Rolls-Royce

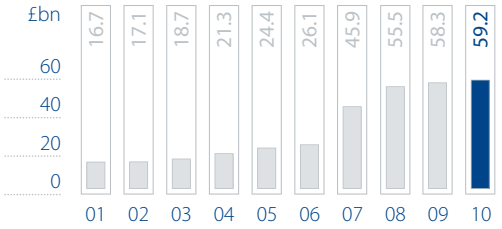
TEAMWORK AND TECHNOLOGY

Rolls-Royce plc
Annual report 2010

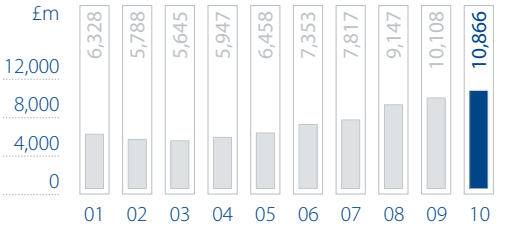
Trusted to deliver excellence

Our ability to design and develop high-technology products and then integrate these into sophisticated power systems for land, sea and air, provides us with access to global markets.

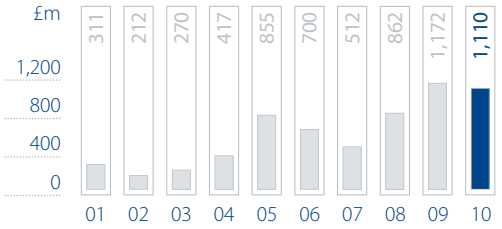
ORDER BOOK – FIRM AND ANNOUNCED (£bn)



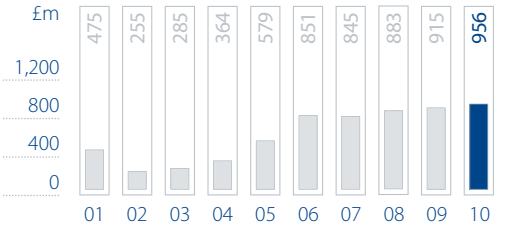
UNDERLYING REVENUE (£m)



PROFIT BEFORE FINANCING (£m)



UNDERLYING PROFIT BEFORE TAX (£m)



Note: Reconciliation of underlying revenues and results is provided in note 2 of the Consolidated Financial Statements.

BUSINESS REVIEW

OTHER MATTERS

FINANCIAL STATEMENTS

Directors' report
The directors present the Annual report for the year ended December 31, 2010 which includes the business review, governance report and audited financial statements for the year. References to 'Rolls-Royce', the 'Group', the 'Company', 'we', or 'our' are to Rolls-Royce plc and/or its subsidiaries, or any of them as the context may require. Pages 01 to 49, inclusive, of this Annual report comprise a Directors' report that has been drawn up and presented in accordance with English company law and the liabilities of the directors in connection with that report shall be subject to the limitations and restrictions provided by such law. Rolls-Royce plc is incorporated as a public limited company and is registered in England under the UK Companies Act 1985 with the registered number 1003142. Rolls-Royce plc's registered office is 65 Buckingham Gate, London, SW1E 6AT.

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

CHIEF EXECUTIVE'S REVIEW

"Rolls-Royce has maintained progress. Our financial position was further strengthened in 2010."

This is my fifteenth and final Chief Executive's review, and so it is a particular pleasure to report that Rolls-Royce has delivered a strong performance in 2010 despite challenging economic conditions.

Underlying revenue has grown seven per cent to £10.9 billion and underlying profit before tax has increased by four per cent to £956 million. Our financial position has also continued to improve with average net cash balances reaching £969 million, an improvement of £336 million over the same period in 2009. This demonstrates once again the strength and resilience of the Group and the progress that we have made in recent years. It is a measure of this progress that the civil, defence and marine businesses now each generate underlying profits of more than £300 million.

I was an early pessimist about the condition of the world economy and I expect to be a late optimist. The situation remains fragile, recovery has been asymmetric and the global financial system retains the capacity to surprise unpleasantly. However, our consistent investment in a broad portfolio of products and services and our strong customer relationships have given us access to a wide range of global markets.

This breadth has allowed Rolls-Royce to maintain progress through the downturn and the disruption to the world economy which began in 2007. Since then the business has grown its order book, revenues, profits and average net cash, and increased payments to shareholders while at the same time we have invested more than £4 billion in the business.

Investing for the long term

During 2010, we have continued our programme of investment, funding world-class facilities in all major geographies, providing capacity for future growth, contributing to improved productivity and delivering products with operational lives which may well extend to half a century. We remain confident in our ability to double revenues in the coming decade through organic growth alone. However, we also have the management and financial capability to accelerate growth through acquisition and partnership.

Strategy

Our consistent strategy, applied over many years, has helped deliver a more broadly based, better balanced and more resilient portfolio. This strategy has five key elements:

- address four global markets, civil aerospace, defence aerospace, marine and energy;
- invest in technology, infrastructure and capability;
- develop a competitive portfolio of products and services;
- grow market share and our installed product base; and
- add value for customers through the provision of product-related services.

We have high barriers to entry as a result of the technology required for the design, systems integration, manufacture and support of our products. In addition we work hard to transfer intellectual property, products and innovation across businesses to achieve competitive advantage in the markets which we serve.

An increasingly global business

The business today is the consequence of decisions and investments made over many years. When I first joined the Company in 1984, Rolls-Royce had a narrow product range and its business was mainly UK focused with some presence in the US. This position has changed fundamentally. We are now able to trade successfully on a global basis and are developing our presence around the world. This brings us closer to customers and allows us access to funding and skills. Our customer insight and our ability to develop technologies and integrate them into complex power systems, give us access to markets where demand remains strong for the products and services that we provide.

The decision to locate the head office of our marine business in Singapore will have a profound impact on our ability to develop a global view. We now manage about one third of our revenue from Singapore, a further third from North America and the balance from the United Kingdom and Europe. This means that management teams, running businesses that in themselves are the size

of FTSE 100 companies, will think about challenges and opportunities from a different perspective. This will be of huge benefit to the Group as we respond to customer requirements and competition.

In 2010, rapid progress was made in the construction of our major new aerospace facilities at Crosspointe in the US to manufacture discs and at Seletar in Singapore where we will assemble and test large civil engines and manufacture wide-chord fan blades. During the year, we also opened a new Mechanical Test complex at Dahlewitz in Germany to conduct testing for our businesses worldwide.

We continue to expand our marine services. We already have 34 facilities around the world and the network is growing fast, ensuring that our locations match our customers' requirements. Of course our supply chain has also become increasingly global with around 8,000 suppliers in North and South America, Europe and Asia. We continue to invest in improving our supply chain management, to integrate these suppliers into our worldwide operations and to improve our quality and capabilities.

Our business today

Our business is conducted through four major customer focused businesses:

Civil aerospace

We have seen signs of recovery in the civil aerospace sector, although the strength of this recovery varies between regions. Nonetheless, we have continued to sign significant new orders, particularly with customers based in Asia and the Middle East. This includes two individual orders worth more than £1 billion from China and the Middle East. In all, new orders amounted to £7.5 billion during 2010, demonstrating the continued confidence of our customers in our portfolio.

The two new members of the Trent family continued their development programmes through 2010. The Trent 1000 is powering the Boeing 787 on the aircraft's flight test schedule. The engine for the Airbus A350 XWB, which is due to enter service in 2013, ran for the first time in June. This promises to be the most successful member of the Trent family with 1,150 engines already on order. Across the portfolio, our order book requires us to more than double our output of Trent engines by the middle of this decade.

An uncontained disc release occurred on a Trent 900 engine on board a Qantas operated Airbus A380 in November 2010. This regrettable incident attracted widespread attention. Uncontained disc failures happen with a frequency of about once a year on the world's large civil aircraft fleet. However, this was the first time an event of this nature had occurred on a large civil Rolls-Royce engine since 1994.

The safety of our products is our highest priority and each time a serious incident happens Rolls-Royce and the aviation industry learns lessons. These are embedded in the rigorous certification requirements, safety procedures and standards of regulation which make flying an extraordinarily safe form of transport. In line with this regime, Rolls-Royce worked closely with the regulators, Airbus and our customers to put in place an effective inspection programme, to identify root cause and to achieve a rapid return of the Trent 900 fleet to normal operation.

Marine

The growth of our marine business over the past decade has been a major feature in the broadening of our portfolio. In that time revenues have grown by six times, and we now have equipment on board 30,000 vessels. This growth is a consequence of our focus on power systems integration for increasingly complex and efficient vessels.

Rolls-Royce has a strong position in the offshore support industry with production facilities in nine countries and a growing support network. The acquisition of ODIM ASA during 2010, has added significantly to our systems capability and gives us greater access to the growing markets of seismic surveying and subsea deepwater installation. This will be particularly important as oil and gas exploration moves into ever deeper waters, for instance in Brazil, where more complex and capable vessels are required.

Our naval business secured a breakthrough order from the US Navy to power ten Littoral Combat Ships with MT30 marine gas turbine engines. This represents the largest naval surface vessel contract the Group has signed. In the UK, all six Type 45 Destroyers for the Royal Navy have now been launched, equipped with our highly-efficient WR-21 gas turbine power system.

£59.2bn
Order book

In the merchant sector, our technology enables us to respond to the growing demand for improved environmental performance of marine engines. As just one example of this, in 2010 we signed a contract for the world's largest gas-powered ferry which will operate in the environmentally sensitive coastal waters of Norway, fuelled by liquefied natural gas. This technology dramatically reduces CO_2 emissions and virtually eliminates soot and sulphur emissions.

