' remuneration report above was approved by the Board of directors on February 8, 2006.

Carl G Symon
Chairman of the Remuneration committee

Consolidated income statement

For the year ended December 31, 2005

	Notes	2005 £m	2004 £m
Revenue	2, 3	**6,603**	5,947
Cost of sales		**(4,924)**	(4,744)
Gross profit		**1,679**	1,203
Other operating income	4	**60**	73
Commercial and administrative costs		**(624)**	(599)
Research and development costs		**(282)**	(288)
Share of profit of joint ventures	11	**46**	19
Group operating profit		**879**	408
(Loss)/profit on sale of businesses	32	**(2)**	9
Profit before financing costs		**877**	417
Financial income	5	**442**	372
Financial expenses	5	**(842)**	(425)
Net financing costs*		**(400)**	(53)
Profit before taxation**	4	**477**	364
Taxation	6	**(130)**	(100)
Profit for the period		**347**	264
Attributable to:			
Equity holders of the parent		**350**	263
Minority interest		**(3)**	1
Profit for the period		**347**	264
Earnings per ordinary share:			
Basic	7	**20.11p**	15.56p
Diluted	7	**19.31p**	15.05p
Payments to shareholders		**(154)**	(140)
*Net interest payable	5	**(39)**	(52)
**Underlying profit before taxation	2	**584**	364

Consolidated balance sheet

At December 31, 2005

	Notes	2005 £m	2004 £m
ASSETS			
Non-current assets			
Intangible assets	9	**1,281**	1,227
Property, plant and equipment	10	**1,683**	1,672
Investments – joint ventures	11	**247**	211
Other investments	12	**52**	57
Deferred tax assets	21	**439**	318
		3,702	3,485
Current assets			
Inventory	13	**1,309**	1,090
Trade and other receivables	14	**2,047**	2,049
Taxation recoverable		**3**	2
Other financial assets	20	**464**	
Short-term investments		**37**	36
Cash and cash equivalents	15	**1,757**	1,452
		5,617	4,629
Total assets		**9,319**	8,114
LIABILITIES			
Current liabilities			
Borrowings	16	**(75)**	(207)
Other financial liabilities	20	**(234)**	
Trade and other payables	17	**(2,689)**	(2,395)
Current tax liabilities		**(171)**	(176)
Provisions	22	**(138)**	(173)
		(3,307)	(2,951)
Non-current liabilities			
Borrowings	18	**(1,458)**	(1,430)
Other financial liabilities	20	**(339)**	
Other payables	19	**(650)**	(543)
Deferred tax liabilities	21	**(178)**	(115)
Provisions	22	**(223)**	(220)
Post-retirement benefit obligations	23	**(1,659)**	(1,409)
		(4,507)	(3,717)
Total liabilities		**(7,814)**	(6,668)
Net assets		**1,505**	1,446
EQUITY			
Capital and reserves			
Called-up share capital	24	**352**	346
Share premium account	25	**30**	4
Merger reserve	25	**3**	3
Capital redemption reserve	25	**206**	74
Transition hedging reserve	25	**379**	
Cash flow hedging reserve	25	**—**	
Translation reserve	25	**17**	(38)
Retained earnings	25	**512**	1,053
Equity attributable to equity holders of the parent		**1,499**	1,442
Minority interest	26	**6**	4
Total equity		**1,505**	1,446

The financial statements on pages 50 to 107 and 114 to 117 were approved by the Board on February 8, 2006 and signed on its behalf by:

Simon Robertson Chairman

Andrew Shilston Finance Director

Consolidated cash flow statement

For the year ended December 31, 2005

	2005 £m	2004 £m
Reconciliation of operating cash flows		
Profit before taxation	**477**	364
Share of profit of joint ventures	**(46)**	(19)
Loss/(gain) on sale of businesses	**2**	(9)
Loss on sale of property, plant and equipment	**1**	2
Net interest payable	**39**	52
Net other financing expenses	**361**	1
Taxation paid	**(60)**	(84)
Depreciation of intangible assets (note 9)	**54**	58
Depreciation of property, plant and equipment (note 10)	**200**	242
Decrease in provisions	**(31)**	(8)
Increase in inventories	**(221)**	(116)
(Increase)/decrease in trade and other receivables	**(252)**	179
Increase/(decrease) in payables	**720**	(31)
Decrease in other financial assets and liabilities	**283**	
Post-retirement benefits adjustment	**(69)**	(42)
Share-based payments	**26**	6
Hedge reserve movements	**(459)**	
Dividends received from joint ventures	**35**	15
Net cash inflow from operating activities	**1,060**	610
Cash flows from investing activities		
Disposals of unlisted investments	**5**	—
Additions to intangible assets	**(116)**	(142)
Purchases of property, plant and equipment	**(235)**	(175)
Disposals of property, plant and equipment	**69**	66
Disposals of businesses (note 32)	**1**	16
Investments in joint ventures	**(13)**	(2)
Net cash outflow from investing activities	**(289)**	(237)
Cash flows from financing activities		
Borrowings due within one year – repayment of loans	**(202)**	(57)
– increase in loans	**—**	—
Borrowings due after one year – repayment of loans	**(5)**	(95)
– increase in loans	**—**	500
Capital element of finance lease payments	**(11)**	(52)
Net cash (outflow)/inflow from (decrease)/increase in borrowings	**(218)**	296
Interest received	**41**	58
Interest paid	**(88)**	(107)
Interest element of finance lease payments	**(2)**	(3)
(Increase)/decrease in government securities and corporate bonds	**(1)**	3
Equity dividends paid	**—**	(33)
Issue of ordinary shares	**26**	4
Settlement of financial liabilities to purchase own shares	**(149)**	(2)
Redemption of B Shares	**(52)**	(27)
Net cash (outflow)/inflow from financing activities	**(443)**	189
Increase in cash and cash equivalents	**328**	562
Cash and cash equivalents at January 1	**1,439**	909
Exchange and other non-cash adjustments	**46**	(32)
Adjustment on implementation of IAS 32 and IAS 39	**(68)**	
Cash and cash equivalents at December 31	**1,745**	1,439

	2005 £m	2004 £m
Reconciliation of increase in cash and cash equivalents to movement in net funds		
Increase in cash and cash equivalents	**328**	562
Cash outflow/(inflow) from increase/(decrease) in government securities and corporate bonds	**1**	(3)
Net cash outflow/(inflow) from decrease/(increase) in borrowings	**218**	(296)
Change in net funds resulting from cash flows	**547**	263
Borrowings of businesses disposed	**1**	—
Finance lease additions	**(1)**	—
Zero-coupon bonds 2005/2007 (9.0% interest accretion)	**—**	(4)
Exchange adjustments	**5**	(8)
Fair value adjustments	**47**	
Movement in net funds	**599**	251
Net debt at January 1	**(149)**	(400)
Adjustment on implementation of IAS 32 and IAS 39	**(189)**	
	261	(149)
Fair value of swaps hedging fixed rate borrowings	**74**	
Net funds/(debt) at December 31	**335**	(149)

Analysis of net funds	At January 1, 2005 £m	Adjustment for IAS 32/39 £m	Restated at January 1, 2005 £m	Cash flow £m	Borrowings of businesses disposed £m	Exchange adjustments £m	Fair value adjustments £m	Other non-cash changes £m	At December 31, 2005 £m
Cash at bank and in hand	**758**	**(68)**	**690**	**(374)**	**—**	**22**	**—**	**—**	**338**
Overdrafts	**(13)**	**—**	**(13)**	**—**	**1**	**—**	**—**	**—**	**(12)**
Short-term deposits	**694**	**—**	**694**	**702**	**—**	**23**	**—**	**—**	**1,419**
Cash and cash equivalents	**1,439**	**(68)**	**1,371**	**328**	**1**	**45**	**—**	**—**	**1,745**
Investments	**36**	**—**	**36**	**1**	**—**	**—**	**—**	**—**	**37**
Other borrowings due within one year	**(182)**	**(7)**	**(189)**	**202**	**—**	**(5)**	**7**	**(70)**	**(55)**
Borrowings due after one year	**(1,410)**	**(114)**	**(1,524)**	**5**	**—**	**(35)**	**40**	**70**	**(1,444)**
Finance leases	**(32)**	**—**	**(32)**	**11**	**—**	**—**	**—**	**(1)**	**(22)**
	(149)	**(189)**	**(338)**	**547**	**1**	**5**	**47**	**(1)**	**261**
Fair value of swaps hedging fixed rate borrowings		**121**	**121**				**(47)**		**74**
	(149)	**(68)**	**(217)**	**547**	**1**	**5**	**—**	**(1)**	**335**

Consolidated statement of recognised income and expense

For the year ended December 31, 2005

	2005 £m	2004 £m
Foreign exchange adjustments [1]	**49**	(38)
Actuarial losses	**(282)**	(7)
Deferred taxation on actuarial losses	**84**	2
Transfers from transition hedging reserve	**(324)**	
Transfers from cash flow hedging reserve	**3**	
Other adjustments	**—**	2
Net expense recognised directly in equity	**(470)**	(41)
Profit for the period	**347**	264
Total recognised income and expense for the period	**(123)**	223
Attributable to:		
Equity holders of the parent	**(120)**	222
Minority interest	**(3)**	1
Total recognised income and expense for the period	**(123)**	223
Total recognised income and expense for the period	**(123)**	223
Adjustments relating to implementation of IAS 32 and IAS 39 from January 1, 2005 [2]	**151**	
	28	223

[1] Loss on net investment hedge relating to foreign subsidiaries **£26m** (2004 £19m gain).
[2] See note 33.

Summary of movements in equity

For the year ended December 31, 2005

	2005 £m	2004 £m
At January 1 (as previously reported under UK GAAP)	**1,446**	2,143
Adjustments on adoption of IFRS from January 1, 2004 [1]		(927)
At January 1	**1,446**	1,216
Total recognised income and expense for the period	**(123)**	223
Adjustments relating to implementation of IAS 32 and IAS 39 from January 1, 2005 [1]	**151**	
Scrip dividend adjustments	**—**	20
Redemption of B Shares		(27)
Issue of B Shares	**(141)**	
On issue of ordinary shares	**117**	4
Relating to own shares	**2**	(2)
Share-based payment adjustment	**48**	12
Sale of shares in subsidiary company to a minority interest	**5**	—
At December 31	**1,505**	1,446
Attributable to:		
Equity holders of the parent	**1,499**	1,442
Minority interest	**6**	4
Total equity	**1,505**	1,446

[1] See note 33.

1 Significant accounting policies

The Company

Rolls-Royce Group plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended December 31, 2005 comprise the Company and its subsidiaries (together referred to as the 'Group') and the Group's interest in jointly controlled entities. The financial statements were authorised for issue by the directors on February 8, 2006.

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, 2005, together with the amendment to IAS 19 Employee Benefits – as explained under post-retirement benefits below. The Company has elected to prepare its parent company accounts under UK Generally Accepted Accounting Practices (GAAP).

These are the Group's first consolidated financial statements prepared in accordance with adopted IFRS.

The Group has adopted the exemption granted by IFRS 1 First-time Adoption of International Financial Reporting Standards that IAS 32 and IAS 39 Financial Instruments need not be applied to the comparative period. Consequently the restated results for the year ended December 31, 2004 have been prepared using the accounting policies for financial instruments previously adopted under UK GAAP. Additionally the following optional exemptions, provided by IFRS 1 from full retrospective application of IFRS accounting policies, have been applied:

- Business combinations – the provisions of IFRS 3 have been applied from January 1, 2004. The net carrying value of goodwill at December 31, 2003 under the previous accounting policies has been deemed to be the cost at January 1, 2004;
- Property, plant and equipment – where assets have previously been revalued, the revalued amount at January 1, 2004 has been deemed to be the cost at January 1, 2004;
- Cumulative translation differences arising on consolidation of overseas subsidiaries are required to be held in a separate reserve. This reserve has been deemed to be nil on January 1, 2004.

An explanation of how the transition to IFRS has affected the reported financial position, financial performance and cash flows of the Group is provided in note 33, which also includes the balance sheet at January 1, 2005 showing the impact of the adoption of IAS 32 and IAS 39 in 2005.

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

The Group's significant accounting policies are set out below, together with the judgements made by management in applying these policies, which have the most significant effect on the amounts recognised in the financial statements, apart from those involving estimations, which are dealt with separately below. These accounting policies have been applied consistently to all periods presented in these consolidated financial statements and in preparing an opening IFRS balance sheet at January 1, 2004 for the purposes of the transition to IFRS subject to the application of IFRS 1 as noted.

The accounting policies have been applied consistently by Group entities.

Basis of consolidation

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

A subsidiary is an entity controlled by the Company. Control exists when the Company has the power, directly or indirectly to govern the financial and operating policies of the entity so as to derive benefits from its activities.

A joint venture is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. The results of joint ventures are accounted for using the equity method of accounting.

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

Significant accounting policies and judgements applied

Foreign currency translation

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. Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are taken to equity. The net investment hedging of overseas undertakings is described under hedge accounting.

Revenue recognition

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

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured. On occasion, the Group may participate in the financing of engines in conjunction with airframe manufacturers. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing whether significant risk and rewards of ownership have been transferred to the customer. Where it is judged that sufficient risks and rewards are not transferred, the transaction is treated as a leasing transaction, resulting in an operating lease between the Group and the customer. No deliveries of engines were treated as operating leases during 2005. Depending on the specific circumstances, where applicable, the financing arrangements may result in the consolidation of the entity established to facilitate the financing. Such special purpose entities will be consolidated as required by IAS 27 Consolidated and Separate Financial Statements if it is considered that the Group controls the entity. The Group has consolidated one such entity (Pembroke 717 Holdings Limited).

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

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

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

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

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

Government investment

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

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. The intangible assets are assessed for impairment bi-annually, or earlier if there are indications of impairment.

Recoverable engine costs

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

Purchased goodwill

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

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

Certification costs and participation fees

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

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. The Group has adopted the amendment to IAS 19 early, whereby actuarial gains and losses are recognised immediately in the statement of recognised income and expense.

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

Share-based payments

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

The Group issues equity-settled and cash-settled share-based payments to certain employees. Equity-settled share-based payments are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant. The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares or options that will eventually vest. For cash-settled share-based payments a liability equal to the proportion of the goods or services received is recognised at the current fair value determined at each balance sheet date.

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

See note 27 for further description of the share-based payment plans.

Financial instruments

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

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

Financial instruments are initially measured at fair value. Their subsequent measurement depends on their classification:

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

Hedge accounting

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

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

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

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

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.

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

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

Until December 31, 2004, and as allowed by IFRS 1, the Group applied hedge accounting for forecast foreign exchange transactions and commodity exposures in accordance with UK 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.

Interest

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

Taxation

The tax charge on the profit or loss for the year comprises current and deferred tax.

Current tax is the expected tax payable for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of the assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled. Deferred tax is charged or credited in the income statement, except when it relates to items credited or charged directly to equity in which case the deferred tax is also dealt with in equity.

Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be utilised.

Segmental reporting

A segment is a distinguishable component of the Group that is engaged in providing products and services. As the risks and rates of return are predominately affected by differences in these products and services, the primary format for reporting segment information is based on business segments.

Inventory
Inventory and work in progress are valued at the lower of cost and net realisable value on a first-in, first-out basis. Cost comprises direct materials and, where applicable, direct labour costs and those overheads that have been incurred in bringing the inventories to their present location and condition. Net realisable value represents the estimated selling prices less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

Cash and cash equivalents
Cash and cash equivalents include cash at bank and in hand and short-term deposits with a maturity of three months or less on inception. The Group considers overdrafts (repayable on demand) to be an integral part of its cash management activities and these are included in cash and cash equivalents for the purposes of the cash flow statement.

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

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

i) Land and buildings, as advised by the Group's professional advisors:
   a) Freehold buildings – five to 45 years (average 23 years).
   b) Leasehold buildings – lower of advisors' estimates or period of lease.
   c) No depreciation is provided on freehold land.
ii) Plant and equipment – five to 25 years (average 16 years)
iii) Aircraft and engines – five to 20 years (average 13 years)
iv) No depreciation is provided on assets in the course of construction.

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

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

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.

Contingent liabilities
In connection with the sale of its products, the Group will, on some occasions, provide financing support for its customers. These arrangements fall into two categories; credit based guarantees and asset value guarantees. In accordance with the requirements of IAS 39 and IFRS 4, credit based guarantees are treated as insurance contracts. As the Group considers asset value guarantees as being non-financial liabilities, these have also been treated as insurance contracts.

The Group's contingent liabilities related 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.

Government grants
Government grants are recognised as income over the periods necessary to match them with the related costs which they are intended to compensate.

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

Forecasts and discount rates
The carrying value of a number of items on the balance sheet are dependent on the estimates of future cash flows arising from the Group's operations:

– The impairment tests for goodwill are dependent on forecasts of the cash flows of the cash generating units that give rise to the goodwill and the discount rate applied. No impairment resulted from the annual impairment tests in 2005.
– If the assessment of development, participation, certification and recoverable engine costs recognised as intangible assets indicates the possibility of impairment, a detailed impairment test is undertaken. The impairment test would be dependent on the forecast cash flows of the engine programmes and customer aftermarket activity as appropriate and the discount rate applied. No impairment resulted from the assessment in 2005.
– The financial liabilities arising from financial risk and revenue sharing partnerships are valued at each reporting date using the amortised cost method. 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 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.