Defence aerospace

Our defence aerospace business is highly diversified with 160 customers in more than 100 countries. Despite the pressure on public spending in its traditional markets we continue to benefit from our investment in a broad product and services portfolio, all of which have global applications. In particular, we see growth opportunities in emerging economies in Asia, the Middle East and South America.

In the UK, the Strategic Defence and Security Review has impacted a number of long-standing programmes, including the Harrier jump jet, which was taken out of service during 2010. However, new products and our substantial service activities will both ensure the resilience of this part of the defence business and create opportunities.

New European collaborative ventures are progressing well and are expected to have a strong export market. In particular, the TP400 turboprop on the Airbus A400M has now successfully completed 3,000 hours of flight testing. Rolls-Royce is also the leading supplier of engines for transport aircraft globally, powering large fleets such as the C-130, C-130J, Spartan C-27 and Osprey V-22.

In the US, the government approved 2010 funding for the development of the F136 engine for the Joint Strike Fighter. We believe this is an important programme not just for the aircraft but to ensure competition and value for taxpayers and customers.

We are also involved in major research projects such as Adoptive Versatile Engine Technology (ADVENT), which is designed to significantly reduce fuel consumption. These position us well for future military programmes.

Energy and nuclear

Our energy business has two main activities. These are supplying power to the oil and gas sector and the provision of power generation products and services.

Rolls-Royce has been a major supplier of power systems for rigs and platforms since the earliest days of offshore oil and gas production. Our gas turbines and compressors operate in harsh conditions and remote locations on behalf of major oil companies. For example, our industrial RB211, Avon and Trent units are now employed on 60 major pipelines around the world. New discoveries and the associated distribution of their output are creating strong demand for our products and services.

The power generation market continues to be restrained by weak demand for electricity in our traditional markets. However, we have secured significant new orders in emerging economies including India and Venezuela and we see good opportunities for long-term growth for both our gas turbine and reciprocating engine portfolio. It is clear that future developments in this sector are likely to be driven by the need for affordable, efficient, distributed multi-fuel systems. Our gas turbine and reciprocating engine portfolio provides a good basis to address these markets.

In addition, over the past decade, the Group has invested in new technologies such as tidal power and fuel cells. During 2010, we conducted a full scale test of a tidal power turbine, anchored on the sea bed off the coast of Scotland. This has generated 500kW at full power and has been successfully linked into the national grid.

We continue to expand our activities in civil nuclear power generation. During 2010, we secured contracts to provide nuclear safety systems in France and in China and have developed supply relationships with reactor vendors and utilities both in the UK and globally. These areas of investment enable us to address the particular requirements of low or zero carbon power generation with solutions that build on our core capabilities.

Strength through teamwork

The successful development of our portfolio depends critically on world-class people and teamwork. The global nature of our business means that our people

must work effectively across time zones, geographies and cultures. Of the 38,900 men and women we employ, 45 per cent are now based outside the UK. This makes communications and shared values critical.

This year we built on the success of our annual strategy storyboard with a televised presentation to most of the senior managers in the Group. The managers who attended this event have been responsible for presenting the storyboard to every employee of the Group. This has enabled people at all levels and in every location in the organisation to understand our objectives and to feed back their own thoughts.

We believe that effective recruitment and continuous training are critical to our success. This year, we recruited 220 apprentices and over 300 graduates from 25 countries. We devote significant resource to the continuous development and training of our people. Over the past five years the Group has committed £150 million to this area alone. Our UK Apprenticeship scheme has been awarded Beacon Status by the Office for Standards in Education (Ofsted) and we have schemes of similar quality globally.

We benefit from the diversity that our global presence brings, recognising that a clear understanding of developing customer requirements, world-class technology and exceptional teamwork are the keys to our future success.

Prospects

The long-term disciplined application of our strategy has created a broad portfolio of products, services and capabilities that ensures a wide range of options for future growth. The expected doubling of revenue over the next decade is underpinned by a record order book, which gives good visibility of the future, and a strong balance sheet which enables us to invest in the people, technology and capability that will enhance competitiveness.

In the short term we expect demand in some markets to remain subdued. However, we have access to the faster growing global markets and our large installed base allows us to benefit from an increasing emphasis on the services we can provide to our customers.

Last September, when I announced my intention to retire, I said there were three considerations that made me comfortable with my decision: I know Rolls-Royce is in a strong position with more choices than we have had in the past; we have a world-class team; and I am confident in the Board's appointment of John Rishton as my successor. He will be an outstanding Chief Executive.

Rolls-Royce has been my working life for 27 years. Wherever I have gone in the world, I have always been proud to be Chief Executive of this Company. It has been an extraordinary privilege to work with so many outstanding people and to contribute to the development of a business that has been at the forefront of engineering and technology for over 100 years. I wish Rolls-Royce, its employees and its shareholders continued success.

Sir John Rose
Chief Executive
February 9, 2011

MARKET OUTLOOK

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

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

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

CIVIL AEROSPACE

The Group produces a 20-year global market outlook, which covers passenger and cargo jets, corporate and regional aircraft. We predict that, over the next 20 years 137,000 engines, worth over US$800 billion, will be required for more than 63,000 commercial aircraft and business jets. The forecast predicts faster growth rates for long-haul markets and those markets to, from and within Asia. These markets will continue to benefit from more liberal air service agreements, which boost demand. Factors affecting demand include GDP growth, aircraft productivity, operating costs, environmental issues and the number of aircraft retirements. While the market can be temporarily disrupted by external events, such as war, acts of terrorism, or economic downturns, it has, in the past, always returned to its long-term growth trend. In addition to the demand for engines, the Group forecasts a market opportunity worth US$600 billion for the provision of product-related aftermarket services.

DEFENCE AEROSPACE

The Group forecasts that demand for military engines will be worth US$160 billion over the next 20 years. This outlook was moderated, slightly based on US and European budget pressures. The largest single market is expected to be the US, followed by Europe and the Far East. Within Asia, demand will be dominated by Japan, South Korea and India. Trends are driven by the scale of defence budgets and geopolitical developments around the world. As in the Group's other business sectors, programme lives are long and there is a significant opportunity to support equipment with aftermarket services, estimated at US$270 billion over the same period. Customers' budget constraints and their need to increase the value they derive from their assets have accelerated the move in this direction.

MARINE

The Group forecasts a demand for marine power and propulsion systems valued at US$215 billion over the next 20 years. Demand will be greatest in the commercial sector, where the shipping of raw materials, finished goods and people, in addition to oil and gas exploration and production activity, play crucial roles in the world economy. These activities require large fleets of specialised and increasingly sophisticated ships, which have to be continually renewed and supported to remain operationally efficient. Merchant and offshore markets are rarely at the same stage of the business cycle, which helps to reduce overall volatility. Whilst naval markets are driven by different considerations, customers are similarly seeking to get more from their budgets, leading to increasing demand for integrated systems and through-life support arrangements. As in the Group's other markets, marine aftermarket services are expected to generate significant opportunities, with demand forecasted at US$125 billion over the next 20 years.

ENERGY

The International Energy Agency has forecast that over the next 20 years, the worldwide demand for oil will grow by more than 18 per cent, for gas by 44 per cent and for energy by more than 30 per cent. To satisfy this demand, there will be a growing requirement for aero-derivative gas turbines in various applications. The Group's 20-year forecast values the total aero-derivative gas turbine sales in the oil and gas and power generation sectors at more than US$70 billion. Over this period, demand for associated aftermarket services is expected to be around US$50 billion. While the oil and gas market is large and growing, demand for aero-derivative gas turbines in the power generation segment is twice that of oil and gas.

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

OUR CONSISTENT STRATEGY

OUR CONSISTENT STRATEGY IS BASED ON FIVE KEY ELEMENTS

1

ADDRESS FOUR GLOBAL MARKETS

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

Civil aerospace
Broadest engine range in the world

£4,919m
Underlying revenue 2010

Defence aerospace
Europe's biggest engine maker

£2,123m
Underlying revenue 2010

Marine
World-leading systems provider and integrator

£2,591m
Underlying revenue 2010

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

£1,233m
Underlying revenue 2010

2

INVEST IN TECHNOLOGY INFRASTRUCTURE AND CAPABILITY

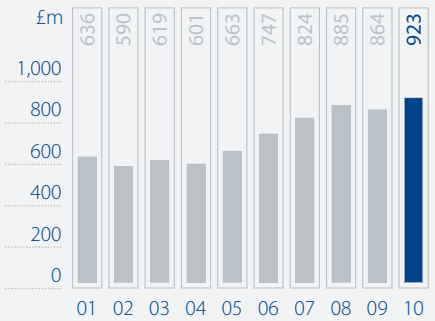
Over the past five years, we have invested £4.2 billion in R&D. We invest substantially in employee development and, in 2010, we invested £361 million in capital projects.

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

Investment in research and development during 2010

£923m

GROSS RESEARCH AND DEVELOPMENT EXPENDITURE (£m)



3

DEVELOP A COMPETITIVE PORTFOLIO OF PRODUCTS AND SERVICES

We have 40 major engineering programmes and we are involved in many of the future projects in the markets we serve. These key projects will define the power systems market for many years.

In 2010, we continued to bring new advanced products to market, including our new wave-piercing design of offshore support vessel. This vessel improves efficiency of operation and safety at sea for the crew.

UNDERPINNED BY CORE CHARACTERISTICS

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

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

4

GROW MARKET SHARE AND OUR INSTALLED PRODUCT BASE

Across our Group, the installed base of products in service is expected to generate attractive returns over many decades.

The Trent 700 is the market leading engine on the Airbus A330. The engine secured US$5 billion of business in the second half of 2010.

5

ADD VALUE FOR CUSTOMERS THROUGH THE PROVISION OF PRODUCT-RELATED SERVICES

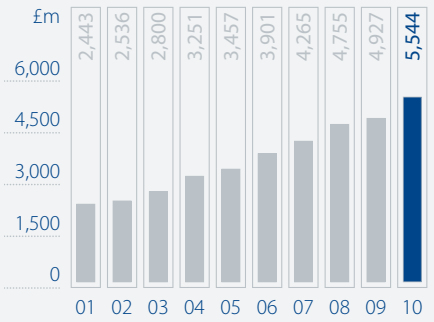
We seek to add value for our customers with aftermarket services that will maximise the performance and reliability of our products.

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

Underlying services revenue 2010

£5,544m

UNDERLYING SERVICES REVENUE (£m)



DELIVERING A 20-YEAR TRACK RECORD OF CONTINUED GROWTH

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

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

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

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

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

Technological superiority
Gaining competitive advantage through continual investment in technology.

Operational excellence
Working constantly to meet and exceed customer expectations.

Organisational capability
Attracting and retaining the best people globally.

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

KEY PERFORMANCE INDICATORS

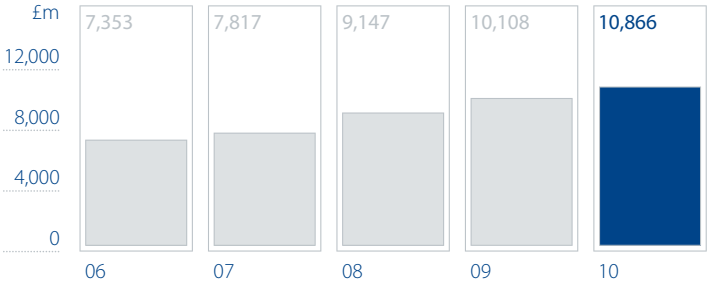
The Board uses a range of financial and non-financial indicators to monitor Group and segmental performance in line with the strategy described on pages 06-07. These indicators are chosen to monitor both current performance and the success of investments that will sustain and enhance future performance. Key performance indicators are included in the appropriate sections of the business review and are as follows:

Key performance indicators

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

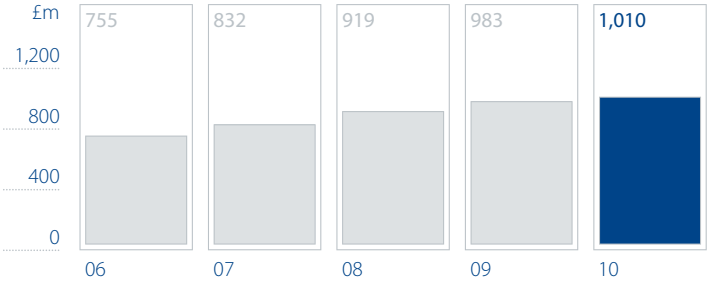
UNDERLYING REVENUE £10,866m

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



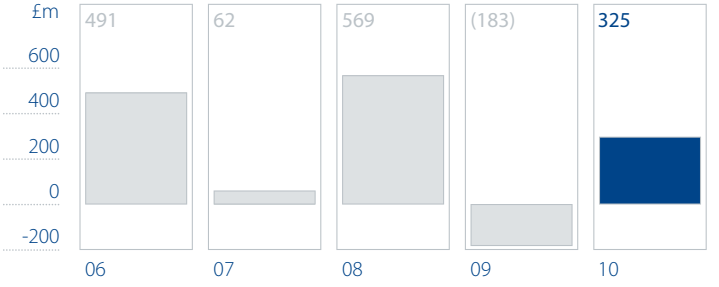
UNDERLYING PROFIT BEFORE FINANCING £1,010m

Underlying profit before financing is presented on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements. In particular: (a) revenues and costs denominated in US dollars and euros are presented on the basis of the exchange rates achieved during the year; (b) similar adjustments are made in respect of commodity derivatives; and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis. The derivation of underlying profit before financing is shown in note 2 on page 64 of the consolidated financial statements.



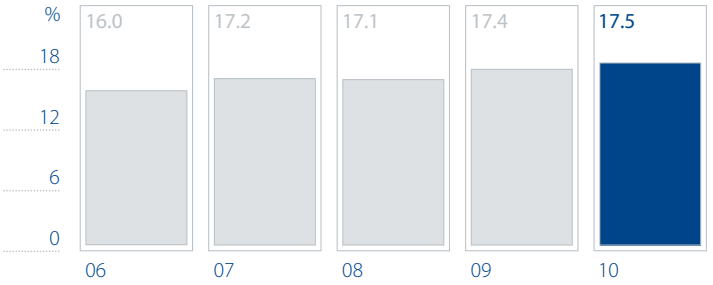
CASH FLOW £325m

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



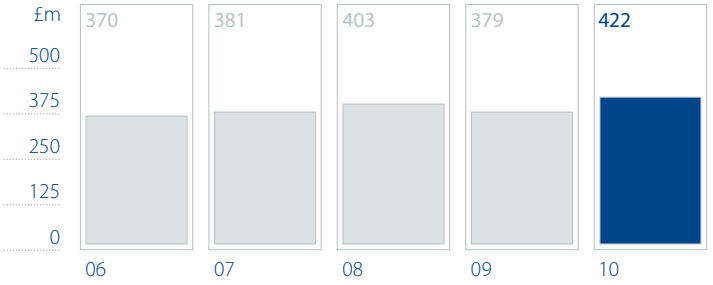
RETURN ON CAPITAL EMPLOYED **17.5%**

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



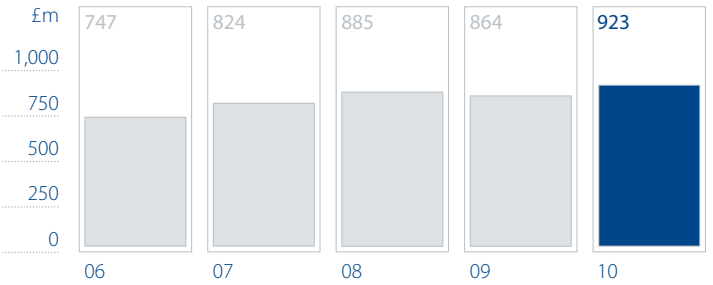
NET RESEARCH AND DEVELOPMENT CHARGE **£422m**

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



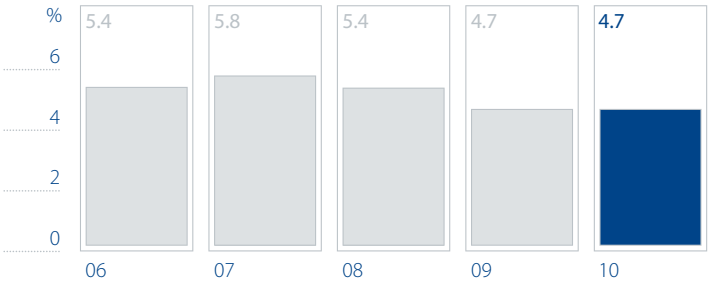
GROSS RESEARCH AND DEVELOPMENT EXPENDITURE **£923m**

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



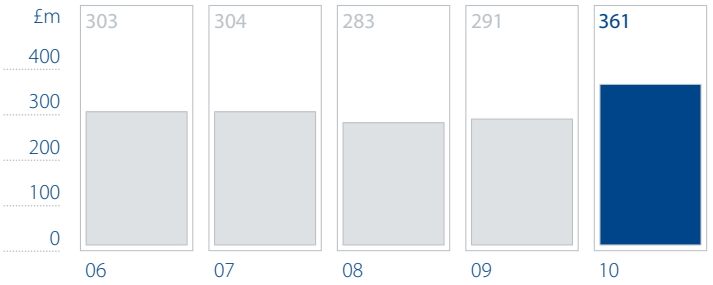
NET RESEARCH AND DEVELOPMENT EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE **4.7%**

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



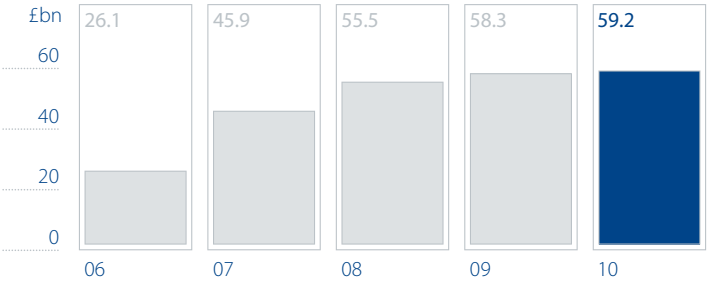
CAPITAL EXPENDITURE **£361m**

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



ORDER BOOK **£59.2bn**

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



TRAINING AND DEVELOPMENT **£33m**

£33 million investment in 2010

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

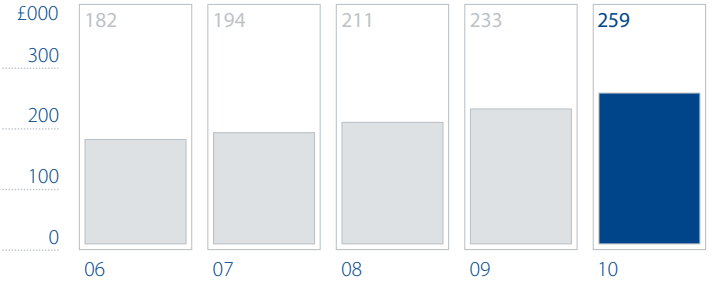
EMPLOYEE ENGAGEMENT **38,900**

38,900 employees in 2010

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

UNDERLYING REVENUE PER EMPLOYEE **£259,000**

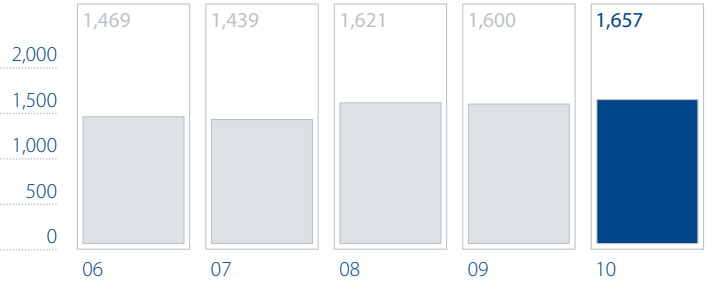
A measure of personnel productivity, this indicator measures underlying revenue generated per employee on a three-year rolling basis.