Post-retirement benefits
The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19. The accounting valuation, which was based on assumptions determined with independent actuarial advice, resulted in a deficit of £1,659m before deferred taxation being recognised on the balance sheet at December 31, 2005. The size of the deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 23.

Provisions
As described in the accounting policy above, the Group measures provisions at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates are made, taking account of information available and different possible outcomes.

Contingent liabilities
As described in note 30, the Group has significant long-term contingent obligations. The directors consider that the possibility that there will be any significant loss arising from these contingencies as remote. In reaching this opinion, the directors have considered the likelihood of the contingency crystallising and have taken account of forecast aircraft values that generally provide security against the contingent liability.

2004 policies relating to financial instruments
The Group has adopted the exemption granted by IFRS 1 that IAS 32 and IAS 39 Financial Instruments need not be applied to the comparative period. Consequently the 2004 disclosure provided for financial instruments (note 28) is in accordance with UK GAAP, under which the accounting treatment of the key financial instruments used by the Group is as follows:

i) Gains or losses arising on forward exchange contracts are taken to the profit and loss account in the same period as the underlying transaction.
ii) Net interest arising on interest rate agreements is taken to the profit and loss account.
iii) Premiums paid or received on currency options are taken to the profit and loss account when the option expires or matures.
iv) Gains or losses arising on jet fuel swaps are taken to the profit and loss account in the same period as the underlying transaction.

If the underlying transaction to a hedge ceases to exist, the hedge is terminated and the profits and losses on termination are recognised in the profit and loss account immediately. If the hedge transaction is terminated, the profits and losses on termination are held in the balance sheet and amortised over the life of the original underlying transactions.

Revisions to IFRS not applicable in 2005
During 2005, the IASB published an amendment to IAS 39 relating to Financial Guarantee Contracts. This amendment is applicable from 2006 and will require the accounting policy for credit based guarantees to be amended. The Group has not finalised its assessment of the impact of adopting this amendment, but does not anticipate that its impact on the income statement will be significant.

IFRS 7 Financial Instruments: Disclosures and Amendment to IAS 1 Capital Disclosures are applicable from 2007. These amendments to disclosure requirements will have no effect on the reported results.

The Group does not consider that any other standards or interpretations issued by the IASB, but not yet applicable, will have a significant impact on the financial statements.

2 Segmental analysis

The Group operates in five segments which reflect the internal organisation and management structure according to the nature of the products and services provided:

Civil aerospace – Development, manufacture, marketing and sales of commercial aero engines and aftermarket services.
Defence aerospace – Development, manufacture, marketing and sales of military aero engines and aftermarket services.
Marine – Development, manufacture, marketing and sales of marine propulsion systems and aftermarket services.
Energy – Development, manufacture, marketing and sales of power systems for the offshore oil & gas industry, electrical power generation and aftermarket services.
Financial services – Engine leasing, aircraft leasing and electrical power project development.

Details for these primary reporting segments are shown below:

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Financial services £m	Central items £m	Eliminations £m	Consolidated £m
Analysis by business segments for year ended December 31, 2005								
Total revenue	3,510	1,413	1,097	505	78	—	—	6,603
Group operating profit excluding share of profit of joint ventures	625	170	86	(1)	(2)	(45)	—	833
Share of profit of joint ventures	34	7	1	5	(1)	—	—	46
Loss on sale of businesses	—	—	—	(2)	—	—	—	(2)
Profit before finance charges and taxation	659	177	87	2	(3)	(45)	—	877
Financial income						442		442
Financial expenses						(842)		(842)
Taxation						(130)		(130)
Profit for the period								347
Other information:								
Segment assets	4,325	816	1,136	566	250	—	(273)	6,820
Investments in joint ventures	147	28	1	30	41	—	—	247
Cash and short-term investments						1,794		1,794
Fair value of swaps hedging fixed rate borrowings						74		74
Unallocated assets						384		384
Total assets								9,319
Segment liabilities	(3,194)	(904)	(545)	(282)	(91)	—	273	(4,743)
Borrowings						(1,533)		(1,533)
Unallocated liabilities						(1,538)		(1,538)
Total liabilities								(7,814)
Expenditure on intangible assets and property, plant and equipment	262	48	29	14	11			364
Depreciation and amortisation	164	32	19	9	19			243
Impairments	—	—	—	—	11			11

2 Segmental analysis continued

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Financial services £m	Central items £m	Eliminations £m	Consolidated £m
Analysis by business segments for year ended December 31, 2004								
Total revenue	3,040	1,374	963	489	81	—	—	5,947
Group operating profit excluding share of profit of joint ventures	177	177	78	7	(9)	(41)	—	389
Share of profit of joint ventures	8	2	—	7	2	—	—	19
Profit on sale of businesses	9	—	—	—	—	—	—	9
Profit before finance charges and taxation	194	179	78	14	(7)	(41)	—	417
Financial income						372		372
Financial expenses						(425)		(425)
Taxation						(100)		(100)
Profit for the period								264
Other information:								
Segment assets	3,634	791	1,107	579	350	—	(236)	6,225
Investments in joint ventures	117	25	2	25	42	—	—	211
Cash and short-term investments						1,488		1,488
Unallocated assets						190		190
Total assets								8,114
Segment liabilities	(2,408)	(765)	(544)	(280)	(78)	—	236	(3,839)
Borrowings						(1,637)		(1,637)
Unallocated liabilities						(1,192)		(1,192)
Total liabilities								(6,668)
Expenditure on intangible assets and property, plant and equipment	239	40	32	14	8			333
Depreciation and amortisation	159	33	18	9	31			250
Impairments	36	—	1	—	13			50

2 Segmental analysis continued

Geographical segments

The Group's revenue by destination is shown below:

	2005 £m	2004 £m
United Kingdom	**886**	915
Rest of Europe	**1,059**	954
USA	**2,408**	1,944
Canada	**191**	205
Asia	**1,516**	1,290
Africa	**152**	196
Australasia	**96**	93
Other	**295**	350
	6,603	5,947

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

	Segment assets		Additions to intangible assets and property, plant and equipment	
	2005 £m	2004 £m	2005 £m	2004 £m
United Kingdom	**6,730**	5,842	**316**	293
North America	**1,265**	1,066	**24**	25
Nordics	**832**	814	**11**	8
Germany	**652**	515	**5**	5
Other	**310**	238	**8**	2
Eliminations	**(470)**	(361)	—	—
Total	**9,319**	8,114	**364**	333

Underlying profit reconciliation:

	2005			2004		
	£m	Underlying adjustments £m	Underlying results £m	£m	Underlying adjustments £m	Underlying results £m
Profit before financing costs						
Civil aerospace	**659**	**(205)**	**454**	194	—	194
Defence aerospace	**177**	**3**	**180**	179	—	179
Marine	**87**	**2**	**89**	78	—	78
Energy	**2**	**2**	**4**	14	—	14
Financial services	**(3)**	**—**	**(3)**	(7)	—	(7)
Central items	**(45)**	**—**	**(45)**	(41)	—	(41)
	877	**(198)**	**679**	417	—	417
Financing costs	**(400)**	**305**	**(95)**	(53)	—	(53)
Profit before tax	**477**	**107**	**584**	364	—	364

Underlying adjustments

	2005		2004	
	Profit before financing costs £m	Profit before tax £m	Profit before financing costs £m	Profit before tax £m
Release of transition hedge reserve	**(452)**	**(452)**	—	—
Realised gains on settled derivative contracts	**328**	**396**	—	—
Gains carried forward in contract balances	**(74)**	**(74)**	—	—
Net unrealised fair value changes to derivative contracts	**—**	**345**	—	—
Revaluation of trading assets and liabilities	**—**	**(78)**	—	—
Exchange differences and forecast changes relating to RRSPs	**—**	**(30)**	—	—
	(198)	**107**	—	—

The reconciliation of underlying earnings per share is provided in note 7.

3 Revenue

The Group's revenue is analysed as follows:

	2005 £m	2004 £m
Revenue from sale of original equipment	**3,061**	2,696
Revenue from aftermarket services	**3,542**	3,251
Total revenue	**6,603**	5,947

4 Profit before taxation

	2005 £m	2004 £m
After crediting		
Risk and revenue sharing partnership receipts – credited to other operating income	**60**	73
Operating lease rentals receivable – credited within revenues from aftermarket services	**39**	37
After charging		
Amortisation of certification costs	**9**	15
Amortisation of development costs	**13**	17
Amortisation of recoverable engine costs	**32**	26
Depreciation of owned property, plant and equipment [1]	**192**	230
Depreciation of property, plant and equipment held under finance leases [1]	**8**	12
Operating lease rentals payable – hire of plant and equipment	**58**	55
– hire of other assets	**19**	17
Research and development expenditure	**282**	288
RRSP payments – included in cost of sales	**146**	240

[1] Including appropriate amounts charged to inventories.

Auditors' fees were as follows during the year:

Audit 2005 – Group	**£3.4m**	(2004 £3.2m)
Other 2005 – United Kingdom	**£1.1m**	(2004 £0.9m)
– Rest of World	**£0.5m**	(2004 £0.6m)

Other fees paid to the auditors comprise:

Taxation	**£0.5m**	(2004 £0.7m)
Accounting	**£1.1m**	(2004 £0.7m)
Mergers and acquisitions	**£nil**	(2004 £0.1m)

Accounting fees in 2005 include **£0.9m** for IFRS implementation (2004 £0.5m).

5 Net financing costs

	2005 £m	2004 £m
Interest receivable	**65**	58
Fair value gains on commodity derivatives (note 20)	**54**	
Expected return on pension scheme assets (note 23)	**312**	314
Net foreign exchange gains	**11**	
Financial income	**442**	372
Interest payable	**(104)**	(110)
Fair value losses on foreign currency contracts (note 20)	**(399)**	
Finance charge and valuation changes relating to financial RRSPs (note 20)	**(13)**	
Interest on pension scheme liabilities (note 23)	**(321)**	(315)
Other financing charges	**(5)**	
Financial expenses	**(842)**	(425)
Net financing costs	**(400)**	(53)
Analysed as:		
Net interest payable	**(39)**	(52)
Net other financing expenses	**(361)**	(1)
Net financing costs	**(400)**	(53)

6 Taxation

	UK		Overseas		Total	
Current tax	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m
Current tax charge for the period	**25**	52	**63**	70	**88**	122
Less double tax relief	**(25)**	(48)	**—**	—	**(25)**	(48)
	—	4	**63**	70	**63**	74
Adjustments in respect of prior periods	**(3)**	1	**(4)**	—	**(7)**	1
	(3)	5	**59**	70	**56**	75
Deferred tax						
Deferred tax charge/(credit) for the period	**61**	17	**(2)**	16	**59**	33
Adjustments in respect of prior periods	**3**	(12)	**12**	4	**15**	(8)
	61	10	**69**	90	**130**	100

Deferred taxation balances are analysed in note 21.

Tax reconciliation		
Profit before taxation	**477**	364
Less share of profits of joint ventures (note 11)	**(46)**	(19)
Profit before taxation excluding joint ventures	**431**	345
Nominal tax charge at UK corporation tax rate **30%** (2004 30%)	**129**	103
UK R&D tax credit	**(18)**	(13)
Other items	**11**	17
Adjustments in respect of prior periods	**8**	(7)
	130	100
Analysis of taxation charge:		
Trading activities	**167**	100
Non-underlying items	**(37)**	—
	130	100

7 Earnings per ordinary share and underlying profit reconciliation

The Group seeks to present a measure of underlying performance, which excludes items considered to be non-operating in nature. Underlying profit excludes the unrealised amounts arising from revaluations required by IAS 32 and IAS 39, and includes the realised amounts arising from settled derivative hedging transactions. The calculation of underlying profit and underlying earnings per share is shown below. For the year to December 31, 2004, IAS 32 and IAS 39 were not applied and consequently no adjustment is required.

Basic earnings per ordinary share are calculated by dividing the profit attributable to ordinary shareholders of **£350m** (2004 £263m) by **1,740 million** (2004 1,690 million) ordinary shares, being the average number of ordinary shares in issue during the period, excluding own shares held under trust which have been treated as if they had been cancelled.

Underlying earnings per ordinary share have been calculated as follows:

	2005		2004	
	Pence	**£m**	Pence	£m
Profit attributable to equity holders of the parent	**20.11**	**350**	15.56	263
Exclude:				
Release of hedge reserves	**(25.97)**	**(452)**	—	—
Unrealised fair value changes to derivative contracts	**19.83**	**345**	—	—
Revaluation of trading assets and liabilities	**(4.49)**	**(78)**	—	—
Exchange differences and forecast changes relating to financial RRSPs	**(1.72)**	**(30)**	—	—
Include:				
Realised gain on settled derivative contracts	**22.76**	**396**	—	—
Less foreign exchange derivative gains carried forward in contract accounting	**(4.25)**	**(74)**	—	—
Related tax effect	**(2.13)**	**(37)**	—	—
Underlying earnings per ordinary share	**24.14**	**420**	15.56	263

Diluted earnings per ordinary share are calculated by dividing the profit attributable to ordinary shareholders of **£350m** (2004 £263m) by **1,813 million** (2004 1,747 million) ordinary shares, being **1,740 million** (2004 1,690 million) as above, adjusted by the bonus element of existing share options of **73 million** (2004 57 million).

8 Employee information

	2005 Number	2004 Number
Average weekly number of Group employees during the year		
United Kingdom	**21,300**	21,000
Overseas	**14,300**	14,200
	35,600	35,200
Civil aerospace	**20,400**	19,900
Defence aerospace	**5,100**	5,100
Marine	**7,200**	7,200
Energy	**2,800**	2,900
Financial services	**100**	100
	35,600	35,200

	£m	£m
Group employment costs [1]		
Wages and salaries	**1,320**	1,278
Social security costs	**138**	128
Share-based payment (note 27)	**26**	19
Pensions and other post-retirement benefits (note 23)	**132**	103
	1,616	1,528

[1] Directors' remuneration is shown on page 43.

9 Intangible assets

	Goodwill [1] £m	Certification costs and participation fees £m	Internally generated development expenditure £m	Recoverable engine costs £m	Total £m
Cost:					
At January 1, 2004	759	175	289	208	1,431
Additions	—	99	22	21	142
At January 1, 2005	**759**	**274**	**311**	**229**	**1,573**
Exchange adjustments	**(8)**	**—**	**—**	**—**	**(8)**
Additions	**—**	**10**	**70**	**36**	**116**
At December 31, 2005	**751**	**284**	**381**	**265**	**1,681**
Accumulated amortisation and impairment:					
At January 1, 2004	—	114	86	88	288
Provided during the year	—	15	17	26	58
At January 1, 2005	**—**	**129**	**103**	**114**	**346**
Provided during the year	**—**	**9**	**13**	**32**	**54**
At December 31, 2005	**—**	**138**	**116**	**146**	**400**
Net book value at December 31, 2005	**751**	**146**	**265**	**119**	**1,281**
Net book value at December 31, 2004	759	145	208	115	1,227
Net book value at January 1, 2004	759	61	203	120	1,143

[1] Goodwill principally relates to Civil aerospace £194m, Marine £489m and Energy £61m. The carrying value of goodwill has been assessed on a value-in-use basis using internal forecasts and a discount rate based on the Group's weighted average cost of capital.

10 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, 2004	522	1,949	337	156	2,964
Exchange adjustments	(1)	(17)	(16)	(3)	(37)
Additions	10	56	6	119	191
On disposals of businesses	(1)	(6)	—	—	(7)
Reclassifications	11	86	—	(97)	—
Disposals/write-offs	(6)	(100)	(102)	—	(208)
At January 1, 2005	**535**	**1,968**	**225**	**175**	**2,903**
Exchange adjustments	**9**	**36**	**20**	**3**	**68**
Additions	**20**	**79**	**9**	**140**	**248**
On disposals of businesses	**—**	**(5)**	**—**	**—**	**(5)**
Reclassifications	**23**	**78**	**—**	**(101)**	**—**
Disposals/write-offs	**—**	**(166)**	**(42)**	**—**	**(208)**
At December 31, 2005	**587**	**1,990**	**212**	**217**	**3,006**
Accumulated depreciation and impairment:					
At January 1, 2004	96	941	108	—	1,145
Exchange adjustments	—	(10)	(5)	—	(15)
Provided during the year [1]	20	176	46	—	242
On disposals of businesses	—	(4)	—	—	(4)
Disposals/write-offs	(1)	(79)	(57)	—	(137)
At January 1, 2005	**115**	**1,024**	**92**	**—**	**1,231**
Exchange adjustments	**4**	**24**	**9**	**—**	**37**
Provided during the year [1]	**22**	**154**	**24**	**—**	**200**
On disposals of businesses	**—**	**(4)**	**—**	**—**	**(4)**
Disposals/write-offs	**—**	**(122)**	**(19)**	**—**	**(141)**
At December 31, 2005	**141**	**1,076**	**106**	**—**	**1,323**
Net book value at December 31, 2005	**446**	**914**	**106**	**217**	**1,683**
Net book value at December 31, 2004	420	944	133	175	1,672
Net book value at January 1, 2004	426	1,008	229	156	1,819

[1] Includes impairment charge of **£11m** (2004 £50m) relating to the write-down of aircraft to values provided by independent aircraft appraisers.