ENGINE DELIVERIES **1,657**

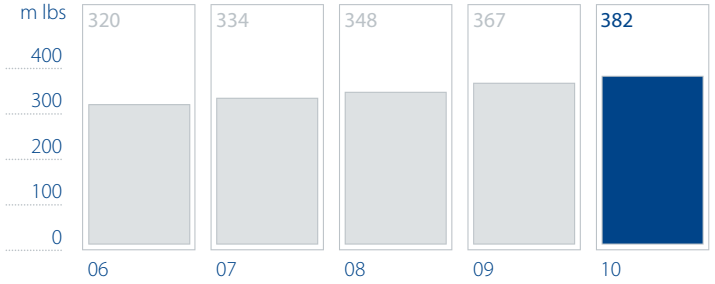
The Group's installed engine base represents an opportunity to generate future aftermarket business. This is measured as the number of Group products delivered during the year within each business except for marine, as its products do not lend themselves to this measure due to their diversity.

Note: Figures have been restated to include diesel engines.



INSTALLED THRUST – CIVIL AEROSPACE **382m lbs**

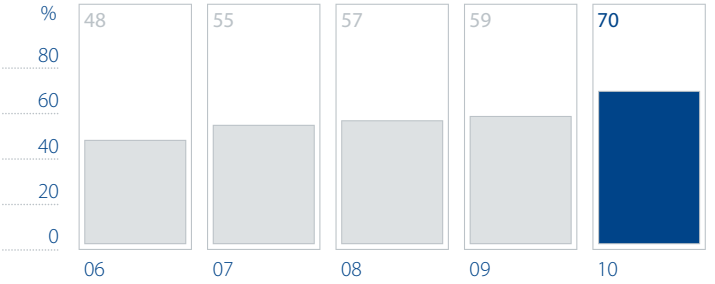
Installed thrust is the indicator of the amount of product in use by our customers and therefore the scale of opportunity this presents for our services business.



PERCENTAGE OF CIVIL FLEET UNDER MANAGEMENT **70%**

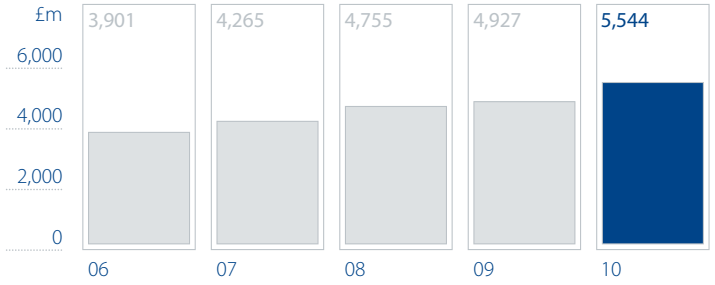
Long-term contracts are an important way of generating value for customers. The percentage of fleet under management gives a measure of the proportion of the installed base where the future aftermarket arrangements are agreed under long-term contracts.

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



UNDERLYING SERVICES REVENUE **£5,544m**

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



EMISSIONS

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

PRINCIPAL RISKS AND UNCERTAINTIES

The Group has established and implemented a sound risk management structure throughout the business, that supports programme execution, informs decision making and ultimately leads to better business performance.

	RISK	DESCRIPTION	POTENTIAL IMPACT	MITIGATION
BUSINESS ENVIRONMENT	Environmental impact of products and operations	The Group recognises that its products and business operations have an impact on the environment, particularly in relation to climate change. Environmental performance is of great importance to customers and regulators; Rolls-Royce is determined to be part of the solution to these environmental challenges.	Failure to respond proactively to the escalating environmental challenge could result in a dilution of reputation, and ultimately loss of market share to competitors. Product life cycles may also be shortened, with a consequent impact on the business model.	• Significant investment in innovative solutions and enhancements for the aviation, marine and energy markets. • Research and development in low carbon technologies such as nuclear power, fuel cells and tidal energy. • Governance structure headed by the Environment Council oversees improvements in the environmental performance of the Group.
	Legislative and regulatory pressures	The Group operates in a highly regulated environment and aims to comply with all relevant statutes. Increasing requirements from domestic and international legislation continue to be experienced; examples include anti-bribery, authorisation of chemicals and substances, and financial regulations, specifically relating to 'over-the-counter' derivatives.	Non-compliance with applicable legislation and regulations would expose the Group to significant financial fines and penalties and may have a damaging effect on its reputation.	• Establishment of a business-wide compliance structure, focusing on anti-bribery and corruption legislation. • Enhanced policies and training on Gifts and Hospitality and Commercial Intermediaries for all employees. • Lobbying to inform and influence the content and implementation of new legislation and regulations.
	Significant external events	Events may occur, externally to the business, that could undermine the basis of its operational and financial forecasts. Such events might include terrorism, political change, global pandemic, natural disaster or continued and deeper economic retrenchment.	Such events could lead to a prolonged reduction in demand for transportation, and hence for a proportion of the Group's products and services. There may also be constraints on the Group's ability to conduct its business operations, for example, in the case of disruption to business premises or mobility of personnel.	• A balanced business portfolio and diversity of global operations mitigate the impact of events in any one market sector or geographic territory. • A responsive and regularly exercised team for the proactive management of external events ensures that disruptions to the business, and to customers' operations, are minimised. • See also 'IT security' risk.
STRATEGIC	Competitive pressures	The markets in which the Group operates are highly competitive and this competition is increasing as a result of global economic uncertainties. The majority of product programmes are long term in nature and access to key customer platforms, most importantly Airbus and Boeing, is critical to success. This requires sustained investment in technology, capability and infrastructure, all creating high barriers to entry. However, these factors alone do not protect the Group from competition, including pricing and technical advances made by competitors.	If the Rolls-Royce products, services and pricing do not remain competitive, this could result in the loss of market share, with attendant impact on long-term financial performance.	• Establishment of long-term customer relationships allows the Group to differentiate its products and services and protect margins in the face of competitive pressures. • Steady focus on improvement in operational performance, for example through the modernisation of facilities. • Increased focus on managing the costs of operations and products. • Sustained investment in technology acquisition, and robust protection of intellectual property (see also 'IT security' risk).
	Export controls	Rolls-Royce designs and supplies a number of products and services for the military. Many countries in which the Group conducts its business have legislation controlling the export of specified goods and technology intended or adaptable for military application.	Non-compliance with export controls could impact both programme performance and the Group's reputation. Our ability to conduct business in certain jurisdictions could be revoked if we are non-compliant.	• Exports Committee, chaired by the Chief Operating Officer, directs strategy and policy on exports. • Export control managers embedded throughout the business. • Export controls awareness training. • Maintenance of the capability to monitor and comply with requirements.
	Government spending	The Group conducts activities as a result of government investments, whether through direct sales or support to technology and other programmes. Such spending could be expected to experience continued pressure during a time of global financial uncertainty and budgetary constraint in Europe and the US in particular.	A decrease in governmental spending could have an adverse effect on the Group's future performance. For example, asset usage and/or flying hours could reduce across military fleets impacting aftermarket revenues. Reduction in technology investment programmes could delay product development and introduction.	• Development of a diversified portfolio of products and services to various markets and regions. • Proactive lobbying for research and technology funding. • Focus on performance to achieve commitments under current contracts.
	Global resource capability	The Rolls-Royce position at the forefront of technology and innovation, and its commitment to delivering significant volumes of business to its customers, demand that we maintain world-class capabilities in all core resource groups, particularly management. Demographic trends, the UK immigration cap and limited supply of appropriately educated and skilled personnel in science, technology, engineering and mathematics subjects exacerbate this risk.	Failure to grow the Group's resource capability to the necessary levels whilst maintaining world-class quality, would adversely impact delivery of customer programmes, threaten our reputation and stifle opportunities for future innovation and growth.	• Significant investment in resourcing and capability infrastructure, notably in the transformation of the Human Resources function. • Comprehensive systems in place for the development of individuals' competencies and the objective assessment of performance, linked to reward. • The Group lobbies on the implications of the UK immigration cap, whilst managing the situation under the interim arrangements announced in 2010.

RISK	DESCRIPTION	POTENTIAL IMPACT	MITIGATION	
Counterparty credit risk	Rolls-Royce works with various counterparties including financial institutions, customers, joint venture partners and insurers. Counterparty failure is recognised as a principal risk driven mainly by the economic uncertainties and pressures in the current environment.	Cash and profit margins could be impacted in the short term, although the Group has built a strong balance sheet to protect itself from the impact of individual defaults.	• Established policy for managing counterparty credit risk. • Common framework to measure, report and control exposures to counterparties across the Group using value-at-risk and fair-value techniques. • Internal credit rating assigned to each counterparty, assessed with reference to publicly available credit information and subject to regular review. Refer to the Finance Director's review on page 34 for additional information.	FINANCIAL
Currency risk	The Group is exposed to movements in exchange rates for both foreign currency transactions and the translation of net assets and income statements of foreign subsidiaries. The Group regards its interests in overseas subsidiary companies as long-term investments. The Group is exposed to a number of foreign currencies; the most significant being USD to GBP and USD to EUR.	Fluctuations in exchange rates to which the Group is exposed could adversely affect operational results or the outcomes of financial transactions.	• Hedging policy, using a variety of financial instruments, to minimise the impact of fluctuations in exchange rates on future transactions and cash flows. • Translational exposures managed through the currency matching of assets and liabilities, where applicable. • Risks reviewed regularly, and appropriate risk mitigation performed where material mismatches arise. Refer to the Finance Director's review on page 34 for additional information.	
Credit rating	As a long-term business, the Group attaches significant importance to maintaining a sound investment grade credit rating, which it views as necessary for the business to operate effectively.	Downgrading of the Group's credit rating would inhibit its ability to secure funding, hedge forward or provide vendor financing, reducing and impacting cash, profit, and reputation.	• The Group has developed a strong financial risk profile and continues to improve the business risk profile. Refer to the Finance Director's review on page 34 for additional information.	
Supply chain performance	The Group's products and services are delivered through the effective operation of its facilities and key capabilities, including its supply chain. Success in strengthening our market position and our presence on a number of high profile civil and defence aerospace programmes, together with a growing marine business, places increased demands on the performance of the supply chain. There is an ongoing exposure to the price of base metals, arising from business operations.	Significant supply chain disruption, and failure to deliver parts on time or to committed costs and quality, would undermine the assumptions within business cases, adversely impacting profit and cash. Consequent damage to reputation could also hinder our ability to win future business.	• Investment in developing world-class manufacturing processes in Asia, North America and Europe. • Well-established business continuity management process that focuses on critical facilities, activities, processes, skills and suppliers. Significant progress in dual sourcing in these areas. • Increased focus on understanding and addressing sources of risk arising in the external supply chain, particularly those associated with financial instability. • Comprehensive programme of business interruption insurance. • Policies to hedge the price of selected base metals.	OPERATIONAL
Ethics	The Group recognises the benefits derived from conducting business in an ethical and socially responsible manner. This approach extends from the sourcing of raw materials and components to the manufacture and delivery of products and services in all of its global locations and markets. It applies to the provision of a safe and healthy place of work and investment in technologies to reduce the environmental impact of our products and operations.	Shortcomings in the Group's business conduct would result in significant financial penalties, disruption to our business and/or have a damaging effect on our reputation.	• Ethics Committee established to oversee and maintain the highest ethical standards. • Global Code of Business Ethics, in 18 languages, issued to all employees supported by a training and engagement programme to improve awareness of the Group's values. • Global telephone and intranet channels are available for employees to report in confidence any concerns regarding potentially unethical behaviours. See also 'Environmental impact of products and operations' risk.	
Programme portfolio	The Group manages complex product programmes with demanding technical and volume requirements against stringent, and sometimes fluctuating, customer schedules. This requires co-ordination of the engineering function, manufacturing operations, the external supply chain and other partners.	Failure to achieve programme goals would have significant financial and reputational implications for the Group, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation. Impairment is discussed further in the Finance Director's review on page 34.	• Continuous improvement of all processes and project management controls to ensure both technical and business objectives are achieved. • All major programmes subject to approval and regular review by the Board, with particular focus on the nature and potential impact of emerging risks and the effective mitigation of previously identified threats.	
IT security	The continuing globalisation of the business and advances in technology have resulted in more data being transmitted internationally, posing an increased security risk.	A breach of IT security may result in controlled data or intellectual property being lost, corrupted or accessed by non-authorised users. Adverse impacts upon operational effectiveness, compliance with legislation or the reputation of the Group might arise.	• Continual upgrading of security equipment and software, and deployment of a multi-layered protection system that includes web gateway filtering, firewalls and intruder detection. • Additional specialist resources committed. • Active sharing of information through industry and government forums.	
Product performance	The Group strives to deliver world-class products that are safe and reliable, focusing attention on product design, robust quality and processes, pre-service maturity and in-service management. Safety is the Group's highest priority.	Deteriorations in product safety could significantly affect the Group's reputation. Shortfalls in performance at entry into service or through life could lead to penalties or additional costs in the aftermarket, and would degrade the business cases upon which revenues are forecast.	• The Group operates, and will continue to operate, in a 'safety first' culture. • Ongoing actions and activities being driven to improve maturity at entry into service. • Continuing engineering focus on improvements to product reliability and service lives.	

CIVIL AEROSPACE

The civil aerospace business powers over 30 types of commercial aircraft and has a strong position in all sectors of the market: widebody, narrowbody and corporate and regional aircraft. Over 13,000 engines are currently in service with 650 airlines, freight operators and lessors and 4,000 corporate operators. A Rolls-Royce powered aircraft takes off or lands every 2.5 seconds.

£4,919m
Underlying revenue 2010

£392m
Underlying profit 2010

Highlights

- First run, on schedule, for Trent XWB
- Trent 1000 accumulated more than 2,000 test flight hours
- Trent 700 continues to lead on Airbus A330
- AE 3007A2 enters into service
- V2500 record production level
- 92 per cent of Trent engines under TotalCare®

Key financial data

	2006	2007	2008	2009	**2010**
Underlying revenue £m	3,907	4,038	4,502	4,481	**4,919**
	+15%	+3%	+11%	0%	**+10%**
Underlying profit before financing £m	519	564	566	493	**392**
	+14%	+9%	0%	-13%	**-20%**
Net assets £m	1,889	2,260	246	2,733	**2,627**

Other key performance indicators

	2006	2007	2008	2009	**2010**
Order book £bn	20.0	35.9	43.5	47.0	**48.5**
	+5%	+80%	+21%	+8%	**+3%**
Engine deliveries	856	851	987	844	**846**
Underlying service revenues £m	2,310	2,554	2,726	2,626	**3,027**
Underlying service revenues %	59	63	61	59	**62**
Percentage of fleet under management	48	55	57	59	**70**

The airline industry has shown recovery in 2010, (after significant losses in 2008 and 2009) with above-average passenger and cargo traffic growth and a return to profit for many airlines. Business jet flights also increased, although not to the levels before the downturn. Large cabin business aircraft deliveries, where Rolls-Royce has a strong position, have been more resilient, driven by demand in Asia and Europe, although the US market remains weak. The small- and mid-size aircraft sectors, which are concentrated in the US market, continued to be subdued.

Widebody

We made good progress with the latest members of the Trent engine family, the Trent XWB and Trent 1000. The Trent XWB will power the Airbus A350 XWB and ran for the first time in June – fulfilling a schedule commitment we made four years ago. Seven engines will run in 2011 as part of a comprehensive test programme.

The Trent 1000, which powers the Boeing 787 Dreamliner, has accumulated more than 2,000 hours of test flight time on four aircraft. The engine won several new orders in 2010, taking the total on order to nearly 550. The aircraft is now expected to enter service in the third quarter of 2011.

The business continues to work closely with both large aircraft manufacturers, Airbus and Boeing, to support these programmes.

Of the Trent engines already in service, the Trent 700 confirmed its market leading position on the Airbus A330. It has won more than 90 per cent of orders announced in 2010 and more than 70 per cent in the past five years. Orders were particularly strong in the second half of 2010, with US$5 billion of business announced since the start of July.

Rolls-Royce continued to enjoy success in growth markets. In China, Air China, China Eastern and Cathay Pacific selected Trent XWB and Trent 700 engines. In South East Asia, Thai Airways and Garuda ordered Trent 700s, and in the Middle East, Emirates and Egyptair extended TotalCare service agreements and Tunisair became a new member of the Trent family, ordering Trent 700s.

A Trent 900 engine suffered a significant failure on a Qantas Airbus A380. The cause of this failure, which was specific to the Trent 900 and related to a component in the turbine area, was quickly established and addressed. The A380 fleet has returned to normal operation.

Narrowbody

In the narrowbody market the V2500 engine, produced by International Aero Engines (IAE) in which Rolls-Royce is a major partner, delivered 371 engines in 2010, its highest ever production level. IAE gained significant contract awards from Sichuan Airlines, Vietnam Airlines, TAM Airlines, BOC Airlines and China Southern. There are now more than 4,500 V2500 engines flying with more than 190 customers worldwide.

Corporate and regional

In the small- and medium-size engine market the BR725 remains on schedule for entry into service on the Gulfstream G650 in 2012, following an exemplary flight and engine test programme. The first Embraer Legacy 650 large executive jet, powered by the new Rolls-Royce AE 3007A2 engine, was delivered to a Middle East customer in December.

Services

Revenues from TotalCare long-term support agreements remained resilient in 2010. The proportion of Trent engines in service with TotalCare reached more than 90 per cent, while time and materials activity showed some recovery in the second half of the year. Overall reliability of the Rolls-Royce engine fleet continued to improve with Trent engines achieving on average one million hours between in-flight shut downs, a rate 20 times better than that required by the regulators for approval of Extended Range Twin Operations.

Future

The business continues to plan for the future, with new two-shaft and three-shaft engines. The Advance2 and Advance3 technology programmes are being driven to support the potential for new engine requirements in the latter part of the decade. The business is also continuing its research into open rotor technology, which we believe could provide a step change in engine performance.

Construction work at the Seletar large engine assembly complex in Singapore is well advanced and is scheduled to open in 2012. Work at the new Crosspointe facility in Virginia, US, is also proceeding to plan.

While economic prospects remain uncertain in many countries for 2011, traffic growth is improving and we expect to see it return to its historic average of five per cent per annum.

Oil prices have remained generally high, encouraging airlines to retire older aircraft during the economic downturn. The Rolls-Royce powered fleet is relatively young and as a result, more fuel efficient. We are benefiting from the upturn as hours flown under TotalCare agreements continue to grow. This underlines the value of our balanced services and products business model.