Property, plant and equipment includes:

	2005 £m	2004 £m
Net book value of finance leased assets	**41**	48
Assets held for use in operating leases:		
Cost	**196**	206
Depreciation	**(93)**	(79)
Net book value	**103**	127
Non-depreciable land	**96**	97
Land and buildings at net book value comprise:		
Freehold	**416**	388
Long leasehold	**14**	16
Short leasehold	**16**	16
	446	420
Capitalised interest included in net book value of assets in course of construction	**—**	2
Capital expenditure commitments – contracted but not provided for	**147**	86
Net book value of assets held as security for liabilities	**49**	46
Cost of fully depreciated assets	**399**	342

11 Investments – joint ventures

	Shares at cost £m	Share of post acquisition reserves £m	Loans £m	Total £m
At January 1, 2004	128	79	6	213
Exchange adjustments	(4)	(4)	—	(8)
Additions	1	—	1	2
Share of retained profit	—	4	—	4
At January 1, 2005	**125**	**79**	**7**	**211** [1]
Exchange adjustments	**4**	**5**	**—**	**9**
Additions	**2**	**—**	**11**	**13**
Taxation paid by the Group	**—**	**3**	**—**	**3**
Share of retained profit	**—**	**11**	**—**	**11**
At December 31, 2005	**131**	**98**	**18**	**247** [1]

The principal joint ventures are listed on pages 116 and 117.

[1] Investments in joint ventures are represented by:

	2005 £m	2004 £m
Share of aggregate assets:		
Non-current assets	**671**	618
Current assets	**559**	460
Share of aggregate liabilities: [2]		
Non-current liabilities	**(522)**	(391)
Current liabilities	**(465)**	(481)
Goodwill	**4**	5
	247	211

[2] Includes borrowings of **£480m** (2004 £456m)

	2005 £m	2004 £m
Share of income	**80**	50
Share of interest	**(24)**	(22)
Share of taxation	**(10)**	(9)
	46	19
Dividend received	**(35)**	(15)
Share of retained profit	**11**	4

The tax charge on joint venture profits represents an effective tax rate of **18 per cent** (2004 32 per cent), a reduction of 14 per cent. This results from a change in profit mix between joint ventures taxed at different effective rates.

12 Investments – other

	2005 £m	2004 £m
Unlisted investments at cost:		
At January 1	**57**	63
Additions	**1**	—
Amortisation/disposals	**(6)**	(6)
At December 31	**52**	57

The fair values of these available for sale assets are not significantly different to cost.

13 Inventory

	2005 £m	2004 £m
Raw materials	**151**	147
Work in progress	**487**	423
Long-term contracts work in progress	**137**	148
Finished goods	**808**	624
Payments on account	**47**	63
	1,630	1,405
Progress payments received against:[1]		
Long-term contracts	**(104)**	(178)
Other inventory	**(217)**	(137)
	1,309	1,090
Inventories stated at net realisable value	**112**	110
Inventories pledged as security for liabilities	**—**	—
Amount of inventory write-down	**30**	23
Reversal of inventory write-down	**3**	3
[1] Includes payments received from joint ventures	**14**	15

14 Trade and other receivables

	2005 £m	2004 £m
Trade receivables	**738**	756
Amounts recoverable on contracts	**698**	625
Amounts owed by joint ventures	**215**	239
Other receivables	**226**	245
Prepayments and accrued income	**170**	184
	2,047 [1]	2,049 [1]

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

Trade receivables	**5**	14
Amounts recoverable on contracts	**526**	534
Amounts owed by joint ventures	**27**	37
Other receivables	**58**	58
Prepayments and accrued income	**30**	51
	646	694

15 Cash and cash equivalents

	2005 £m	2004 £m
Cash at bank and in hand	**338**	758
Short-term deposits	**1,419**	694
	1,757	1,452
Overdrafts (note 16)	**(12)**	(13)
Cash and cash equivalents per cash flow statement (page 52)	**1,745**	1,439

16 Borrowings – amounts falling due within one year

	2005 £m	2004 £m
Overdrafts	**12**	13
Bank loans	**55**	5
Obligations under finance leases (note 29)	**8**	12
4½% Notes 2005 [1]	**—**	177
	75	207

[1] The Group borrowed through a subsidiary company €256m in order to provide a loan for general purposes. This note was the subject of currency swap agreements under which counterparties undertook to pay amounts at fixed rates of interest and exchange in consideration for amounts payable by the subsidiary at variable rates of interest at fixed exchange rates.

17 Trade and other payables

	2005 £m	2004 £m
Payments received on account [1]	**362**	277
Trade payables	**537**	573
Amounts owed to joint ventures	**162**	110
Other taxation and social security	**62**	71
Other payables	**680**	612
Accruals and deferred income	**886**	752
	2,689	2,395

[1] Includes payments received from joint ventures	**115**	66

18 Borrowings – amounts falling due after one year

	2005 £m	2004 £m
Unsecured		
Bank loans	**4**	73
6 3/8% Notes 2007 [1]	**354**	310
7 3/8% Notes 2016 [2]	**200**	200
5.84% Notes 2010 [3]	**107**	97
6.38% Notes 2013 [3]	**134**	120
6.55% Notes 2015 [3]	**49**	43
4 1/2% Notes 2011 [1]	**524**	500
Other loan 2009 (interest rate nil)	**1**	1
Secured		
Bank loans [4]	**71**	66
Obligations under finance leases payable: [5] (note 29)		
Between one and two years	**5**	6
Between two and five years	**8**	14
After five years	**1**	—
	1,458	1,430
Repayable		
Between one and two years – by instalments	**49**	12
– otherwise	**—**	65
Between two and five years – by instalments	**11**	57
– otherwise	**354**	310
After five years – by instalments	**29**	26
– otherwise	**1,015**	960
	1,458	1,430

[1] The Group has borrowed through a subsidiary €1,250m in order to provide a loan for general purposes. These notes are the subject of currency swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable by the subsidiary at variable rates of interest and at fixed exchange rates.
[2] The Group has borrowed through a subsidiary £200m in order to provide a loan for general purposes.
[3] The Group has borrowed through a subsidiary US$500m in the US Private Placement market. This borrowing is the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge. Until October 5, 2005 the borrowing was included in a net investment hedging relationship. From October 6, 2005 the borrowing has been included in a fair value hedging relationship in respect of the foreign exchange risk.
[4] Secured on aircraft.
[5] Obligations under finance leases are secured by related leased assets.

19 Other payables – amounts falling due after one year

	2005 £m	2004 £m
Payments received on account [1]	**214**	118
Amounts owed to joint ventures	**30**	25
Other payables	**104**	129
Accruals and deferred income	**302**	271
	650	543
[1] Includes payments received from joint ventures	**13**	19

20 Other financial assets and liabilities

Details of the Group's policies on the use of financial instruments are given in note 28 and in the accounting policies on pages 55 to 59.

In accordance with the option allowed by IFRS 1 'First time adoption of International Financial Reporting Standards', the Group has implemented IAS 32 and IAS 39 Financial Instruments prospectively from January 1, 2005 (see note 33).

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

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	B Shares £m	Total £m
Assets	364	31	69	—	—	464
Liabilities	(136)	—	(7)	(423)	(7)	(573)
	228	31	62	(423)	(7)	(109)

Other financial liabilities are analysed as follows:	
Current liabilities	(234)
Non-current liabilities	(339)
	(573)

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 jet fuel. From January 1, 2005, the Group does not include foreign exchange or commodity financial instruments in any cash flow hedging relationships for accounting purposes. To hedge the currency risk associated with a borrowing denominated in US$, the Group has currency derivatives designated as part of a fair value hedge.

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

Foreign exchange financial instruments

	Total £m	Included in transition hedging reserve £m	Included in income statement £m
Fair value at January 1, 2005 on implementation of IAS 39	986	986 [1]	
Fair value changes to derivative contracts not in accounting hedging relationships	(399)	—	(399)
Fair value changes to fair value hedges	5	—	5
Fair value of contracts utilised	(364)	—	—
Transferred to income statement	—	(448) [1]	448
Fair value at December 31, 2005	228	538	

[1] Additionallly £10m relating to derivatives settled prior to transition to IFRS was included in the transition hedging reserve and transferred to the income statement for the year.

Commodity financial instruments

	Total £m	Included in transition hedging reserve £m	Included in income statement £m
Fair value at January 1, 2005 on implementation of IAS 39	9	9	
Fair value changes to derivative contracts not in accounting hedging relationships	54	—	54
Fair value of contracts utilised	(32)	—	—
Transferred to income statement	—	(4)	4
Fair value at December 31, 2005	31	5	

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

20 Other financial assets and liabilities continued

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 are included in the hedging reserve and released to match actual payments on the hedged item.

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

Interest rate financial instruments

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m	Included in cash flow hedging reserve £m	Included in income statement £m
Fair value at January 1, 2005 on implementation of IAS 39	110	121	(11)	(3)	
Changes deemed effective for cash flow hedge accounting purposes	—	—	—	—	—
Changes deemed ineffective for cash flow hedge accounting purposes	4	—	4	—	4
Other changes	(52)	(52)	—	—	(52)
Transferred to income statement	—	—	—	3	(3)
Fair value at December 31, 2005	62	69	(7)	—	

Financial risk and revenue sharing partnerships (RRSPs)

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

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

	£m	£m
On implementation of IAS 32 and IAS 39 at January 1, 2005		468
Cash paid to partners		(58)
Amount included in the income statement:		
Financing charge	43	
Excluded from underlying profit:		
Exchange adjustments	56	
Restructuring of RRSP agreements and forecast adjustments	(86)	13
At December 31, 2005		423

Own share total return swaps

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

	£m
At January 1, 2005 on implementation of IAS 39	142
On settlement of forward purchase contracts	(141)
Transferred to income statement	(1)
Fair value at December 31, 2005	—

20 Other financial assets and liabilities continued

B Shares

Since July 2004, the Company has issued non-cumulative redeemable convertible preference shares (B Shares) as an alternative to paying a cash dividend. Shareholders are able to redeem any number of their B Shares for cash or convert them into ordinary shares. Any B Shares retained, attract a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. In certain circumstances the Company has the option to compulsorily redeem the B Shares, at any time if the aggregate number of B Shares in issue is less than ten per cent of the aggregate number of B Shares issued, or on the acquisition or capital restructuring of the Company.

On a return of capital on a winding-up, the holders of B 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 B 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.

Movements in the B Shares during the year were as follows:

	B Shares of 0.01p	Nominal value £m
Authorised		
At January 1, and December 31, 2005	**1,000,000,000,000**	**1,000**
Issued and fully paid		
At January 1, 2005 [1]	**4,600,710,064**	**5**
Shares issued	**141,013,817,330**	**141**
Shares converted into ordinary shares	**(87,425,228,890)**	**(87)**
Shares redeemed	**(51,638,258,304)**	**(52)**
At December 31, 2005	**6,551,040,200**	**7**

[1] The adoption of IAS 32 and IAS 39 from January 1, 2005 has led to the reclassification of B Shares from equity to other financial liabilities.

21 Deferred taxation

	£m
At January 1, 2004 (restated)	219
Amount charged to income statement	(25)
Amount credited to statement of recognised income and expense	2
Amount credited to equity	6
Exchange movements	1
At January 1, 2005	**203**
On implementation of IAS 32 and IAS 39 on January 1, 2005	**(119)**
At January 1, 2005 (restated)	**84**
Amount charged to income statement	**(74)**
Amount credited to statement of recognised income and expense	**84**
Amount credited to equity	**162**
Exchange movements	**5**
At December 31, 2005	**261**

The analysis of the deferred tax position is as follows:

	2005 £m	2004 £m
Property, plant and equipment	**(138)**	(131)
Other temporary differences	**(219)**	(181)
Pensions and other post-retirement benefits	**505**	425
Foreign exchange and commodity financial assets and liabilities	**(77)**	—
Losses	**126**	26
Advance corporation tax	**64**	64
	261	203
Analysed as:		
Deferred tax assets	**439**	318
Deferred tax liabilities	**(178)**	(115)
	261	203
Deferred tax not recognised on unused tax losses and other items [1]	**146**	126

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

In addition there are temporary differences of **£467m** (2004 £380m) relating to investments in subsidiaries and joint ventures. No deferred tax has been provided in respect of these differences, since the timing of the reversals can be controlled and it is probable that the temporary differences will not reverse in the future.

22 Provisions

	At December 31, 2004 £m	Exchange adjustments £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2005 £m
Warranty/guarantees	171	1	(10)	46	(46)	162
Contract loss	48	—	(3)	9	(11)	43
Customer financing	92	(3)	(1)	16	(14)	90
Insurance	38	—	—	1	(1)	38
Restructuring	16	—	—	5	(12)	9
Other	28	1	(3)	3	(10)	19
	393	(1)	(17)	80 [1]	(94)	361

[1] Includes £5m for amounts discounted.

Analysed as:

	At December 31, 2005 £m	At December 31, 2004 £m
Current liabilities	138	173
Non-current liabilities	223	220
	361	393

Warranty provisions 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 one year.
Customer financing provisions cover guarantees provided for asset values and/or financing as described in note 30. Timing of utilisation is uncertain.
Insurance provisions relate to the Group's captive insurance business with timing of utilisation being uncertain.
Other provisions comprise a number of liabilities with varying expected utilisation rates.

23 Post-retirement benefits

Defined benefit schemes

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

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

The valuations of the schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2005. The most recent funding valuations of the main UK schemes were:

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

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

	2005		2004	
	UK schemes %	**Overseas schemes %**	UK schemes %	Overseas schemes %
Rate of increase in salaries	**4.4**	**3.4**	4.4	2.4
Rate of increase of pensions in payment	**2.6** [1]	**0.2**	2.6	0.2
Discount rate	**4.7**	**5.3**	5.3	5.7
Expected rate of return on scheme assets	**6.2**	**7.0**	6.6	7.3
Inflation assumption	**2.9**	**2.6**	2.9	2.8

[1] Benefits accruing after April 5, 2005 are assumed to increase in payment at a rate of 2.1 per cent.

The mortality assumptions used for the Rolls-Royce Pension Fund (the largest scheme in the Group) are based upon actual recent mortality experiences of members within the scheme and also allow for future mortality improvements.

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

Amounts recognised in the income statement

	2005			2004		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Operating cost						
Current service cost	**79**	**22**	**101**	75	19	94
Past service cost	**—**	**8**	**8**	—	—	—
Curtailment/settlement	**—**	**—**	**—**	(2)	—	(2)
	79	**30**	**109**	73	19	92
Finance income expense						
Expected return on assets	**(298)**	**(14)**	**(312)**	(303)	(11)	(314)
Interest on liabilities	**295**	**26**	**321**	292	23	315
	(3)	**12**	**9**	(11)	12	1
Total income statement charge	**76**	**42**	**118**	62	31	93

The actual return on scheme assets was **£900m** (2004 £440m).

The operating cost is charged as follows:

	2005 £m	2004 £m
Cost of sales	**77**	65
Commercial and administrative costs	**25**	21
Research and development	**7**	6

Actuarial losses of **£282m** (2004 £7m) have been reported in the statement of recognised income and expense. Cumulative actuarial losses from January 1, 2004 reported in the statement of recognised income and expense are **£289m** (2004 £7m).

23 Post-retirement benefits continued

Amounts recognised in the balance sheet

	2005			2004		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	**(6,661)**	**(296)**	**(6,957)**	(5,688)	(219)	(5,907)
Fair value of scheme assets	**5,343**	**220**	**5,563**	4,527	171	4,698
	(1,318)	**(76)**	**(1,394)**	(1,161)	(48)	(1,209)
Present value of unfunded obligations	**—**	**(263)**	**(263)**	—	(200)	(200)
Irrecoverable surplus	**—**	**(2)**	**(2)**	—	—	—
Net liability recognised in the balance sheet	**(1,318)**	**(341)**	**(1,659)**	(1,161)	(248)	(1,409)

Changes in present value of defined benefit obligations

	2005			2004		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
At January 1	**(5,688)**	**(419)**	**(6,107)**	(5,493)	(383)	(5,876)
Exchange adjustments	**—**	**(49)**	**(49)**	—	20	20
Current service cost	**(79)**	**(22)**	**(101)**	(75)	(19)	(94)
Past service cost	**—**	**(8)**	**(8)**	—	—	—
Finance cost	**(295)**	**(26)**	**(321)**	(292)	(23)	(315)
Contributions	**(35)**	**(1)**	**(36)**	(33)	(2)	(35)
Net benefits paid out	**253**	**13**	**266**	270	13	283
Actuarial loss	**(817)**	**(53)**	**(870)**	(108)	(25)	(133)
Settlements/curtailment	**—**	**6**	**6**	43	—	43
At December 31	**(6,661)**	**(559)**	**(7,220)**	(5,688)	(419)	(6,107)

The defined benefit obligation relating to post-retirement medical benefits would increase by £23m if the healthcare trend rate increases by one per cent, and reduce by £41m if it decreases by one per cent.