DEFENCE AEROSPACE

Rolls-Royce is the world's second largest provider of defence aero-engine products and services, with 18,000 engines in service for 160 customers in 103 countries. Our engines power aircraft in all sectors: transport, combat, reconnaissance, training, helicopters and unmanned aerial vehicles.

£2,123m
Underlying revenue 2010

£309m
Underlying profit 2010

Highlights

- TP400 engine approaching 3,000 test flying hours
- F-35B achieved first vertical landing
- Adour engine order worth £200 million from India
- Service business worth £1.5 billion secured

Key financial data

	2006	2007	2008	2009	**2010**
Underlying revenue £m	1,601	1,673	1,686	2,010	**2,123**
	+13%	+4%	+1%	+19%	**+6%**
Underlying profit before financing £m	193	199	223	253	**309**
	+7%	+3%	+12%	+13%	**+22%**
Net assets £m	(83)	(247)	(228)	(329)	**(569)**

Other key performance indicators

	2006	2007	2008	2009	**2010**
Order book £bn	3.2	4.4	5.5	6.5	**6.5**
	-3%	+38%	+25%	+18%	**0%**
Engine deliveries	514	495	517	662	**710**
Underlying service revenues £m	853	877	947	1,046	**1,103**
Underlying service revenues %	53	52	56	52	**52**
Percentage of fleet under management	11	11	12	16	**18**

There continues to be pressure on defence spending in our key markets in Europe and the US. However, our broad product portfolio and strong service and support position on many of the new and established defence aircraft programmes have continued to provide protection against the changes in defence spending by these important customers.

We still see growth opportunities in these markets and, in addition, we are well positioned to secure growth from emerging economies in Asia, the Middle East and South America.

Transport

Rolls-Royce consolidated its position as a world leader in the transport market as our AE 2100 engine for the Lockheed Martin C-130J transport aircraft continued to register orders with existing customers, such as the US Air Force, while the global fleet expanded with the Indian Air Force taking delivery of its first aircraft.

The Airbus A400M military transport aircraft enjoyed a year of flight test success with its TP400 engines achieving more than 3,000 flying hours and completing the final bench test requirements, thereby clearing the path to certification.

In 2011, we expect to begin flight testing with the US Air Force for the certification of the T56 engine enhancement kit for the C-130. This will provide significant fuel savings, a substantial improvement to engine reliability and improved hot day/high-altitude performance over the existing engine fleet.

Combat

In the combat sector our twin contributions to the Lockheed Martin F-35 programme continue to make significant progress in the test phase. The unique short take-off and vertical landing (STOVL) Rolls-Royce LiftSystem® powered the F-35B variant aircraft to its first vertical landing in March 2010. It is now ready for Initial Service Release in advance of the first customer deliveries to the US Marine Corps, scheduled for 2011.

The F136 engine programme for the F-35 Joint Strike Fighter has continued to illustrate the benefits of its advanced design and technologies, which are uniquely tailored for the requirements of the aircraft. Six production-standard F136 engines have been tested during 2010 and the programme is making excellent progress on the path to first flight.

Trainers

In India, the Government placed an order for a second tranche of Adour-powered Hawk Advanced Jet Trainers, worth up to £200 million.

Helicopters

In the helicopter market we were awarded a multi-million dollar contract by the US Army to design and develop a dual-channel, full authority, digital engine control (FADEC) for the M250-powered OH-58 Kiowa Warrior helicopter. We also received the US Army Kiowa Warrior Supplier Excellence Award.

In addition, the LHTEC CTS800 engine, which powered three first flights in 2009, achieved the milestone of 50,000 in-service flying hours.

Services

The success of our services business continued in 2010, attracting major contracts worth around £1.5 billion. Among these was an extension of the long-term support for the RB199 engines powering the UK's Tornado fleet, and MissionCare™ contracts to provide availability-based engine support for V-22 Osprey transport aircraft and the C-130J in service with the US. The US Navy again renewed its support agreement for Adour F405 engines in the T-45 Goshawk trainer. The Canadian Air Force's AE 2100 engines are now also part of the MissionCare fleet.

Future

We continue to make good progress on the US Air Force Adaptive Versatile Engine Technology (ADVENT) demonstrator programme. It is designed to reduce fuel consumption significantly, enabling extended mission ranges and loiter times. In December, we completed the fan rig tests and work continues in preparation for the core and engine demonstrator phases of the programme.

Our Unmanned Air Systems portfolio was further increased by the roll out of the BAE Systems Taranis technology demonstrator powered by the Adour engine. We continue to invest in performance improvements of established fleets such as the Northrop Grumman Global Hawk which is powered by our AE 3007.

Despite the budget cuts in traditional geographical markets, the defence business has the opportunity to compete in a global market potentially worth around US$430 billion over the next 20 years. Many of our customer requirements for the next ten years are already contracted and there are key export opportunities for programmes across all market sectors.

MARINE

Rolls-Royce has a world-leading range of capabilities in the marine market, encompassing the design, supply and support of power and propulsion systems. We are leaders in the integration of technologically complex, mission critical systems for offshore oil and gas, merchant and naval vessels.

£2,591m
Underlying revenue 2010

£332m
Underlying profit 2010

Highlights

- Strong profit growth despite challenging market environment
- ODIM acquired to extend deepwater oil and gas capabilities
- First order secured for revolutionary wave-piercing UT Design vessel
- World's largest gas-powered ferry commissioned – using Bergen engines
- US Navy order for ten MT30-powered Littoral Combat Ships
- Global service capabilities extended

Key financial data

	2006	2007	2008	2009	**2010**
Underlying revenue £m	1,299	1,548	2,204	2,589	**2,591**
	+18%	+19%	+42%	+17%	**+0%**
Underlying profit before financing £m	101	113	183	263	**332**
	+13%	+12%	+62%	+44%	**+26%**
Net assets £m	543	508	453	661	**758**

Other key performance indicators

	2006	2007	2008	2009	**2010**
Order book £bn	2.4	4.7	5.2	3.5	**3.0**
	+41%	+96%	+11%	-33%	**-16%**
Underlying service revenues £m	487	545	712	785	**872**
Underlying service revenues %	37	35	32	30	**34**

Rolls-Royce has more than 2,500 marine customers and has equipment installed on over 30,000 vessels worldwide, including those of 70 navies.

The marine business had another strong year, despite lingering macroeconomic uncertainty and a sluggish recovery in new shipbuilding activity. Service opportunities continued to increase as a result both of the large number of vessels incorporating Rolls-Royce equipment entering the market in recent years, and our expanding services network.

Revenues proved to be resilient in 2010 despite a slowdown in original equipment orders. Growth was driven by our aftermarket services and ongoing success in the offshore market. As a result, marine profit has increased by 26 per cent in 2010.

Offshore

The design of offshore vessels and the high-technology equipment they employ, is central to our business today, and we continued our strong performance in this sector. This was largely based on the success of our specialist UT Design vessels and ability to integrate sophisticated systems into complex ships. The latter part of 2010 saw a slight rebound in orders for highly specialised offshore vessels, highlighted by the first order for the innovative UT 790 wave-piercing series. This new design improves stability and crew safety, while minimising environmental impact.

During 2010, we completed the acquisition of ODIM. The advanced automated handling solutions ODIM brings to our marine business has further extended our capabilities in the range of vessels and equipment we supply to support oil and gas customers in areas such as seismic surveys, deepwater installation, well intervention and other subsea operations.

As the oil and gas industry continues to explore ever deeper waters, the capabilities that the business now has in these highly-skilled areas will mean that we continue to be a strong partner for our offshore exploration and production customers.

Naval

Our naval business had a strong year, with significant activity in the UK, the US and South Korea. In early 2011, we received an order from Lockheed Martin for the provision of MT30s, the world's most powerful gas turbine, together with Kamewa waterjets, to power a further ten US Navy Littoral Combat Ships. This is the largest surface fleet order ever achieved by Rolls-Royce. We continued to deliver power and propulsion equipment for the UK's new Queen Elizabeth class aircraft carriers.

Merchant

We invest in technology that addresses the need for more efficient marine power and propulsion systems. This is primarily through the reduction of exhaust gas emissions and improvements in ship design. Our Bergen gas engines already surpass International Maritime Organization (IMO) limits for NOx emissions, and several orders for these cleaner engines were secured for specialist coastal vessels and ferries in 2010.

We believe that our strong focus on environment and safety technology will be increasingly attractive to customers, resulting in new business opportunities in the merchant and specialist vessel sector.

Services

Our services revenues grew by 11 per cent in 2010, now representing 34 per cent of total marine revenue, and we have continued to develop both capacity and capability to realise the significant opportunity that our increasing installed base represents.

Our global pool of service engineers increased by 20 per cent during the year and we have further extended our service centre network with four facilities across Europe and Africa being expanded or opened.

We have enhanced our range of equipment upgrades and successfully introduced an innovative underwater repair service that reduces vessel downtime and increases our ability to support customers operating in remote locations. In addition, we are continuing to develop equipment health monitoring capabilities, leveraging proven expertise in other Group sectors.

Future

Our strong profit performance in 2010 was a result of delivery of existing orders combined with continued growth in service related activity.

Although new orders in equipment reduced in 2010, there was some recovery in the second half of the year. This, combined with anticipated further growth in services, provides us with good visibility of revenues in 2011.

ENERGY

The energy business supplies gas turbines, compressors and diesel power units to customers around the world. The business is a world leader in the supply of power for onshore and offshore oil and gas applications. Our developing civil nuclear capability has further strengthened our position in the power generation market.

£1,233m
Underlying revenue 2010

£27m
Underlying profit 2010

Highlights

- Eight industrial Trent units sold
- Avon 200 upgrade now sold to over 80 customers
- 57 Bergen diesel engines sold for land-based power applications
- 20 nuclear instrumentation and control systems for China

Key financial data

	2006	2007	2008	2009	**2010**
Underlying revenue £m	546	558	755	1,028	**1,233**
	+2%	+2%	+35%	+36%	**+20%**
Underlying profit before financing £m	(18)	5	(2)	24	**27**
	-1900%	+128%	-140%	+1300%	**+13%**
Net assets £m	355	346	377	542	**410**

Other key performance indicators

	2006	2007	2008	2009	**2010**
Order book £bn	0.5	0.9	1.3	1.3	**1.2**
	+25%	+80%	+44%	0%	**-8%**
Engine deliveries	87	78	106	87	**95**
Underlying service revenues £m	251	289	370	470	**542**
Underlying service revenues %	46	52	49	46	**44**
Percentage of fleet under management	6	7	9	10	**10**

The energy business delivered a strong performance in 2010 with underlying revenue of £1.2 billion, an increase of 20 per cent over 2009, and profit growth of 13 per cent as the business delivered a strong second half recovery to offset the £26 million charge taken in the first half of the year related to the industrial Trent engine. During 2010, the land-based diesel power business was integrated into energy, increasing revenue by £140 million.

Oil prices continued to strengthen during the year and, as a result, bid activity increased in the oil and gas sector, although it is also the case that a number of potential projects were delayed. The traditional power generation market for the Trent continues to be depressed by the low demand for electricity in developed countries. However, the business has been successful in securing new unit orders for both the Trent gas turbine and Bergen reciprocating engines in countries where significant power shortfalls exist, with major orders received from Bangladesh, India, and Venezuela.

Orders for land-based diesel and gas engine power generation applications tripled in 2010 when compared to the preceding two years.

A packaging partnership for the industrial Trent was agreed with STX in South Korea, further broadening territorial coverage.

Services

Demand for aftermarket products and services again grew strongly with another record year delivering revenue of £542 million, an increase of 15 per cent over 2009. Including the land-based diesel units there are now a total of 662 units, or 33 per cent of the fleet under long-term service agreements. Operators continue to benefit from product upgrades that incorporate the latest technology, including the Avon 200 upgrade, which was introduced in 2006 and has now been delivered to more than 24 customers.

Developments

Investment in low carbon technology products continued with the ongoing development of fuel cell technology. In tidal generation the 500kW demonstration unit at the European Marine Energy Centre in the Orkney Islands successfully achieved its technical milestones, generating in excess of 50MWh in the process and earning a Renewable Offset Credit under the UK Government's tariff regime. Plans are now underway to build a 1MW unit that will provide the basis for a commercially available product.

Nuclear

During 2010, we continued to progress plans for a UK nuclear manufacturing base and announced the opening of two new nuclear-specific University Technology Centres (UTCs), located at Imperial College London and the University of Manchester. Rolls-Royce is also a lead partner in the UK Government's Nuclear Advanced Manufacturing Research Centre (NAMRC) facility, which is due to open in September 2011.

The business further extended its nuclear manufacturing skills base through the integration of Canada-based ODIM Numet, specialising in engineering, manufacturing and through-life support of nuclear island systems.

In India, a Memorandum of Understanding was signed with Larsen & Toubro Ltd for a collaborative approach to address new nuclear build markets both in India and internationally. At the beginning of 2011, Rolls-Royce signed an agreement to collaborate with Nuclear Power Delivery UK consortium on its plans to deploy the Westinghouse nuclear reactor in the UK.

The nuclear instrumentation and control business performed well in 2010, establishing a solid platform for global growth across Central and Eastern Europe, China and India. It is also delivering 20 safety instrumentation and control systems for eight new plants in China.

Future

Traditionally a strong oil price has resulted in increased business for original equipment in the oil and gas sector. We would therefore expect the market to continue to strengthen for products and services if the oil price remains relatively high. In power generation we now have a broad range of systems to offer and this puts us in a position of strength to take advantage of any market upturn. We will also continue to explore opportunities in emerging economies.

ENGINEERING AND TECHNOLOGY

In 2010, Rolls-Royce invested a total of £923 million in gross research and development, of which £506 million was funded from Group resources.

Research and development are fundamental to our future success, providing technologies and intellectual property that allow us to compete on a global basis in highly competitive markets.

£923m

Gross research and development 2010

Highlights

- Successful rig demonstrator for the ADVENT programme
- Certification of the RR300-powered Robinson helicopter
- First test of the Trent XWB
- The AE 3007A2-powered Legacy 650 achieved entry into service
- LiftSystem™ on the F35 Lightning II completed a flawless first hover
- The tidal stream generator ran to full power (500kW)

Key performance indicators

	2006	2007	2008	2009	**2010**
Gross research and development expenditure £m	747	824	885	864	**923**
Net research and development expenditure £m	395	454	490	471	**506**
Net research and development charge £m	370	381	403	379	**422**
Net research and development expenditure % of underlying revenue	5.4	5.8	5.4	4.7	**4.7**

The Group's engineering and technology activities are undertaken by close to 10,000 product, engineering and technology specialists covering more than 40 major programmes. The activity is global with main engineering centres located in the UK, US, Germany, the Nordic countries, Singapore and India.

Research

Our advanced research is supported through our worldwide network of 28 Rolls-Royce University Technology Centres, working across a range of specialist subject areas such as materials, noise, vibration and combustion. Two new centres for nuclear technology at Imperial College London and at the University of Manchester were added during the year.

During 2010, we strengthened our new Advanced Technology Centre (ATC) in Singapore which is developing manufacturing and electrical systems and high-power computing capabilities. Work began on the new, dedicated home for the ATC as part of the Seletar development. We opened our new Mechanical Test Operations Centre in Dahlewitz, Germany, during the year. This centre provides mechanical testing capability for all areas of the Group. Building on the success of our membership of the Advanced Manufacturing Research Centre (AMRC), we continue to increase our focus on advanced manufacturing. In the UK, we opened the Advanced Fabrication Research Centre at Strathclyde, Scotland, and the Nuclear Advanced Manufacturing Research Centre project was launched. We are also establishing the Commonwealth Centre for Advanced Manufacturing (CCAM) at the Crosspointe complex in the Commonwealth of Virginia, USA.

In 2010, we established the Manufacturing Technology Centre (MTC) in Coventry, UK. MTC will be the largest in the network of AMRCs when it opens in 2011. Technology programmes in the areas of high integrity joining, intelligent automation, advanced fixturing and net shape powder manufacture have already been launched through MTC partnerships with founder members Rolls-Royce, Airbus and Aero Engine Controls.

Environmental performance

Further improving the environmental performance of our products and operations is a key driver for research and development in Rolls-Royce. We completed the first build of the Environmentally Friendly Engine, and the second build of our mid-size technology demonstrator engine, E3E, was tested successfully in Germany. The E3E, two-shaft core demonstrated, amongst other successes, critical operability throughout the flight envelope up to 38,000ft, for the novel lean-burn combustor.

The European STREAMLINE programme led by Rolls-Royce was launched in 2010. The project includes 22 partners in eight countries and focuses on demonstrating radical new marine propulsion concepts, aimed at delivering increases in efficiency of at least 15 per cent. We achieved notable engineering successes in each of our key business sectors in 2010.

Civil aerospace

In the civil aerospace business, the first Trent XWB engine went to test on schedule in June, running to 100,000lbs of thrust later in the year. Flight testing of the BR725 for the new Gulfstream G650 progressed well and has now achieved 1,000 hours. The Trent 1000 flight test programme for the Boeing 787 continued, although Boeing announced in early 2011 that the entry into service for the aircraft would be further delayed until later in 2011.

2010 also brought a number of challenges to the civil aerospace business. The eruption of a volcano in Iceland in April 2010 resulted in significant disruption to the aviation industry. Our engineering team took a leading role and worked in a systematic way to assist the airlines and industry regulators on this issue. Towards the end of 2010, a Trent 900 suffered a high-profile failure on a Qantas Airbus A380, which initiated a significant and urgent response from the engineering team in order to return to normal operations.

Marine

In 2010, the marine business acquired ODIM and we have successfully integrated the engineers of this business into the Rolls-Royce engineering community. ODIM's people have a wealth of skills and technological knowledge. We anticipate the acquisition will enhance our offshore capability significantly. Marine sold the first offshore vessel with a wave-piercing design (UT 754 WP) for delivery in 2012 and the Dynamic Positioning Release 3 (DP3) successfully passed concept design review.

Defence aerospace

In defence aerospace, the STOVL variant of the Lockheed Martin F-35 Lightning II, equipped with the Rolls-Royce LiftSystem®, successfully completed a flawless first hover and vertical landing in March 2010. The pace of the F136 engine development programme accelerated significantly during 2010 with six new test engines delivered during the year. Approximately 900 test hours were completed according to plan for the F136 programme in 2010. The programme also continued its successful history of meeting contractual milestones with the first STOVL propulsion system delivered to test, on time.

LibertyWorks® in Indianapolis continues to perform well on the ADVENT demonstrator programme; rig testing demonstrated fan performance as expected and with a favourable stability margin. Work continues in preparation for the core and engine demonstrator phases of the programme.

In 2010, Robinson Helicopter obtained FAA certification for the RR300-powered R66 helicopter and commenced customer deliveries.

Energy

We continue to develop our business activities in the civil nuclear market and also continued with further investment in nuclear engineers and in infrastructure.

Our first tidal stream generator was deployed offshore of the Orkney Islands. A major milestone was reached on November 10, 2010 when the turbine generated 500kW at full power for the first time at the test site. The turbine is now being operated unrestricted with several periods of fully automatic 24-hour operation and has achieved all requirements to gain a renewable obligation certificate.

OPERATIONS

We continue to invest in operational capability to enable the long-term growth plans of the Group to be executed.