Changes in fair value of scheme assets

	2005			2004		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
At January 1	**4,527**	**171**	**4,698**	4,262	148	4,410
Exchange adjustments	**—**	**22**	**22**	—	(3)	(3)
Expected return on assets	**298**	**14**	**312**	303	11	314
Contributions – employer	**146**	**31**	**177**	112	30	142
– employee	**35**	**1**	**36**	33	2	35
Benefits paid out	**(253)**	**(13)**	**(266)**	(270)	(13)	(283)
Actuarial gain/(loss)	**590**	**(2)**	**588**	128	(2)	126
Settlements/curtailment	**—**	**(6)**	**(6)**	(41)	(2)	(43)
At December 31	**5,343**	**218**	**5,561**	4,527	171	4,698

23 Post-retirement benefits continued

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

UK schemes

	2005		2004	
	Expected rate of return %	**Market value £m**	Expected rate of return %	Market value £m
Equities	**7.1**	**3,654**	7.6	2,998
Sovereign debt	**4.1**	**565**	4.6	699
Corporate bonds	**4.5**	**978**	5.1	642
Other	**4.3**	**146**	5.3	188
		5,343		4,527

Overseas schemes

	2005		2004	
	Expected rate of return %	**Market value £m**	Expected rate of return %	Market value £m
Equities	**8.6**	**131**	8.3	99
Corporate bonds	**4.5**	**72**	5.6	58
Other	**4.6**	**17**	6.8	14
		220		171

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 rates of return on individual categories of scheme assets are determined by reference to relevant indices. The overall expected rate of return is calculated by weighting the individual rates in accordance with the anticipated balance in the schemes' investment portfolios.

History of plans

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

Balance sheet

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

Experience gains/losses

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

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

The Group expects to contribute approximately £180m to its defined benefit schemes in 2006.

23 Post-retirement benefits continued

Defined contribution schemes

The Group operates a number of defined contribution schemes.

The total expense recognised in the income statement was **£14m** (2004 £10m).

24 Share capital

					Non-equity		Equity
	Special share of £1	B Shares of 0.1p each	Nominal value £m	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each	Nominal value £m
Authorised							
At January 1, 2004 and December 31, 2005	1			50,000	—	2,499,999,998	500
Upon approval of B Share scheme at the 2004 AGM		1,000,000,000,000	1,000				
Issued and fully paid							
At January 1, 2004	1	—	—	—	—	1,666,619,843	333
Issued for B Share scheme	—	83,922,435,550	84	—	—	—	—
Exercise of share options	—	—	—	—	—	2,654,484	1
In lieu of paying dividends in cash	—	—	—	—	—	10,671,927	2
B Share conversion into ordinary shares		(52,631,193,754)	(52)	—	—	24,826,034	5
Redemption of B Shares	—	(26,690,531,732)	(27)	—	—	—	—
At January 1, 2005	1	4,600,710,064	5	—	—	1,704,772,288	341
B Shares reclassified on implementation of IAS 32 and IAS 39[1]		(4,600,710,064)	(5)				
At January 1, 2005 (restated)	1			—	—	1,704,772,288	341
Exercise of share options	—			—	—	19,174,767	4
B Share conversion into ordinary shares	—			—	—	34,754,246	7
At December 31, 2005	1			—	—	1,758,701,301	352

[1] Reclassified as other financial liabilities (note 20).

Certain rights, set out in the Company's Articles of Association, attach to the special rights redeemable preference share (special share) issued to HM Government. Subject to the provisions of the Companies Act 1985, the special share may be redeemed by the Treasury Solicitor at par at any time. The special share confers no rights to dividends or to vote at general meetings but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

25 Reserves

	Share premium £m	Merger reserve £m	Capital redemption reserve £m	Transition hedging reserve £m	Cash flow hedging reserve £m	Translation reserve £m	Retained earnings[1] £m
							2005
At January 1, 2005	**4**	**3**	**74**	**—**	**—**	**(38)**	**1,053**
On implementation of IAS 32 and IAS 39	**—**	**—**	**—**	**703**	**(3)**	**6**	**(550)**
At January 1, 2005 (restated)	**4**	**3**	**74**	**703**	**(3)**	**(32)**	**503**
Exchange adjustments	**—**	**—**	**—**	**—**	**—**	**49**	**—**
Arising on share issues (net of expenses)	**26**	**—**	**—**	**—**	**—**	**—**	**—**
Hedging reserve transfers to income statement	**—**	**—**	**—**	**(462)**	**3**	**—**	**—**
Profit for the year	**—**	**—**	**—**	**—**	**—**	**—**	**350**
Actuarial loss	**—**	**—**	**—**	**—**	**—**	**—**	**(282)**
Deferred tax on actuarial loss	**—**	**—**	**—**	**—**	**—**	**—**	**84**
Other deferred tax movements through reserves	**—**	**—**	**—**	**138**	**—**	**—**	**24**
Relating to own shares	**—**	**—**	**—**	**—**	**—**	**—**	**—**
Issue of B Shares	**—**	**—**	**—**	**—**	**—**	**—**	**(141)**
Redemption of B Shares	**—**	**—**	**52**	**—**	**—**	**—**	**(52)**
Conversion of B Shares into ordinary shares	**—**	**—**	**80**	**—**	**—**	**—**	**—**
Share-based payment adjustment	**—**	**—**	**—**	**—**	**—**	**—**	**26**
At December 31, 2005	**30**	**3**	**206**	**379**	**—**	**17**	**512**

	Share premium £m	Merger reserve £m	Capital redemption reserve £m	Transition hedging reserve £m	Cash flow hedging reserve £m	Translation reserve £m	Retained earnings[1] £m
							2004
At January 1, 2004	1	3	—	—	—	—	876
Exchange adjustments	—	—	—	—	—	(38)	—
Scrip dividend adjustment	—	(2)	—	—	—	—	20
Arising on share issues (net of expenses)	3	—	—	—	—	—	—
Other adjustments	—	2	—	—	—	—	—
Profit for the year	—	—	—	—	—	—	263
Actuarial loss	—	—	—	—	—	—	(7)
Deferred tax on actuarial loss	—	—	—	—	—	—	2
Other deferred tax movements through reserves	—	—	—	—	—	—	6
Relating to own shares	—	—	—	—	—	—	(2)
Issue of B Shares	—	—	—	—	—	—	(84)
Redemption of B Shares	—	—	27	—	—	—	(27)
Conversion of B Shares into ordinary shares	—	—	47	—	—	—	—
Share-based payment adjustment	—	—	—	—	—	—	6
At December 31, 2004	4	3	74	—	—	(38)	1,053

[1] At December 31, 2005, **68,536,712 shares** with a net book value of **£132m** (2004 847,877 shares with a net book value of £2m) were held and included in retained earnings.

26 Minority interest

	£m
At January 1, 2004	3
Total recognised income and expense for the year	1
At January 1, 2005	**4**
Total recognised income and expense for the year	**(3)**
Sale of shares in subsidiary company to a minority interest	**5**
At December 31, 2005	**6**

27 Share-based payments

Share-based payment plans in operation during the period

The Group had the following share-based payment plans in operation during the period:

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). Further information regarding the operation of the plan can be found on pages 40 and 41 of the Directors' remuneration report.

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 Inland Revenue approved. Overseas, employees in 28 countries participate in sharesave plans through arrangements broadly comparable to the UK plan. A small proportion of the sharesave options are settled in cash. Further information regarding the operation of the plan can be found on page 41 of the Directors' remuneration report.

Executive Share Option Plan (ESOP)

This plan involves the grant of market value share options to participants. The options are subject to a non-market based performance condition (growth in EPS). The options have a maximum contractual life of ten years. Further information regarding the operation of the plan can be found on page 41 of the Directors' remuneration report. There was no grant of executive share options in 2004 or 2005. Following the introduction of the PSP, it is not intended to grant any further executive share options.

Annual Performance Related Award plan (APRA) deferred shares

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

Share Incentive Plan (SIP)

The 'Free Share' element of the Share Incentive Plan (SIP). Eligible employees receive shares with a value of up to one week's salary. There are no conditions attached to the shares.

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

The Group recognised a total expense of **£26m** (2004 £19m).

27 Share-based payments continued

The movement in options to subscribe for shares under the Group's various share plans is shown in the tables below. A further breakdown of the options outstanding at the year end is provided in the table on page 86.

PSP	Number of shares awarded 2005 Millions	2004 Millions
Outstanding at beginning of the year	**6**	—
Awarded during the year	**5**	6
Forfeited during the year	**—**	—
Vested during the year	**—**	—
Outstanding at December 31	**11**	6

Sharesave	2005 Number of share options Millions	2005 Weighted average exercise price Pence	2004 Number of share options Millions	2004 Weighted average exercise price Pence
Outstanding at beginning of the year	**74**	**130p**	78	130p
Granted during the year	**12**	**298p**	—	—
Forfeited during the year	**(1)**	**139p**	(3)	131p
Exercised during the year	**(20)**	**140p**	(1)	122p
Outstanding at December 31	**65**	**157p**	74	130p
Exercisable at December 31	**—**	**—**	—	—

ESOP	2005 Number of share options Millions	2005 Weighted average exercise price Pence	2004 Number of share options Millions	2004 Weighted average exercise price Pence
Outstanding at beginning of the year	**80**	**149p**	89	150p
Granted during the year	**—**	**—**	—	—
Forfeited during the year	**(3)**	**169p**	(5)	167p
Exercised during the year	**—**	**—**	(4)	162p
Outstanding at December 31	**77**	**148p**	80	149p
Exercisable at December 31	**—**	**—**	—	—

Deferred shares under APRA	Number of shares awarded 2005 Millions	2004 Millions
Outstanding at beginning of the year	**12**	14
Awarded during the year	**3**	3
Forfeited during the year	**—**	(1)
Vested during the year	**(7)**	(4)
Outstanding at December 31	**8**	12

Free Shares under SIP	Number of shares awarded 2005 Millions	2004 Millions
Awarded during the year	**1**	1

Options were exercised on a regular basis during the year. The average share price during the year was 310p.

27 Share-based payments continued

Fair values

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

	2005 Pence	2004 Pence
PSP	**282p**	249p
Sharesave – 3 year	**131p**	—
Sharesave – 5 year	**154p**	—
APRA deferred share awards	**260p**	220p
SIP Free Share awards	**257p**	231p

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

PSP awards

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

	2005	2004
Weighted average share price	**262p**	233p
Expected dividends	**7.81p**	7.61p
Volatility	**34%**	35%
Correlation	**19%**	22%
Expected life	**3 years**	3 years
Risk free interest rate	**4.9%**	5.2%

As explained on page 41 of the Directors' remuneration report, the PSP has a Total Shareholder Return (TSR) market-based performance condition, such that the Company's TSR over the performance period will be compared with the TSR of the companies constituting the FTSE 100 index on the date of grant. If the Company's TSR exceeds the median TSR of the FTSE 100, the number of shares that vest will be increased by 25 per cent. The fair value of an award of shares under the PSP has been adjusted to take into account this market-based performance condition using a pricing model based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies and which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value relative to the share price at the date of grant.

Sharesave awards

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

	2005	2004
Weighted average share price	**351p**	—
Exercise price	**298p**	—
Volatility	**40%**	—
Expected dividends	**7.86p**	—
Expected life[1] – 3 year Sharesave	**3.3-3.8 years**	—
– 5 year Sharesave	**5.3-5.8 years**	—
Close periods:		
From January 1	**6 weeks**	6 weeks
From July 1	**1 month**	1 month
Risk free interest rate	**4.4%**	—

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

Deferred shares under APRA and Free Shares under SIP

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

27 Share-based payments continued

Fair values of options granted in 2003

The charge under IFRS 2 for the current period includes a charge for options granted under the ESOP and Sharesave plans during the year ended December 31, 2003, with the following grant date fair values:

	2003
ESOP	22.7p
Sharesave – 3 year	61p
Sharesave – 5 year	71p

These fair values were calculated using the binomial model and the following assumptions:

	ESOP	Sharesave
Weighted average share price	79p	173p
Weighted average exercise price	78p	142p
Volatility	43%	43%
Expected dividends	7.61p	7.61p
Expected life[1] – 3 year Sharesave		3.15-3.65 years
– 5 year Sharesave		5.15-5.65 years
– ESOP	4.5 years	
Close periods:		
From January 1	6 weeks	6 weeks
From July 1	1 month	1 month
Risk free interest rate	4.1%	4.6%

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

At December 31, 2005, the following ordinary shares were subject to options:

	Date of grant	Number	Exercise price	Exercisable dates
Executive share option scheme	1996	50,400	238p	2006
Executive share option plan	1999	906,416	269p	2006-2009
	1999	206,801	216p	2006-2009
	2000	4,775,649	194p	2006-2010
	2000	1,473,793	194p	2006-2010
	2000	18,404	163p	2006-2010
	2000	86,658	163p	2006-2010
	2000	11,731	170p	2006-2010
	2001	794,363	216p	2006-2011
	2001	7,542,313	216p	2006-2011
	2001	13,516,053	216p	2007-2011
	2001	27,522	218p	2006-2011
	2001	233,141	218p	2006-2011
	2002	12,418,730	188p	2006-2012
	2002	579,537	188p	2006-2012
	2002	581,312	216p	2007-2012
	2003	34,285,557	77p	2006-2013
	2003	11,340	170p	2006-2013
	2003	166,391	170p	2006-2013
Sharesave plans	1999	1,981,389	194p	2007
	2001	27,447,270	108p	2007/2009
	2003	23,268,198	141p	2006/2009
	2005	11,990,112	298p	2009/2011

Under the terms of the Rolls-Royce plc Executive Share Option Scheme and the Rolls-Royce 1999 Executive Share Option Plan, options granted to 504 directors and senior executives were outstanding at December 31, 2005.

28 Financial instruments

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

In accordance with the option allowed by IFRS 1 'First time adoption of IFRS', the Group has adopted IAS 32 and IAS 39 'Financial Instruments' prospectively from January 1, 2005, and consequently information for 2005 is provided on this basis. For 2004, information has been provided on the previously published basis under UK GAAP.

Risk management policies and hedging activities

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

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

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

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

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

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

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

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

28 Financial instruments continued

Derivative financial instruments

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

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

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:

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

Other derivative financial instruments are denominated in the following currencies:

	2005 £m
Sterling	24
US dollar	558
Euro	813
Other	50

28 Financial instruments continued

Fair values of financial instruments

The fair value of a financial instrument is the price at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair values have been determined with reference to available market information at the balance sheet date, using the methodologies discussed below.

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

	2005	
	Book value £m	Fair value £m
Assets		
Unlisted non-current investments	52	52
Cash at bank and in hand	338	338
Short-term deposits and investments	1,456	1,456
Trade receivables	963	963
Other financial assets:		
Derivative financial assets	464	464
Other non-derivative financial assets	258	258
Liabilities		
Trade payables	(1,538)	(1,538)
Borrowings – current	(75)	(74)
– non-current	(1,458)	(1,530)
Other financial liabilities:		
Derivative financial liabilities	(143)	(143)
Financial risk and revenue sharing partnerships	(423)	(454)
B Shares	(7)	(7)
Other non-derivative financial liabilities	(246)	(246)

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

Trade receivables, trade payables, short-term investments and cash and cash equivalents – Fair values are assumed to approximate to cost either due to the short-term maturity of the instruments or because the interest rate of the investments is reset after periods not exceeding six months.

Borrowings, other financial assets and other financial liabilities – Where available, market values have been used to determine fair values. Where market values are not available, fair values have been estimated by discounting expected future cash flows using prevailing interest rate curves. Amounts denominated in foreign curencies are valued at the exchange rate prevailing at the balance sheet date.

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

					2005
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Assets					
Unlisted non-current investments	46	—	2	4	52
Cash at bank and in hand	111	67	87	73	338
Short-term deposits and investments	986	377	84	9	1,456
Trade receivables	194	633	74	62	963
Other non-derivative financial assets	84	122	19	33	258
Liabilities					
Trade payables	(731)	(550)	(130)	(127)	(1,538)
Borrowings – current	(8)	(11)	(1)	(55)	(75)
– non-current	(213)	(361)	(882)	(2)	(1,458)
Other financial liabilities:					
Financial risk and revenue sharing partnerships	—	(325)	(98)	—	(423)
B Shares	(7)	—	—	—	(7)
Other non-derivative financial liabilities	(178)	(36)	(10)	(22)	(246)

28 Financial instruments continued

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:

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

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.

			Period in which interest rate reprices				
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments[1]	4.8700%	37	14	7	—	9	7
Cash at bank and in hand[2]		338	338	—	—	—	—
Short-term deposits[3]		1,419	1,419	—	—	—	—
Unsecured bank loans							
Canadian $100m floating rate loan	CAD LIBOR +0.55	(50)	(50)	—	—	—	—
After effect of interest rate swaps	5.2750%	—	—	—	—	—	—
s8m floating rate loan	EURIBOR +1.178	(6)	(6)	—	—	—	—
Overdrafts[4]		(12)	(12)	—	—	—	—
Effect of other interest rate swaps	2.0933%	—	115	—	(28)	(63)	(24)
Other unsecured							
Other loan 2009 (interest rate nil)	0.0000%	(1)	—	—	—	(1)	—
Unsecured bond issues							
6⅜% Notes 2007 s500m	6.3750%	(354)	—	—	(354)	—	—
After effect of interest rate swaps	GBP LIBOR +0.866	—	(354)	—	354	—	—
7⅜% Notes 2016 £200m	7.3750%	(200)	—	—	—	—	(200)
5.84% Notes 2010 US$187m	5.8400%	(107)	—	—	—	(107)	—
After effect of interest rate swaps	USD LIBOR +1.159	—	(107)	—	—	107	—
6.38% Notes 2013 US$230m	6.3800%	(134)	—	—	—	—	(134)
After effect of interest rate swaps	USD LIBOR +1.26	—	(134)	—	—	—	134
6.55% Notes 2015 US$83m	6.5500%	(49)	—	—	—	—	(49)
After effect of interest rate swaps	USD LIBOR +1.24	—	(49)	—	—	—	49
4½% Notes 2011 s750m	4.5000%	(524)	—	—	—	—	(524)
After effect of interest rate swaps	GBP LIBOR +0.932	—	(524)	—	—	—	524
Secured bank loans							
US$ floating rate loan	USD LIBOR +0.98	(74)	(74)	—	—	—	—
After effect of interest rate swaps	5.1540%	—	74	(74)	—	—	—
Other secured							
Obligations under finance leases payable	6.8603%	(22)	(4)	(4)	(5)	(8)	(1)
		261	646	(71)	(33)	(63)	(218)

[1] Interest on the short-term investments are at fixed rates. The weighted average interest rate on the sterling securities is 4.87 per cent. The periods in which they reprice is shown in the table above.
[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] Floating rate financial liabilities comprise borrowings bearing interest at rates fixed in advance for periods ranging from one to six months based on the applicable LIBOR rate.

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 obligation 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.

28 Financial instruments continued

Maturity analysis

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

	2005 £m
In one year or less or on demand	**75**
In more than one year but not more than two years	**49**
In more than two years but not more than five years	**365**
In more than five years	**1,044**
	1,533

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

	2005 £m
Expiring within one year	—
Expiring in one to two years	—
Expiring thereafter	**250**
	250

Comparative information for 2004

This is provided on the previously published basis under UK GAAP.

Funding and interest rates

					2004
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
Financial assets					
Cash at bank and in hand [1]	200	418	45	95	758
Short-term deposits [2]	652	34	3	5	694
Government securities and corporate bonds [3]	34	2	—	—	36
Unlisted fixed asset investments [4]	47	3	2	5	57
Debtors – amounts falling due after one year [4]	41	36	13	19	109
	974	493	63	124	1,654
Financial liabilities [5]					
Floating-rate borrowings [6]	(714)	(180)	(8)	(5)	(907)
Fixed-rate borrowings	(508)	(87)	—	(65)	(660)
Borrowings on which no interest is paid [7]	—	—	—	(1)	(1)
Other creditors – amounts falling due after one year [4]	(42)	(31)	(1)	(12)	(86)
	(1,264)	(298)	(9)	(83)	(1,654)

Notes
[1] Cash at bank and in hand comprises bank balances and deposits placed on money markets overnight.
[2] Short-term deposits are deposits placed on money markets for periods ranging from two nights up to one month.
[3] Interest on the securities and bonds are at fixed rates. The weighted average interest rate on the sterling securities is 5.8 per cent. The weighted average time for these securities is 2.5 years.
[4] These amounts do not incur or accrue interest.
[5] Financial liabilities are stated after taking into account the various interest rate and currency swaps entered into by the Group.
[6] Floating-rate financial liabilities comprise borrowings bearing interest at rates fixed in advance for periods ranging from one to six months based on the applicable LIBOR rate.
[7] The weighted average period for borrowings on which no interest is paid is five years.

28 Financial instruments continued

The analysis of fixed-rate borrowings is as follows:

	2004		
	Total £m	Weighted average interest rate at which fixed %	Weighted average period for which rate is fixed Months
Currency			
Sterling	508	6.9	15
US dollar	87	6.5	43
Other	65	5.4	15

The maturity profile of the Group's financial liabilities is as follows:

	2004 £m
In one year or less, or on demand	204
In more than one year but not more than two years	117
In more than two years but not more than five years	372
In more than five years	961
	1,654

Borrowing facilities

The Group has various borrowing facilities available to it. The undrawn committed facilities available at December 31, 2004 were as follows:

	2004 £m
Expiring within one year	—
Expiring in one to two years	—
Expiring thereafter	250
	250

Exchange risk management

The table below shows the Group's currency exposures at December 31, 2004 on currency transactions that give rise to the net currency gains and losses recognised in the profit and loss account. Such exposures comprise the net monetary assets and liabilities of the Group at December 31, 2004 that are not denominated in the functional currency of the operating company involved. The exposures are stated after taking into account the effects of currency swaps and forward foreign exchange contracts.

	2004 Net foreign currency monetary assets/(liabilities)			
Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m
Sterling	—	—	1	—
US dollar	—	—	—	1
Euro	—	1	—	—
Other	1	4	(1)	4

28 Financial instruments continued

Fair values of financial assets and financial liabilities

The estimated fair value of the Group's financial instruments are summarised below:

	2004	
	Book value £m	Fair value £m
Unlisted non-current fixed asset investments	57	57
Cash at bank and in hand	758	758
Short-term deposits and investments	730	730
Short-term debt	(204)	(211)
Long-term debt	(1,364)	(1,569)
Other creditors – amounts falling due after one year	(86)	(82)
Debtors – amounts falling due after one year	109	104
Derivatives used to hedge the interest, currency and commodity exposure of the business:		
Jet fuel swaps	—	9
Interest rate swaps	23	129
Forward foreign currency contracts	—	986
Forward purchase of shares to meet share option commitments	—	40

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

Cash at bank and in hand, short-term deposits and short-term borrowings:

The book value approximates to fair value either due to the short-term maturity of the instruments or because the interest rate of investments is reset after periods not greater than six months.

Derivatives:

The fair value of derivatives is the estimated amount, based on current market rates, which the Group would expect to pay or receive were it to terminate the derivatives at the balance sheet date.

Hedges of future transactions

As described in the Finance Director's review on pages 24 to 29 the Group's policy is to hedge the following exposures:

Interest rate risk – using interest swaps
Currency exposures on future forecast sales – using forward foreign currency contracts, currency swaps and currency options
Commodity price risk – using jet fuel swaps

Gains and losses on instruments used for hedging are dealt with as outlined in the accounting policies on page 59.

Unrecognised gains and losses on instruments used for hedging, and the movements therein, are as follows:

	2004		
	Gains £m	(Losses) £m	Total net gains/(losses) £m
Unrecognised gains and losses on hedges at January 1, 2004	980	(234)	746
Gains and losses arising in previous year that were recognised in 2004	(280)	90	(190)
Gains and losses arising in previous year that were not recognised in 2004	700	(144)	556
Gains and losses arising in 2004 that were not recognised in 2004	618	(33)	585
Unrecognised gains and losses on hedges at December 31, 2004 of which:	1,318	(177)	1,141
Gains and losses expected to be recognised in 2005	564	(123)	441
Gains and losses expected to be recognised thereafter	754	(54)	700

29 Operating and finance leases

Operating leases

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

	2005 £m	2004 £m
Within one year	**82**	67
Between one and five years	**270**	245
After five years	**134**	159
	486	471

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

	2005 £m	2004 £m
Within one year	**14**	15
Between one and five years	**23**	36
After five years	**7**	14
	44	65

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

- Sublease payments of **£16m** (2004 £17m) and sublease receipts of **£15m** (2004 £16m) were recognised in the income statement in the period.
- Purchase options exist on aero engines with the period to purchase option date varying between four to eight years.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total of future minimum sublease payments expected to be made is **£16m** (2004 £28m) and sublease receipts expected to be received **£2m** (2004 £nil).

Finance leases

Finance lease liabilities are payable as follows:

	2005			2004		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Within one year	**10**	**2**	**8**	14	2	12
Between one and five years	**17**	**4**	**13**	26	6	20
After five years	**1**	**—**	**1**	1	1	—
	28	**6**	**22**	41	9	32

There were no contingent rents recognised as an expense in the period.

Future minimum sublease receipts of **£nil** (2004 £nil) are expected under non-cancellable subleases.

30 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.

Under UK GAAP, contingent liabilities were reported: (a) at the full potential exposure regardless of the time at which such exposures may arise; and (b) in sterling taking account of forward exchange contracts held. Following the adoption of IFRS, the Group has reviewed this policy and has concluded that it is more appropriate to disclose contingent liabilities on a discounted basis. As directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a present value. However, the amounts will be discounted at the Group's borrowing rate to reflect better the time span over which these exposures could arise. In addition, following the decision to cease hedge accounting from January 1, 2005, it is no longer appropriate to take account of forward exchange contracts. As the contingent liabilities are denominated in US dollars, this amount will be reported, together with the sterling equivalent at the reporting date spot rate.

Applying this revised policy, the discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions, at December 31, 2005 amounted to **$1,097m** (**£638m**, 2004 $1,143m, £595m, previously reported £999m). Taking into account the net realisable value of the relevant security including unrestricted cash collateral of **$108m** (**£63m**, 2004 $104m, £54m), the discounted value of the net contingent liabilities in respect of financing arrangements on all delivered aircraft amounted to **$259m** (**£150m**, 2004 $294m, £153m, previously reported £189m). Sensitivity calculations are complex, but for example, if the value of the relevant security was reduced by 20 per cent, a net contingent liability with a discounted value of approximately **$363m** (**£211m**, 2004 $403m, £210m, previously reported £277m) would result. There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

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

31 Related party transactions

	2005 £m	2004 £m
Sales of goods and services to joint ventures	**986**	965
Purchases of goods and services from joint ventures	**(643)**	(437)
Operating lease payments to joint ventures	**(38)**	(36)
Guarantees provided to joint ventures	**2**	5
Dividends received from joint ventures	**35**	15
RRSP receipts from joint ventures	**3**	11
Other income received from joint ventures	**14**	15

The aggregated balances with joint ventures are shown in notes 13, 14, 17 and 19.

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.
Rolls-Royce Group plc is a non-trading holding company for Rolls-Royce plc.
Key management personnel are considered to be the directors and their remuneration is disclosed within the Directors' remuneration report on page 43.

32 Disposal of businesses

During the year the Group disposed of its interests in a number of small businesses, as summarised below:

	Total £m
Non-current assets	1
Inventory	2
Trade and other receivables	4
Trade and other payables	(4)
Borrowings repaid	(1)
Net assets	2
Loss on sale or termination of businesses	(2)
Disposal proceeds less costs	—
Amounts deferred at December 31, 2005	1
Net cash inflow per cash flow statement	1

33 Transition to International Financial Reporting Standards (IFRS)

As stated in note 1, in accordance with European Union Regulations, the Group adopted IFRS from January 1, 2004, and restated its financial statements for the year ended December 31, 2004, which were previously reported under UK Generally Accepted Accounting Practices (GAAP). An analysis of the impact of implementing IFRS was published in a news release on April 14, 2005, available on the Investors section of the Group's website www.rolls-royce.com

The major changes required by the introduction of IFRS were:

- recognition of intangible assets, whereby certain qualifying costs, in particular related to research and development and recoverable engine costs, which were written off under UK GAAP, are required to be recognised and amortised over a future period of time;
- treatment of financial instruments, whereby the majority of financial assets and derivatives, employed by the Group to provide stability for long-term business planning, for example in respect of foreign exchange rates, will be fair-valued on the balance sheet with subsequent changes in fair values recorded in the income statement, unless cash flow hedge accounting is applied;
- financial risk and revenue sharing partnerships, whereby a balance sheet liability is required to be established to reflect the expected future value of payments to partners;
- pensions and other post-retirement costs, whereby pension scheme deficits are required to be recorded on the balance sheet;
- the cessation of amortisation of goodwill; and
- the recording of share-based payments at fair value.

The Group achieved hedge accounting under UK GAAP. However the strict methodology to achieve hedge accounting under IAS 39 limits its application for use by the Group unless there are significant changes to the way in which the Group operates its economic hedging policies. The Group has determined that its existing hedging strategy is in the best interests of the business and its shareholders. It has not, therefore, altered its hedging activities in order to achieve a particular accounting presentation under the new rules.

The Group has applied hedge accounting to its interest rate derivative hedge book, but has not applied cash flow hedge accounting to its foreign exchange and commodity derivative hedge books.

Details of the adjustments made in adopting IFRS are provided below. Reconciliations for the 2004 restated opening and closing balance sheets, income statement and cash flow are also provided.

Presentation of financial statements

The Group's primary financial statements have been presented in accordance with IAS 1 Presentation of Financial Statements.

The principal impact on the income statement is the presentation of the Group's share of the results of joint ventures (which are accounted for using the equity method) as a single line. Under UK GAAP, the Group's shares of operating profit, interest and taxation were reported separately. As a consequence, the Group's share of joint venture taxation is included in profit before tax. There is no impact on reported profit after tax.

The format of the balance sheet has been amended to include the items required by IAS 1 to be presented on the face of the balance sheet.

Transitional arrangements

The rules for the first-time adoption of IFRS are set out in IFRS 1. In general, a company is required to determine its IFRS policies and apply those retrospectively to determine its opening balance sheet under IFRS. IFRS 1 allows a number of exemptions to this general requirement. Where Rolls-Royce has applied these exemptions, they are noted in the relevant section below. In particular the Group has adopted the exemption that IAS 32 and IAS 39 Financial Instruments need not be applied to the comparative period. Consequently the restated results for the year ended December 31, 2004 have been prepared using the accounting policies for financial instruments previously adopted under UK GAAP. This has led to a second transition at January 1, 2005, details of which are provided below, together with a balance sheet reconciliation.

33 Transition to International Financial Reporting Standards (IFRS) continued

Research and development

IAS 38 requires that all development costs meeting specified criteria be capitalised as intangible assets.

As part of its IFRS transition project, Rolls-Royce reviewed all development projects, whether the costs were previously recognised under UK GAAP or not, to determine whether the criteria in IAS 38 were met. The key eligibility criteria for capitalisation relate to:

i) **Identification of development costs.** In general, research and development activities are closely interrelated and it is not until the technical feasibility of the project can be determined with reasonable certainty that development costs can be separately identified; and

ii) **The generation of future economic benefit.** Intangible assets are not recognised unless the project is expected to generate future economic benefit exceeding the amount capitalised.

Certain expenditures on internal product development meet all the criteria of IAS 38 and have therefore been capitalised.

Development costs capitalised are amortised on a straight-line basis over a period not exceeding 15 years. The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Capitalisation of internal expenditure		11
Amortisation of intangible asset		(17)
Adjustment to profit before taxation		(6)
Net assets		
Intangible asset – cost	246	257
Intangible asset – accumulated amortisation	(86)	(103)
	160	154
Related tax effect	(48)	(46)
Adjustment to net assets	112	108

Recoverable engine costs

On occasions, the Group may sell original equipment to customers at an amount below its cost of manufacture, with the expectation 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. Under UK GAAP, these intangible assets were required to be written-off as they arose; under IAS 38 such intangible assets are required to be recognised. The resulting intangible asset will be amortised over the expected utilisation period of the equipment by the initial customer – generally to a maximum of ten years, subject to any specific contractual circumstances.

The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Capitalisation of intangible assets previously written off in 2004		21
Amortisation of intangible assets		(26)
Elimination of related inventory provision recognised under UK GAAP		(5)
Adjustment to profit before taxation		(10)
Net assets		
Intangible assets – cost	208	229
Intangible assets – accumulated amortisation	(88)	(114)
	120	115
Elimination of related inventory provision recognised under UK GAAP	14	9
	134	124
Related tax effect	(40)	(37)
Adjustment to net assets	94	87

33 Transition to International Financial Reporting Standards (IFRS) continued

Goodwill and business combinations

IFRS 3 Business Combinations prohibits the amortisation of goodwill. Instead, it requires goodwill to be carried at cost. Annual impairment tests are required to be performed.

The Group has applied the exemption granted by IFRS 1 to apply IFRS 3 prospectively from the date of transition to IFRS. This has the following impact:

- All prior business combination accounting is frozen at the transition date; and
- The value of goodwill is frozen at the transition date and amortisation previously reported under UK GAAP for the year ended December 31, 2004 is reversed for the IFRS restatement.

The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Reversal of goodwill amortisation relating to subsidiaries		47
Reversal of goodwill amortisation relating to joint ventures		1
Adjustment to profit before taxation		48
Net assets		
Reversal of goodwill amortisation	—	48
	—	48
Related taxation effect	—	(1)
Adjustment to net asset	—	47

Pensions and other post-retirement benefits

IAS 19 Employee Benefits requires separate recognition of the operating and financing costs of defined benefit pension schemes (and similarly funded employee benefits) in the income statement. The standard permits a number of options for the recognition of actuarial gains and losses. The Group's policy is to recognise immediately any variations in full in a statement of recognised income and expense, as permitted in the IASB's amendment to IAS 19 entitled Actuarial Gains and Losses, Group Plans and Disclosures.

The cash funding of the plans is designed, in consultation with independent qualified actuaries, to ensure that present and future contributions should be sufficient to meet future liabilities.

The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Adjustments to operating profit		42
Adjustments to financing costs		(1)
Adjustment to profit before taxation		41
Net assets		
Eliminate amounts recognised under SSAP 24		
Prepaid pension contributions	(239)	(263)
Provision for pension costs	160	159
Include IAS 19 pension liability	(1,466)	(1,409)
	(1,545)	(1,513)
Related taxation effect	447	437
Adjustment to net assets	(1,098)	(1,076)

33 Transition to International Financial Reporting Standards (IFRS) continued

Share-based payments

IFRS 2 Share-based Payments requires the fair value of share options granted to employees since November 7, 2002 (the publication date of the exposure draft of IFRS 2) to be charged to the income statement. The fair value is calculated using an option-pricing model and is charged to income over the relevant vesting periods, adjusted to reflect actual and expected levels of vesting.

The basis of calculation for deferred taxation is in respect of all schemes (including pre November 7, 2002 grants) and is the difference between the market price at the date of the financial statements and the option exercise price. This will not necessarily correlate to the fair value charge.

The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Fair value of share options charged to operating profit		(6)
Adjustment to profit before taxation		(6)
Net assets		
Related taxation effect	2	9
Adjustment to net assets	2	9

Scope of consolidation

On transition to IFRS, IAS 27 Consolidated and Separate Financial Statements required the consolidation of all subsidiaries and special purpose entities that the Group controlled at January 1, 2004. Based on the IAS 27 Definitions of Control, and after taking into account the facts and circumstances relevant at the transition date, the Group determined that it controlled one arrangement (Pembroke 717 Holdings Limited) that was not required to be consolidated under UK GAAP. The consolidation of this company did not have any net impact on the reported results for 2004.

The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Operating profit		4
Finance costs		(4)
Adjustment to profit before taxation		—
Net assets		
Property, plant and equipment	69	46
Current liabilities	(1)	(1)
Borrowings	(77)	(69)
Elimination of provision recognised under UK GAAP	9	24
Adjustment to net assets	—	—

33 Transition to International Financial Reporting Standards (IFRS) continued

Income taxes

The net deferred tax impact of the changes above is shown as part of the relevant adjustment.

In addition, under IAS 12 Income Taxes, certain temporary differences, for example in respect of capital losses and unremitted earnings from joint ventures, which previously were not recognised under UK GAAP, will be recognised.

The impact arising from this change is summarised as follows:

	At January 1, 2004 £m	Year ended December 31, 2004 £m
Income statement		
Changes to deferred tax charge resulting from differences in the basis of calculation		1
Adjustment to profit after taxation		1
Net assets		
Changes to deferred tax balance resulting from differences in the basis of calculation	(45)	(44)
Adjustment to net assets	(45)	(44)

Financial instruments (applicable from January 1, 2005)

IAS 32 and IAS 39 Financial Instruments address the accounting for, and financial reporting of, financial instruments. IAS 32 covers disclosure and presentation, while IAS 39 covers recognition and measurement including detailed rules for hedge accounting. These include the requirements to match the hedged item to the hedging instrument and to measure hedge effectiveness. IAS 39 requires certain financial assets and certain financial liabilities to be recognised at fair value. Accounting for movements in fair value is dependent on the designation of the relevant financial instrument and whether hedge accounting is adopted.

The Group has applied the exemption, granted by IFRS 1, not to apply IAS 32 and IAS 39 to its comparative figures for 2004. On January 1, 2005, the fair value of foreign exchange and commodity derivatives were included in a transition hedging reserve. As the Group has not adopted cash flow hedge accounting for future foreign exchange transactions under IAS 39 from January 1, 2005, the reserve was frozen and will be released to the income statement based on the designated maturities on that date.

The impact on the Group's derivative financial instruments is described below.

Foreign exchange derivatives

A large element of the Group's trading is denominated in US dollars and a significant portion of its costs is incurred in sterling and Euros. In order to protect itself from the associated currency volatility, the Group takes significant levels of forward cover. Under UK GAAP, gains or losses on this cover are not recognised in the income statement until realised, matching them with the underlying transactions. As contracts may be signed several years in advance of delivery, delivery dates may change and meeting the strict criteria for hedge accounting in IAS 39 is not considered to be practicable within the current risk management practices. Rolls-Royce considers that it could amend its risk management practices to achieve hedge accounting. However, Rolls-Royce believes that its current risk management practices are in the best economic interests of shareholders and should not be amended purely to achieve a particular accounting treatment. Accordingly, Rolls-Royce has decided not to adopt cash flow hedge accounting for forecast foreign exchange transactions. Rolls-Royce will continue to hedge its future forecast US dollar income on a portfolio basis, which it considers is the most efficient economic basis for doing so.

As a result of not hedge accounting for forecast foreign exchange transactions, the movements on the fair value of derivative contracts held for the purpose of hedging these transactions will be recognised in the income statement. The size of this movement in fair values will be largely dependent on movements in spot exchange rates.

Under UK GAAP, as part of its hedging policy, Rolls-Royce:

- recognised revenues and costs at the average exchange rate achieved in the year;
- recognised monetary assets and liabilities at the rate expected to be achieved in settling these items, taking account of the foreign exchange cover in place;
- incorporated rates achieved on forward cover in its assessment of the profitability of service and long-term contracts.

Under IFRS, Rolls-Royce will:

- recognise revenues and costs at the exchange rate at the time of the transaction;
- recognise monetary assets and liabilities at the spot exchange rate on the reporting date; and
- assess the profitability of service and long-term contracts without including the impact of forward exchange rate contracts.

Rolls-Royce will adopt fair value hedge accounting for foreign exchange derivatives entered into for the purposes of hedging the fair values of borrowings denominated in a foreign currency. Under fair value hedge accounting, the borrowings being hedged will be measured at fair value in respect of the foreign exchange risk, with movements in fair values of both the derivatives and the borrowings being included in the income statement.

Rolls-Royce will adopt net investment hedge accounting in respect of foreign subsidiaries and foreign currency denominated borrowings. Under net investment hedging, foreign exchange gains and losses arising on the fair value of the borrowings are included in equity to the extent they offset equivalent losses and gains arising on the consolidation of the subsidiary. This policy is unchanged from UK GAAP.

33 Transition to International Financial Reporting Standards (IFRS) continued

Interest rate derivatives

Rolls-Royce will adopt hedge accounting for hedges entered into for the purposes of managing its exposure to movements in interest rates. Fair value hedge accounting will be used for the hedging of fixed rate borrowings and cash flow hedge accounting will be used where the underlying borrowing is a floating rate instrument. Where fair value hedge accounting is used, the debt being hedged will be measured at fair value in respect of the interest rate risk, with movements in the fair values of both the derivative and the debt being included in the income statement. Where cash flow hedge accounting is used, the effective element of the fair value of the derivative will be included in a hedging reserve in equity. This hedging reserve will be released to the income statement to offset changes in interest rates on the hedged floating rate borrowings.

Risk and revenue sharing partnerships

Risk and revenue sharing partnership (RRSP) agreements are a standard form of co-operation in the civil aero-engine industry. In general, partners share: investment in the programme; 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.

As part of the IFRS transition project, RRSP arrangements have been reviewed to assess whether they are financial instruments as defined by IAS 32. Following this review, certain partnerships, where the arrangement is not part of an overall supplier arrangement, will be reclassified as financial instruments on transition to IFRS.

Reclassified RRSP arrangements are accounted for using the amortised cost method, based on the effective interest rate at the inception of the transaction.

Government investment

In the past, Rolls-Royce has received investment in certain projects from the UK Government. Under UK GAAP, these amounts were recognised as income when they were received with the levies being recognised as they became due on engine delivery. A similar review to that for RRSPs concluded that these arrangements were not financial instruments and that no changes are required to the accounting treatment.

Other financial derivatives

The Group has an ongoing exposure to the price of jet fuel from business operations. For reasons similar to those described for foreign exchange above, Rolls-Royce will not adopt hedge accounting for its exposures to changes in the price of jet fuel. These are hedged using commodity swaps.

The Group has entered into forward contracts to purchase its own shares for the purposes of meeting obligations to issue shares under employee share schemes. Under UK GAAP, these contracts were not recognised until the shares were purchased and issued to employees. Under IAS 32, these contracts are categorised as financial liabilities and accounted for on the amortised cost basis.

The Company has issued non-cumulative redeemable convertible preference shares (B Shares) as an alternative to paying a cash dividend. Under IAS 32 these shares are categorised as financial liabilities.

The impact of the transition to IFRS on the net assets in respect of financial instruments as at January 1, 2005 is summarised as follows:

	£m	£m
Net assets		
Amortised cost value of risk and revenue sharing partnerships	**(455)**	
Related taxation effect	**130**	**(325)**
Fair value of foreign exchange derivatives	**996**	
Revaluation of monetary assets and liabilities to spot rate	**(91)**	
Foreign exchange within service and other long-term contracts	**(54)**	
Related taxation effect	**(242)**	**609**
Fair value of interest rate derivatives	**(15)**	
Related taxation effect	**4**	**(11)**
Fair value of commodity derivatives	**9**	
Related taxation effect	**(3)**	**6**
Amortised cost value of contracts to purchase own shares	**(115)**	
Related taxation effect	**(8)**	**(123)**
Reclassification of B Shares as a liability	**(5)**	**(5)**
Adjustment to net assets		**151**

33 Transition to International Financial Reporting Standards (IFRS) continued

Contingent liabilities

The Group's customer financing arrangements fall into two categories that need to be considered separately for IFRS purposes:

Credit Based Guarantees

Credit based guarantees are specifically exempt from being treated as financial derivatives under IAS 39. They are required to be treated as insurance contracts in accordance with IFRS 4 Insurance Contracts. Under IFRS 4 the existing UK GAAP treatment (FRS 12) is 'grandfathered' until such time as the new Insurance Contracts standard comes into effect.

Asset Value Guarantees (AVGs)

The treatment of AVGs is less well defined under IFRS. The Group has treated AVGs as insurance contracts in accordance with IFRS 4, as it considers that this treatment best reflects the underlying nature of the arrangements.

There are no material changes to the treatment of contingent liabilities upon transitioning from UK GAAP to IFRS.

Other

The Group's banking covenants are not affected by the transition to IFRS as they are based on UK GAAP prevailing at the time the relevant borrowing facility was entered into ('frozen UK GAAP').

The Group's borrowing powers under its Articles of Association were amended at the 2004 AGM to a fixed limit in anticipation of the transition to IFRS.

The Scheme of Arrangement and the reduction in share capital undertaken in 2003 provides Rolls-Royce Group plc with a buffer in respect of Distributable Reserves available inter alia for the purposes of making payments to shareholders.

33 Transition to International Financial Reporting Standards (IFRS) continued

Restatement of net assets and equity at January 1, 2004

	Reformatted UK GAAP as previously reported £m	Adjustments: Development costs IAS 38 £m	Recoverable engine costs IAS 38 £m	Post-retirement benefits IAS 19 £m	Scope of consolidation IAS 27 £m	Share-based payments IFRS 2 £m	Tax IAS 12 £m	Other £m	Restated in accordance with IFRS £m
Non-current assets									
Intangible assets	863	160	120	—	—	—	—	—	1,143
Property, plant and equipment	1,750	—	—	—	69	—	—	—	1,819
Investments in joint ventures	202	—	—	—	—	—	—	11	213
Other investments	63	—	—	—	—	—	—	—	63
Deferred tax assets	117	(48)	(40)	444	—	2	(154)	—	321
	2,995	112	80	444	69	2	(154)	11	3,559
Current assets									
Inventory	962	—	14	—	—	—	—	—	976
Trade and other receivables	2,249	—	—	—	—	—	—	—	2,249
Taxation recoverable	1	—	—	—	—	—	—	—	1
Other financial assets	—	—	—	—	—	—	—	—	—
Short-term investments	39	—	—	—	—	—	—	—	39
Cash and cash equivalents	929	—	—	—	—	—	—	—	929
	4,180	—	14	—	—	—	—	—	4,194
Current liabilities									
Borrowings	(94)	—	—	—	(3)	—	—	—	(97)
Other financial liabilities	—	—	—	—	—	—	—	—	—
Trade and other payables	(2,574)	—	—	—	(1)	—	—	—	(2,575)
Current tax liabilities	(185)	—	—	—	—	—	—	—	(185)
Provisions	(159)	—	—	—	—	—	—	—	(159)
	(3,012)	—	—	—	(4)	—	—	—	(3,016)
Non-current liabilities									
Borrowings	(1,197)	—	—	—	(74)	—	—	—	(1,271)
Other financial liabilities	—	—	—	—	—	—	—	—	—
Other payables	(426)	—	—	—	—	—	—	(3)	(429)
Deferred tax liabilities	(214)	—	—	3	—	—	109	—	(102)
Provisions	(262)	—	—	—	9	—	—	—	(253)
Post-retirement benefit obligations	79	—	—	(1,545)	—	—	—	—	(1,466)
	(2,020)	—	—	(1,542)	(65)	—	109	(3)	(3,521)
Net assets	2,143	112	94	(1,098)	—	2	(45)	8	1,216
Equity									
Called-up share capital	333	—	—	—	—	—	—	—	333
Share premium account	1	—	—	—	—	—	—	—	1
Other reserves	99	—	—	—	—	—	—	(96)	3
Retained earnings	1,707	112	94	(1,098)	—	2	(45)	104	876
Equity attributable to equity holders of the parent	2,140	112	94	(1,098)	—	2	(45)	8	1,213
Minority interests	3	—	—	—	—	—	—	—	3
Total equity	2,143	112	94	(1,098)	—	2	(45)	8	1,216

33 Transition to International Financial Reporting Standards (IFRS) continued

Restatement of net assets at December 31, 2004

	Reformatted UK GAAP as previously reported £m	Adjustments: Development costs IAS 38 £m	Recoverable engine costs IAS 38 £m	Post-retirement benefits IAS 19 £m	Share-based payments IFRS 2 £m	Goodwill IFRS 3 £m	Scope of consolidation IAS 27 £m	Tax IAS 12 £m	Other £m	Restated in accordance with IFRS £m
Non-current assets										
Intangible assets	911	154	115	—	—	47	—	—	—	1,227
Property, plant and equipment	1,626	—	—	—	—	—	46	—	—	1,672
Investments in joint ventures	199	—	—	—	—	1	—	—	11	211
Other investments	57	—	—	—	—	—	—	—	—	57
Deferred tax assets	96	(46)	(37)	435	9	(1)	—	(138)	—	318
	2,889	108	78	435	9	47	46	(138)	11	3,485
Current assets										
Inventory	1,081	—	9	—	—	—	—	—	—	1,090
Trade and other receivables	2,049	—	—	—	—	—	—	—	—	2,049
Taxation recoverable	2	—	—	—	—	—	—	—	—	2
Other financial assets	—	—	—	—	—	—	—	—	—	—
Short-term investments	36	—	—	—	—	—	—	—	—	36
Cash and cash equivalents	1,452	—	—	—	—	—	—	—	—	1,452
	4,620	—	9	—	—	—	—	—	—	4,629
Current liabilities										
Borrowings	(204)	—	—	—	—	—	(3)	—	—	(207)
Other financial liabilities	—	—	—	—	—	—	—	—	—	—
Trade and other payables	(2,394)	—	—	—	—	—	(1)	—	—	(2,395)
Current tax liabilities	(176)	—	—	—	—	—	—	—	—	(176)
Provisions	(173)	—	—	—	—	—	—	—	—	(173)
	(2,947)	—	—	—	—	—	(4)	—	—	(2,951)
Non-current liabilities										
Borrowings	(1,364)	—	—	—	—	—	(66)	—	—	(1,430)
Other financial liabilities	—	—	—	—	—	—	—	—	—	—
Other payables	(540)	—	—	—	—	—	—	—	(3)	(543)
Deferred tax liabilities	(211)	—	—	2	—	—	—	94	—	(115)
Provisions	(244)	—	—	—	—	—	24	—	—	(220)
Post-retirement benefit obligations	104	—	—	(1,513)	—	—	—	—	—	(1,409)
	(2,255)	—	—	(1,511)	—	—	(42)	94	(3)	(3,717)
Net assets	2,307	108	87	(1,076)	9	47	—	(44)	8	1,446
Equity										
Called-up share capital	346	—	—	—	—	—	—	—	—	346
Share premium account	4	—	—	—	—	—	—	—	—	4
Other reserves	166	—	—	—	—	—	—	—	(127)	39
Retained earnings	1,787	108	87	(1,076)	9	47	—	(44)	135	1,053
Equity attributable to equity holders of the parent	2,303	108	87	(1,076)	9	47	—	(44)	8	1,442
Minority interests	4	—	—	—	—	—	—	—	—	4
Total equity	2,307	108	87	(1,076)	9	47	—	(44)	8	1,446

33 Transition to International Financial Reporting Standards (IFRS) continued

Restatement of net assets and equity at January 1, 2005

		Adjustments on adoption of IAS 32 and IAS 39								
	As at December 31, 2004 under IFRS £m	Foreign exchange instruments IAS 39 £m	Monetary assets and liabilities IAS 21 £m	Long-term service arrangements IAS 18 £m	Interest rate instruments IAS 39 £m	Commodity instruments IAS 39 £m	Own share total return swaps IAS 39 £m	Other reclassifications IAS 39 £m	Risk and revenue sharing partnerships IAS 39 £m	Restated £m
Non-current assets										
Intangible assets	1,227	—	—	—	—	—	—	—	—	1,227
Property, plant and equipment	1,672	—	—	—	—	—	—	—	—	1,672
Investments in joint ventures	211	—	—	—	—	—	—	—	—	211
Other investments	57	—	—	—	—	—	—	—	—	57
Deferred tax assets	318	(273)	19	16	4	(3)	(8)	—	130	203
	3,485	(273)	19	16	4	(3)	(8)	—	130	3,370
Current assets										
Inventory	1,090	—	—	—	—	—	—	—	—	1,090
Trade and other receivables	2,049	—	(182)	(53)	—	—	—	—	(39)	1,775
Taxation recoverable	2	—	—	—	—	—	—	—	—	2
Other financial assets	—	1,100	—	—	121	9	—	—	—	1,230
Short-term investments	36	—	—	—	—	—	—	—	—	36
Cash and cash equivalents	1,452	—	(48)	—	—	—	—	—	—	1,404
	4,629	1,100	(230)	(53)	121	9	—	—	(39)	5,537
Current liabilities										
Borrowings	(207)	—	(20)	—	(7)	—	—	—	—	(234)
Other financial liabilities	—	(114)	—	—	(15)	—	(20)	(5)	(67)	(221)
Trade and other payables	(2,395)	10	156	—	—	—	—	—	52	(2,177)
Current tax liabilities	(176)	—	—	—	—	—	—	—	—	(176)
Provisions	(173)	—	—	—	—	—	—	—	—	(173)
	(2,951)	(104)	136	—	(22)	—	(20)	(5)	(15)	(2,981)
Non-current liabilities										
Borrowings	(1,430)	—	—	—	(114)	—	—	—	—	(1,544)
Other financial liabilities	—	—	—	—	—	—	(95)	—	(401)	(496)
Other payables	(543)	—	3	(1)	—	—	—	—	—	(541)
Deferred tax liabilities	(115)	(4)	—	—	—	—	—	—	—	(119)
Provisions	(220)	—	—	—	—	—	—	—	—	(220)
Post-retirement benefit obligations	(1,409)	—	—	—	—	—	—	—	—	(1,409)
	(3,717)	(4)	3	(1)	(114)	—	(95)	—	(401)	(4,329)
Net assets	1,446	719	(72)	(38)	(11)	6	(123)	(5)	(325)	1,597
Equity										
Called-up share capital	346	—	—	—	—	—	—	(5)	—	341
Share premium account	4	—	—	—	—	—	—	—	—	4
Other reserves	39	697	—	—	(3)	6	—	6	—	745
Retained earnings	1,053	22	(72)	(38)	(8)	—	(123)	(6)	(325)	503
Equity attributable to equity holders of the parent	1,442	719	(72)	(38)	(11)	6	(123)	(5)	(325)	1,593
Minority interests	4	—	—	—	—	—	—	—	—	4
Total equity	1,446	719	(72)	(38)	(11)	6	(123)	(5)	(325)	1,597

33 Transition to International Financial Reporting Standards (IFRS) continued

Restatement of income statement for the year ended December 31, 2004

		Adjustments							
	Reformatted UK GAAP as previously reported £m	Development costs IAS 38 £m	Recoverable engine costs IAS 38 £m	Post-retirement benefits IAS 19 £m	Share-based payments IFRS 2 £m	Goodwill IFRS 3 £m	Scope of consolidation IAS 27 £m	Tax IAS 12 £m	Restated in accordance with IFRS £m
Group revenue	5,939	—	—	—	—	—	8	—	5,947
Cost of sales	(4,814)	—	(10)	42	(6)	47	(3)	—	(4,744)
Gross profit	1,125	—	(10)	42	(6)	47	5	—	1,203
Other operating income	73	—	—	—	—	—	—	—	73
Commercial and administrative costs	(598)	—	—	—	—	—	(1)	—	(599)
Research and development costs	(282)	(6)	—	—	—	—	—	—	(288)
Share of profit of joint ventures [1]	18	—	—	—	—	1	—	—	19
Group operating profit	336	(6)	(10)	42	(6)	48	4	—	408
Profit on sale of businesses	9	—	—	—	—	—	—	—	9
Profit before financing costs	345	(6)	(10)	42	(6)	48	4	—	417
Net financing costs	(48)	—	—	(1)	—	—	(4)	—	(53)
Profit before taxation	297	(6)	(10)	41	(6)	48	—	—	364
Taxation	(92)	2	3	(14)	1	(1)	—	1	(100)
Profit for the period	205	(4)	(7)	27	(5)	47	—	1	264
Attributable to:									
Equity holders of the parent	204	(4)	(7)	27	(5)	47	—	1	263
Minority interests	1	—	—	—	—	—	—	—	1
	205	(4)	(7)	27	(5)	47	—	1	264

[1] Comprising operating profit £49m, interest £22m, taxation £9m.

33 Transition to International Financial Reporting Standards (IFRS) continued

Restatement of the cash flow statement for the year ended December 31, 2004

							Adjustments		
	Reformatted UK GAAP as previously reported £m	Development costs IAS 38 £m	Recoverable engine costs IAS 38 £m	Post-retirement benefits IAS 19 £m	Share-based payments IFRS 2 £m	Goodwill IFRS 3 £m	Scope of consolidation IAS 27 £m	Tax IAS 12 £m	Restated in accordance with IFRS £m
Profit before taxation	297	(6)	(10)	41	(6)	48	—	—	364
Share of profit of joint ventures	(18)	—	—	—	—	(1)	—	—	(19)
Gain on sale of business	(9)	—	—	—	—	—	—	—	(9)
Loss on sale of property, plant and equipment	2	—	—	—	—	—	—	—	2
Net finance costs	48	—	—	1	—	—	4	—	53
Share-based payments	—	—	—	—	6	—	—	—	6
Taxation paid	(84)	—	—	—	—	—	—	—	(84)
Depreciation of intangible assets	62	17	26	—	—	(47)	—	—	58
Depreciation of property, plant and equipment	224	—	—	—	—	—	18	—	242
Increase in provisions	7	—	—	—	—	—	(15)	—	(8)
Post-retirement benefits adjustment	—	—	—	(42)	—	—	—	—	(42)
Increase in inventories	(121)	—	5	—	—	—	—	—	(116)
Decrease in trade and other receivables	179	—	—	—	—	—	—	—	179
Decrease in trade and other payables	(31)	—	—	—	—	—	—	—	(31)
Dividends received from joint ventures	15	—	—	—	—	—	—	—	15
Net cash flow from operating activities	571	11	21	—	—	—	7	—	610
Additions to intangible assets	(110)	(11)	(21)	—	—	—	—	—	(142)
Purchases of property, plant and equipment	(175)	—	—	—	—	—	—	—	(175)
Disposals of property, plant and equipment	66	—	—	—	—	—	—	—	66
Disposals of businesses	16	—	—	—	—	—	—	—	16
Investments in joint ventures	(2)	—	—	—	—	—	—	—	(2)
Cash flows from investing activities	(205)	(11)	(21)	—	—	—	—	—	(237)
Decrease in government securities and corporate bonds	3	—	—	—	—	—	—	—	3
Borrowings due within one year:									
– repayment of loans	(57)	—	—	—	—	—	—	—	(57)
– increase in loans	—	—	—	—	—	—	—	—	—
Borrowings due after one year:									
– repayment of loans	(92)	—	—	—	—	—	(3)	—	(95)
– increase in loans	500	—	—	—	—	—	—	—	500
Capital element of finance lease payments	(52)	—	—	—	—	—	—	—	(52)
Interest received	58	—	—	—	—	—	—	—	58
Interest paid	(103)	—	—	—	—	—	(4)	—	(107)
Interest element of finance lease payments	(3)	—	—	—	—	—	—	—	(3)
Equity dividends paid	(33)	—	—	—	—	—	—	—	(33)
Issue of ordinary shares	4	—	—	—	—	—	—	—	4
Purchase of own shares	(2)	—	—	—	—	—	—	—	(2)
Redemption of B Shares	(27)	—	—	—	—	—	—	—	(27)
Cash flows from financing activities	196	—	—	—	—	—	(7)	—	189
Increase in cash and cash equivalents	562	—	—	—	—	—	—	—	562

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 the directors are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards.

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

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

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

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the Group financial statements, state whether they have been prepared in accordance with 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 proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

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

Independent auditors' report

To the members of Rolls-Royce Group plc

We have audited the Group financial statements of Rolls-Royce Group plc for the year ended December 31, 2005 which comprise the Group consolidated income statement, the Group consolidated balance sheet, the Group consolidated cash flow statement, the Group consolidated statement of recognised income and expense and the related notes. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent company financial statements of Rolls-Royce Group plc for the year ended December 31, 2005 and on the information in the directors' remuneration report that is described as having been audited.

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU are set out in the statement of directors' responsibilities on this page.

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

We report to you our opinion as to whether the Group financial statements give a true and fair view and whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the directors' report is not consistent with the Group financial statements, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed. We review whether the corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual report and consider whether it is consistent with the audited Group financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Group financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.
We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Group financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Group financial statements.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at December 31, 2005 and of its profit for the year then ended; and
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

KPMG Audit Plc
Chartered Accountants, Registered Auditor
London
February 8, 2006

Company balance sheet

At December 31, 2005

	Notes	2005 £m	2004 £m
Fixed assets			
Investments – subsidiary undertakings	2	**2,153**	2,198
Current assets			
Debtors – amounts falling due within one year	3	**829**	501
Cash at bank		**1**	—
		830	501
Creditors – amounts falling due within one year			
Other creditors	4	**(7)**	—
Net current assets		**823**	501
Total assets less current liabilities		**2,976**	2,699
Net assets		**2,976**	2,699
Capital and reserves			
Called-up share capital	5	**352**	346
Share premium account	6	**30**	4
Merger reserve	6	**777**	918
Capital redemption reserve	6	**206**	74
Profit and loss account	6	**1,611**	1,357
Shareholders' funds [1]		**2,976**	2,699

[1] Equity shareholders' funds **£2,976m** (2004 £2,694m); non-equity shareholders' funds **£nil** (2004 £5m) (see note 4).

The financial statements on pages 109 to 112 were approved by the Board on February 8, 2006 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, 2005

	2005 £m	2004 £m
At January 1 as previously stated	**2,699**	2,101
Adjustment on adoption of FRS 25 and FRS 26	**(5)**	—
At January 1 restated	**2,694**	2,101
Retained profit for the year	**306**	601
Scrip dividend adjustment	**—**	20
Redemption of B Shares	**(141)**	(27)
On issue of ordinary shares	**117**	4
At December 31	**2,976**	2,699

Notes to the Company financial statements

1 Accounting policies

Basis of accounting

The financial statements have been prepared in accordance with applicable United Kingdom accounting standards on the historical cost basis.

The Company has adopted FRS 25 Financial Instruments: Disclosure and Presentation and FRS 26 Financial Instruments: Measurement from January 1, 2005, the impact of which has been the reclassification of B Shares, with a value of £5m, from shareholders funds to other financial liabilities.

In accordance with these standards, comparatives have not been restated. The effect has been to reclassify B Shares from share capital to other creditors.

As permitted by the Companies Act 1985, a separate profit and loss account for the Company has not been included in these financial statements. As permitted by FRS 1 no cash flow statement for the Company has been included. As permitted by FRS 8 no related party disclosures for the Company have been included.

Investments in subsidiary undertakings

Investments in subsidiary undertakings are reported at cost less amounts written off.

Current assets

Amounts are shown at their recoverable amount.

Taxation

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

2 Investments – subsidiary undertakings

	Shares £m
Cost:	
At January 1, 2005	**2,198**
Disposal	**(45)**
At December 31, 2005	**2,153**

3 Debtors – amounts falling due within one year

	2005 £m	2004 £m
Amounts owed by – subsidiary undertakings	**829**	501

4 Other creditors – amounts falling due within one year

B Shares

Movements in the B Shares during the year were as follows:

	B Shares of 0.01p	Nominal value £m
Authorised		
At January 1, and December 31, 2005	**1,000,000,000,000**	**1,000**
Issued and fully paid		
At January 1, 2005 [1]	**4,600,710,064**	**5**
Shares issued	**141,013,817,330**	**141**
Shares converted into ordinary shares	**(87,425,228,890)**	**(87)**
Shares redeemed	**(51,638,258,304)**	**(52)**
At December 31, 2005	**6,551,040,200**	**7**

[1] The adoption of FRS 25 and FRS 26 from January 1, 2005 has led to the reclassification of B Shares from equity to other creditors.

5 Share capital

				Non-equity			Equity
	Special share of £1	B Shares of 0.1p each	Nominal value £m	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each	Nominal value £m
Authorised							
At January 1, 2004 and December 31, 2005	1			50,000	—	2,499,999,998	500
Upon approval of B Share scheme at the 2004 AGM		1,000,000,000,000	1,000				
Issued and fully paid							
At January 1, 2004	1	—	—	—	—	1,666,619,843	333
Issued for B Share scheme	—	83,922,435,550	84	—	—	—	—
Exercise of share options	—	—	—	—	—	2,654,484	1
In lieu of paying dividends in cash	—	—	—	—	—	10,671,927	2
B Share conversion into ordinary shares		(52,631,193,754)	(52)	—	—	24,826,034	5
Redemption of B Shares	—	(26,690,531,732)	(27)	—	—	—	—
At January 1, 2005	1	4,600,710,064	5	—	—	1,704,772,288	341
B Shares reclassified on adoption of FRS 25 and FRS 26	—	(4,600,710,064)	(5)				
At January 1, 2005 (restated)	1			—	—	1,704,772,288	341
Exercise of share options	—			—	—	19,174,767	4
B Share conversion into ordinary shares	—			—	—	34,754,246	7
At December 31, 2005	1			—	—	1,758,701,301	352

Certain rights, set out in the Company's Articles of Association, attach to the special rights redeemable preference share (special share) issued to HM Government. Subject to the provisions of the Companies Act 1985, the special share may be redeemed by the Treasury Solicitor at par at any time. The special share confers no rights to dividends or to vote at general meetings but in the event of a winding-up it shall be repaid at its nominal value in priority to any other shares.

6 Reserves

		Non-distributable		
	Share premium £m	Merger reserve £m	Capital redemption reserve £m	Profit and loss account £m
At January 1, 2005	4	918	74	1,357
Scrip dividend	—	—	—	—
Arising on share issues (net of expenses)	26	—	—	—
Retained profit for the year	—	—	—	306
Issue of B Shares	—	(141)	—	—
Redemption of B Shares	—	—	52	(52)
Conversion of B Shares into ordinary shares	—	—	80	—
At December 31, 2005	30	777	206	1,611

7 Contingent liabilities

The Company has not adopted amendments to FRS 26 in relation to financial guarantee contracts which will apply for periods commencing on or after January 1, 2006.

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.

The Company does not expect the amendments to have any impact on the financial statements for the period commencing January 1, 2006. At December 31, 2005 these guarantees amounted to **£1,344m** (2004 £1,513m).

8 Other information

Emoluments of directors
The remuneration of the directors of the Company is shown in the Directors' remuneration report for the Group on pages 39 to 49.

Auditors' fees
Auditors' fees were as follows during the year:

Audit 2005	**£0.1m**	(2004 £0.1m)
Other 2005	**£nil**	(2004 £nil)

Employees
The Company had no employees in 2005 and 2004.

Share-based payment
The Company has no employees. Shares in the Company have been granted to employees of the Group as part of share-based payment plans, and recharged to the employing company.

Independent auditors' report

To the members of Rolls-Royce Group plc

We have audited the parent company financial statements of Rolls-Royce Group plc for the year ended December 31, 2005 which comprise the balance sheet and the related notes. These parent company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the directors' remuneration report that is described as having been audited .

We have reported separately on the Group financial statements of Rolls-Royce Group plc for the year ended December 31, 2005.

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual report, the directors' remuneration report and the parent company financial statements in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities on page 108.

Our responsibility is to audit the parent company financial statements and the part of the directors' remuneration report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the parent company financial statements give a true and fair view and whether the parent company financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the parent company financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual report and consider whether it is consistent with the audited parent company financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent company financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Opinion

In our opinion:

- the parent company financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 December 2005; and
- the parent company financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc
Chartered Accountants, Registered Auditor

London
February 8, 2006

Principal subsidiary undertakings

At December 31, 2005

Incorporated within the UK – held by Rolls-Royce Group plc	
Rolls-Royce plc	Principal trading/holding company

Incorporated within the UK – held by Rolls-Royce plc unless otherwise stated	
Civil aerospace	
Rolls E.L. Turbofans Limited	Engine support services/holding company
Rolls-Royce General Partner Limited [1]	Management company
Rolls-Royce Total Care Services Limited	Aftermarket support services
Marine	
Rolls-Royce Marine Electrical Systems Limited [2]	Marine electrical systems
Rolls-Royce Marine Power Operations Limited	Nuclear submarine propulsion systems
Energy	
Rolls-Royce Fuel Cell Systems Limited	Development of fuel cell systems
Financial services and corporate	
Rolls-Royce Aircraft Management Limited	Sales finance and other financial services
Rolls-Royce Capital Limited [3]	Sales finance and other financial services
Rolls-Royce International Limited	International support and commercial information services
Rolls-Royce Leasing Limited	Engine leasing
Rolls-Royce Overseas Holdings Limited	Holding company
Rolls-Royce Overseas Investments Limited [4]	Holding company
Rolls-Royce Power Engineering plc	Power generation and marine systems
Rolls-Royce Power Ventures Limited	Provision of project development capabilities
Vinters Engineering plc [5]	Holding company
Vinters plc	Holding company

[1] The interest is held by Rolls-Royce Supplies Limited.
[2] The interest is held by Rolls-Royce Power Engineering plc.
[3] This subsidiary acts as an agent of Rolls-Royce plc.
[4] The interest is held by Rolls-Royce Overseas Holdings Limited.
[5] The interest is held by Vinters plc.

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

Incorporated overseas – held by Rolls-Royce plc unless otherwise stated

Civil aerospace		
Brazil	Rolls-Royce Brasil Limitada	Repair and overhaul
France	Rolls-Royce Technical Support SARL [1]	Project support
Germany	Rolls-Royce Deutschland Ltd & Co KG [2]	BR700 series engine development and manufacture
Italy	Europea Microfusioni Aerospaziali S.p.A.	Manufacture of castings
USA	Rolls-Royce Corporation [3]	Design, development and manufacture of gas turbine engines
USA	Rolls-Royce Engine Services – Oakland Inc. [4]	Repair and overhaul
Defence		
USA	Rolls-Royce Defense Services Inc. [5]	Repair and overhaul
Marine		
China	Rolls-Royce Marine (Shanghai) Limited [6]	Manufacture and supply of marine equipment
Finland	Rolls-Royce OY AB [7]	Manufacture of winches and propeller systems
Norway	Rolls-Royce Marine AS [7]	Design and manufacture of ship equipment/holding company
Norway	Ulstein Holding AS [8]	Holding company
Sweden	Kamewa Holding AB [7]	Holding company
Sweden	Rolls-Royce AB [9]	Manufacture of propeller systems
USA	Rolls-Royce Commercial Marine Inc. [10]	Aftermarket support services
USA	Rolls-Royce Naval Marine Inc. [5]	Design and manufacture of ship propellers
Energy		
Canada	Rolls-Royce Canada Limited [11]	Industrial gas turbines and aero-engine sales, service and overhaul
India	Rolls-Royce Energy Systems India Private Limited [1]	Project management and customer support
Singapore	Rolls-Royce Pte Limited [1]	Engine and turbine compression systems, spares
USA	Rolls-Royce Energy Systems Inc. [5]	Turbine generator packages
Financial services and corporate		
Canada	Rolls-Royce Holdings Canada Inc.	Holding company
Guernsey	Nightingale Insurance Limited [1]	Insurance services
India	Rolls-Royce Operations (India) Pvt Limited [1]	Provision of support services
USA	Rolls-Royce North America (USA) Holdings Co. [12]	Holding company
USA	Rolls-Royce North America Holdings Inc. [13]	Holding company

[1] The interests are held by Rolls-Royce Overseas Holdings Limited.
[2] The interest is held as follows: 49.5 per cent Rolls-Royce Erste Beteiligungs GmbH, 50.5 per cent Rolls-Royce Zweite Beteiligungs GmbH.
[3] The interest is held by Rolls-Royce Asset Management Inc.
[4] The interest is held by Rolls-Royce Defense Services Inc.
[5] The interests are held by Rolls-Royce North America Holdings Inc.
[6] The interest is held by Rolls-Royce Marine Asia Limited.
[7] The interests are held by Vinters International Limited.
[8] The interest is held by Rolls-Royce Marine AS.
[9] The interest is held by Kamewa Holding AB.
[10] The interest is held by Rolls-Royce Naval Marine Inc.
[11] The interest is held by Rolls-Royce Holdings Canada Inc.
[12] The interest is held by Rolls-Royce Overseas Investments Limited.
[13] The interest is held by Rolls-Royce North America (USA) Holdings Co.

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

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

Principal joint ventures

At December 31, 2005

Incorporated within the UK – held by Rolls-Royce plc

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

Incorporated overseas – held by Rolls-Royce plc unless otherwise stated

		Class	% of class held	% of total equity held
Civil aerospace				
China	Xian XR Aero Components Co Limited Manufacturing facility for aero-engine parts	Ordinary	49	49
Germany	N3 Engine Overhaul Services GmbH & Co Kg [1] Repair and overhaul	Partnership	50	50
Germany	N3 Engine Overhaul Services Verwaltungsgesellschaft mbh [2] Repair and overhaul	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited [3] Repair and overhaul	Ordinary	45	45
Israel	TechJet Aerofoils Limited [3] Manufacture of compressor aerofoils	A Ordinary B Ordinary	50 50	50
Saudi Arabia	Middle East Propulsion Company Limited [4] Repair and overhaul	Ordinary	16.7	16.7
Singapore	International Engine Component Overhaul Pte Limited [3] Repair and overhaul	Common	50	50
Singapore	Singapore Aero Engine Services Private Limited [3] (effective interest 39%) Repair and overhaul	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA Manufacture and maintenance of aero engines	Ordinary	46.9	46.9
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & USA) V2500 series engine collaboration	A Shares B Shares C Shares D Shares	100 — — —	32.5

Incorporated overseas – held by Rolls-Royce plc unless otherwise stated continued

		Class	% of class held	% of total equity held
Civil aerospace continued				
USA	Data Systems & Solutions, LLC [5] Advanced controls and predictive data management	Partnership	50	—
USA	Texas Aero Engine Services, LLC [6] Repair and overhaul	Partnership	50	—
USA	Williams-Rolls Inc. [7] (UK & North America) Small engine collaboration	Common	15	15
Defence				
Germany	EPI Europrop International GmbH (Germany) (effective interest 35.5%) A400M engine collaboration	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) EJ200 engine collaboration	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany) MTR390 engine collaboration	Ordinary	33.3	33.3
USA	GE Rolls-Royce Fighter Engine Team LLC [8] F136 development engine for the Joint Strike Fighter (JSF) Programme	Partnership	40	40
Financial services and corporate				
Isle of Man	Pembroke Group Limited [9] (Eire) Aircraft leasing	Ordinary	50	50
USA	Alpha Leasing (US) LLC [10] Engine leasing	Partnership	50	—
USA	Alpha Leasing (US) (No. 2) LLC [10] Engine leasing	Partnership	50	—
USA	Exostar LLC [11] B2B exchange	Partnership	17.6	—
USA	Rolls-Royce & Partners Finance (US) LLC [9] Engine leasing	Partnership	50	—

Unincorporated overseas – held by subsidiary undertakings

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

[1] The partner is Rolls-Royce Zweite Beteiligungs GmbH.
[2] The interest is held by Rolls-Royce Zweite Beteiligungs GmbH.
[3] The interests are held by Rolls-Royce Overseas Holdings Limited.
[4] The interest is held by Middle East Equity Partners Limited.
[5] The partner is Rolls-Royce Control Systems Holdings Co.
[6] The partner is Rolls-Royce Engine Services Holdings Co.
[7] The interest is held by Rolls E.L. Turbofans Limited.
[8] The partner is Rolls-Royce JSF Holdings Inc.
[9] The interest is held by Larten Limited.
[10] The partner is Rolls-Royce Finance Holdings Co.
[11] The partner is Rolls-Royce Investment Co.

The countries of principal operations are stated in brackets after the name of the company.

Group five-year review

For the years ended December 31

Income statement/Profit and loss account	Notes	2005 £m	2004 £m	2003 [1] £m	2002 [1] £m	2001 [1] £m
Revenue/Group turnover		**6,603**	5,947	5,645	5,788	6,328
Profit before net research and development and share of joint venture profit		**1,113**	686	499	443	587
Research and development (net)	1	**(282)**	(288)	(281)	(297)	(358)
Share of profit of joint ventures	2	**46**	19	52	66	82
Profit before financing costs/profit on ordinary activities before interest		**877**	417	270	212	311
Net financing costs/interest payable	3	**(400)**	(53)	(90)	(107)	(119)
Profit before taxation		**477**	364	180	105	192
Taxation	4	**(130)**	(100)	(64)	(52)	(86)
Profit for the period		**347**	264	116	53	106
Attributable to:						
Equity holders of the parent		**350**	263	116	53	106
Minority interest		**(3)**	1	—	—	—
		347	264	116	53	106

[1] Amounts as previously reported under UK GAAP. The impact of the transition from UK GAAP to IFRS is included in note 33 to the financial statements.

Notes					
1 Research and development (gross)	**(663)**	(601)	(619)	(590)	(636)
2 Under IFRS, share of profit of joint ventures is net of share of interest and taxation charges of	**(34)**	(31)	—	—	—
3 Under UK GAAP, interest payable includes the joint ventures share of	**—**	—	(24)	(35)	(42)
4 Under UK GAAP, taxation includes the joint ventures share of	**—**	—	(10)	(9)	(9)
Earnings per ordinary share:					
Basic – IFRS	**20.11p**	15.56p	—	—	—
Diluted – IFRS	**19.31p**	15.05p	—	—	—
Underlying – UK GAAP	**—**	—	12.20p	11.10p	20.20p
Basic – UK GAAP	**—**	—	7.04p	3.29p	6.67p
Payments to shareholders per ordinary share	**8.72p**	8.18p	8.18p	8.18p	8.18p

Balance sheet	2005 £m	2004 £m	2003 [1] £m	2002 [1] £m	2001 [1] £m
Assets	**9,319**	8,114	7,414	7,296	7,334
Liabilities	**(7,814)**	(6,668)	(5,271)	(5,262)	(5,270)
	1,505	1,446	2,143	2,034	2,064
Called-up share capital	**352**	346	333	323	320
Reserves	**1,147**	1,096	1,807	1,709	1,742
Equity attributable to equity holders of the parent	**1,499**	1,442	2,140	2,032	2,062
Minority interest	**6**	4	3	2	2
	1,505	1,446	2,143	2,034	2,064

[1] Amounts as previously reported under UK GAAP.

Cash flow	2005 £m	2004 £m	2003 [1] £m	2002 [1] £m	2001 [1] £m
Cash inflow from operating activities	**1,060**	610	673	611	418
Cash outflow from investing activities – IFRS	**(289)**	(237)	—	—	—
Capital expenditure and financial investment – UK GAAP	**—**	—	(198)	(381)	(181)
Aquisitions and disposals – UK GAAP	**—**	—	(16)	(20)	79
Cash (outflow)/inflow from financing activities – IFRS	**(443)**	189	—	—	—
Interest, dividends and taxation – UK GAAP	**—**	—	(176)	(222)	(147)
Management of liquid resources – UK GAAP	**—**	—	(90)	217	(162)
Financing – UK GAAP	**—**	—	(17)	(81)	113
Increase in cash and cash equivalents (IFRS)/Increase in cash (UK GAAP)	**328**	562	176	124	120

[1] Amounts as previously reported under UK GAAP.

Shareholder information

Internet

The Annual report, Company announcements and other information are available on the Group's website at www.rolls-royce.com

Financial calendar

Ex entitlement to B Shares	March 8, 2006
Calculation period for Conversion Share Value for B Shares	March 8-14, 2006
Record (qualifying) date for entitlement to B Shares	March 10, 2006
Annual General Meeting, Platinum Conference Suite, ExCel, 1 Western Gateway, Royal Victoria Dock, London E16 1XL	11.30am May 3, 2006
Latest time and date for receipt of completed Evergreen Mandates for B Shares	5pm June 2, 2006
Record (qualifying) date for B Share dividend	June 9, 2006
Despatch of cheques/ordinary share certificates/B Share certificates following redemption/conversion of B Shares	July 3, 2006
Press advertisement of 2006 interim results[1]	July 28, 2006
Ex entitlement to B Shares	October 11, 2006
Calculation period for Conversion Share Value for B Shares	October 11-17, 2006
Record (qualifying) date for entitlement to B Shares	October 13, 2006
Record (qualifying) date for B Share dividend	November 24, 2006
Latest time and date for receipt of completed Evergreen Mandates for B Shares	5pm December 1, 2006
Financial year end	December 31, 2006
Despatch of cheques/ordinary share certificates/B Share certificates following redemption/conversion of B Shares	January 3, 2007
2006 Annual report published	March, 2007

[1] Interim results are notified by press advertisements only.

Shareholder information

If you have any queries on the following:

i) Transfer of shares
ii) Change of name or address
iii) Lost share certificates
iv) Lost or out of date dividend cheques
v) Death of a registered holder of shares
vi) B Share distributions

or any other query relating to Rolls-Royce Group plc shares, please write or telephone the Registrar at the following address:

Computershare Investor Services PLC
PO Box 82, The Pavilions, Bridgwater Road, Bristol, BS99 7NH
General helpline: 0870 702 0111 B Share helpline: 0870 703 0162

The Company operates a free-of-charge service for consolidating the individual shareholdings of immediate members of a family. Please ask the Registrar for details if you are interested.

Low cost share dealing

Details of the low cost dealing service in the Company's shares may be obtained from Hoare Govett Corporate Finance Limited (tel 020 7678 8000). Hoare Govett Corporate Finance Limited is a member of the Securities and Futures Authority.

You can obtain the current market price of the Company's shares on the Group's website at www.rolls-royce.com or by viewing teletext or similar services.

Electronic communications/Proxy voting

If you would like to receive future shareholder documentation electronically or wish to appoint a proxy electronically for this year's Annual General Meeting, please log onto the Investors section on the Group's website at www.rolls-royce.com to register.

B Share information

B Share issues	B Shares per ordinary share	Conversion Share Value	First day of trading	Share price on first day of trading: Ordinary shares	Share price on first day of trading: B Shares	CGT apportionment: Ordinary shares	CGT apportionment: B Shares
January 3, 2006	33.4	356p	January 3, 2006	433.045p	0.1015p	99.22%	0.78%
July 1, 2005	50.0	253p	July 1, 2005	291.000p	0.0995p	98.32%	1.68%
January 4, 2005	31.8	250p	January 4, 2005	244.625p	0.0955p	98.77%	1.23%
June 25, 2004	50.0	212p	July 5, 2004	241.875p	0.1130p	97.72%	2.28%

B Share dividends: calculation period	Dividend rate	Record date for B Share dividend	Payment date
January 1, 2006 to June 30, 2006	1.7205487%	June 9, 2006	July 3, 2006
July 1, 2005 to December 31, 2005	1.7353125%	November 25, 2005	January 3, 2006
January 1, 2005 to June 30, 2005	1.8433613%	June 10, 2005	July 1, 2005
July 1, 2004 to December 31, 2004	1.8890625%	November 26, 2004	January 4, 2005

Copies of the Scheme Circular and Summary of Terms of B Share Issue, which contain more detailed information on B Shares, are available in the Investors section on the Group's website at www.rolls-royce.com or on request from the Company or the Registrar's B Share helpline 0870 703 0162.

Analysis of ordinary shareholders at December 31, 2005

Number of shares	Number of shareholders	% of total shareholders	% of total shares
1 – 150	77,823	29.90	0.51
151 – 500	138,053	53.05	1.99
501 – 10,000	42,260	16.24	3.98
10,001 – 100,000	1,400	0.54	2.20
100,001 – 1,000,000	509	0.20	9.78
1,000,001 and over	194	0.07	81.54
	260,239	100.00	100.00

ShareGift

In the UK, Rolls-Royce Group plc supports ShareGift, which is administered by the Orr MacKintosh Foundation (registered charity number 1052686) and which operates a charity share donation scheme for shareholders with small holdings of shares which may prove uneconomical to sell.

If you would like to use ShareGift or receive more information about the scheme, they can be contacted by visiting their website at www.sharegift.org.uk or by writing to The Orr MacKintosh Foundation, 46 Grosvenor Street, London W1K 3HN.

The Company wishes to thank those B Shareholders who elected to donate their B Share dividends to ShareGift.

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