Our strong positions in growing markets, represented by a record order book, together with increasing services activity, place a demand on us to deliver world-class operational excellence from modern and efficient facilities.

£361m

Capital expenditure

Highlights

- Seletar and Crosspointe facilities on schedule
- Simple and scalable processes being embedded globally
- Expansion of repair and overhaul capability in Asia
- Further investment in IT completed across the Group
- Supporting new advanced manufacturing centres

Key performance indicators

	2006	2007	2008	2009	**2010**
Capital expenditure £m	303	304	283	291	**361**
Underlying revenue per employee* £000	182	194	211	233	**259**

* Calculated on a three-year rolling basis

There has been significant uncertainty in the economic environment during the last two years and our supply chain has performed well throughout this volatile period, with an increasing emphasis on productivity, flexibility and execution. The 2010 results reflect this performance through a marginal reduction in inventory and progress in productivity, reflected by an improvement in revenue per employee.

Our global operational network is a highly integrated activity including our own facilities, partners and other external suppliers feeding the gas turbine applications in all four businesses. In addition, we are managing substantial global supply chains to support our growing range of marine and nuclear activities.

Delivering excellence

During 2010, we have continued to focus on operational excellence with our programme of investments to improve current productivity and support the inevitable growth embedded in the order book.

We work in partnership with our external partners and suppliers to reduce waste, improve designs and introduce better manufacturing methods for new and existing products. Our achievements have helped offset inflationary pressures in 2010, however, there remains more to do. Creating simple, scalable processes and a culture of 'right first time' are key to operational excellence and will help achieve cost reductions in every aspect of our operations.

The ongoing drive to reduce inventory provided further benefits in 2010. We are establishing systematic changes that can transform working capital management and, in time, release cash.

Investing for growth

2009 proved to be a year of firsts with an unprecedented number of new programmes reaching first flight or launch. In 2010, the work to support these programmes progressed well. In June 2010, the first Trent XWB engine ran for the first time, in line with the plans we set out four years ago. Flight test work progressed on the new Trent 1000 for the Boeing 787 and the TP400 for the Airbus A400M transport aircraft. In marine, we introduced a new wave-piercing design of offshore support vessel, and in energy we launched the upgraded industrial RB211, the –H63.

Our success at winning business in the wide-bodied aircraft market means we expect to more than double the number of Trent engines being delivered by the middle of this decade. To manage this change in volume, investment in new facilities, tooling and capability continued during 2010. Building work has progressed as planned on the Crosspointe facility in Virginia, US, and at Seletar Aerospace Park in Singapore. With the external building work broadly complete, both are on target to be in operation by 2011 and 2012 respectively.

We opened the new Mechanical Test Operations Centre at Dahlewitz, Germany, and a new facility to support the F-35 LiftFan™ assembly in Indianapolis, US. We also expanded the civil aerospace repair and overhaul joint venture, Singapore Aero Engine Services Limited, increasing capacity to 250 large engines per year.

In the UK, the new disc manufacturing plant in Sunderland is progressing to plan and, in addition, we are supporting the development of four advanced manufacturing research centres. Two similar centres are being developed outside the UK. All of these will help improve manufacturing performance across the supply chain. Additional manufacturing capacity, for the submarines and civil nuclear businesses, is being added to our existing facilities in Derby.

People and capability

We are committed to investing in, and developing, our people to equip them with the skills required to meet the challenges and opportunities we face as the business grows. Through our ethics, health and safety programmes, we are helping our people to make the right decisions and ensuring that the safety of our people and products are at the forefront of our minds and actions. In 2010, we continued to invest heavily in information and technology across the Group. Investments in Product Lifecycle Management (PLM), Computer Aided Process Planning (CAPP) and Manufacturing Execution Systems (MES) are key to providing the tools to enable effectiveness and efficiency.

Future

Our journey to create a global, best-in-class, and fully integrated operations function is well underway. While economic uncertainty seems likely to continue, our priorities remain to improve the effectiveness of our delivery and ensure we are well placed to meet the operational demands of the future.

SERVICES

Rolls-Royce provides power systems for applications that routinely operate in particularly harsh environments, often with years between intervention. Service activities provide over one half of the Group's revenues, having increased ten per cent compound over the past ten years.

£5,544m

Underlying services revenue 2010

Highlights

- Service revenues increased by 13 per cent to £5.5 billion
- 76 per cent of the large civil engine fleet now under TotalCare®
- OSyS expands service diagnostic and predictive capabilities
- Major contracts secured for Tornado, Typhoon and C-130J engines
- Over 30 marine service centres in operation around the world
- 350 industrial gas turbines now covered by long-term service contracts

Key performance indicators

	2006	2007	2008	2009	**2010**
Underlying revenue £m	3,901	4,265	4,755	4,927	**5,544**
Underlying services as a percentage of Group revenue	53%	55%	52%	49%	**51%**

As the original equipment manufacturer, Rolls-Royce is best placed to provide mission critical support, long-term product care and well planned maintenance on behalf of customers in each of the markets we serve. The Group's service capabilities include field maintenance and support services, the provision of replacement parts, equipment overhaul services, component repair, data management, equipment leasing and inventory management. These are typically packaged together and sold as long-term support agreements such as our TotalCare suite. We work closely with customers to align each service package to their operational needs, helping to maximise the availability and efficient operation of the equipment on their behalf.

Civil aerospace

We have 76 per cent of the large engine fleet and 92 per cent of the in-service Trent fleet now managed under TotalCare. We also have 900 corporate and business jet aircraft enrolled in CorporateCare®, the equivalent offering for this market sector. In 2010, operational planning has been further enhanced across the Trent family of engines with the adoption of sophisticated proactive engine life management policies. These combine our technical knowledge with the service data on each individual engine to enable each customer to manage their whole fleet in a more predictable manner.

Our network of On-Wing Care facilities supported over 3,500 events globally in 25 different countries.

Defence aerospace

We continued to develop MissionCare™ provision worldwide and service presence on military bases. A long-term service agreement was signed with Lockheed Martin to support the Canadian Air Force fleet of C-130J military transport aircraft. New contracts were also signed with the UK Ministry of Defence to increase the scope of support for the frontline Tornado and Typhoon fighter aircraft operations. In 2010, Rolls-Royce completed 500,000 flight hours of MissionCare support for the Adour engines that power the US Navy's T-45 training aircraft.

Energy

We secured further long-term service agreements which, together with the additional 38 new gas turbine units that became operational during 2010, mean the number of gas turbines under long-term service agreements is approaching 350. Additionally, a number of long-term service agreements were renewed, the most significant being with Total in the North Sea supporting 14 gas turbine packages on two platforms for a period of ten years. We continue to develop the service infrastructure to support the growth of the Rolls-Royce fleet in China, India, Brazil, Malaysia and Russia, along with extending the global footprint of the business with expanding operations in West Africa and Central Asia.

2010 also saw the 20-year anniversary of the Rolls Wood Group repair and overhaul joint venture. The Rolls Wood joint venture continues to maintain its position as the major supplier of repair and overhaul services for Rolls-Royce industrial gas turbine engines. The scope of the joint venture was expanded in the year with the official opening of a facility in Malaysia in partnership with OTEC.

Marine

Service opportunities have continued to increase in marine as a result of the large number of vessels with Rolls-Royce equipment installed, now totalling over 30,000 vessels worldwide. As this installed base of equipment continues to grow, we are actively expanding our support capacity and capability and now have over 30 dedicated marine service centres serving customers across North and South America, Africa, Europe, the Middle East, Asia and Oceania. Marine customers seek to have their ships serviced close to where they primarily operate, and we continued our expansion by adding around 200 service engineers globally. We continue to expand our service capabilities and in 2010 we completed more than 50 successful underwater intervention repair services which enabled major propulsion overhauls to be completed without the need for time consuming dry docking.

Future

The Group invested over £26 million this year in developing and restructuring our wholly-owned gas turbine repair and overhaul network, which will deliver significant improvements in operational performance and customer satisfaction. 2010 also saw the celebration of ten years of Rolls-Royce ownership of the Oakland repair and overhaul facility in the US.

Our component repair business continues to grow rapidly and delivered £150 million in benefit across all sectors in 2010.

Asset optimisation service development has advanced strongly, led by the Optimized Systems and Solutions Inc. (OSyS) business. OSyS has expanded our in-service diagnostic, risk management and predictive capabilities. Through OSyS, we continue to advance the health monitoring services and capabilities already applied successfully to aircraft engines and energy systems with more than 8,900 assets being monitored.

SUSTAINABILITY

Our business activities need to be seen in the broader context of sustainable development. A secure supply of affordable energy is a prerequisite for sustainable economic growth, which in turn provides the foundations for social development.

Climate change and other environmental concerns mean that new forms of power and propulsion systems are required to address these issues. The environmental challenges posed are complex. Technology will play a critical role and innovation will be vital. Rolls-Royce has highly relevant skills that can be applied to these challenges.

The products and services that we deliver are critical to the operations of our customers and we pay the highest attention to product responsibility, guided by our core values of reliability, integrity and innovation. We also recognise the social responsibilities that come from being a major employer, neighbour and partner as we conduct our business around the world. In this regard we follow our published Global Code of Business Ethics. Corporate responsibility is fully integrated into our business activities. We believe that conducting business in a responsible manner creates competitive advantage by enabling us to:

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

External recognition and benchmarking

Rolls-Royce is ranked in a number of external indices which benchmark our performance:

Business in the Community Corporate Responsibility Index (BitC)

The BitC Index assesses the extent to which corporate strategy is integrated into business practice throughout an organisation. In 2010, Rolls-Royce retained its Gold status with an overall score of 91 per cent. We also scored 94.8 per cent in the Environmental Index component of the overall survey.

Dow Jones Sustainability World and European Indexes (DJSI)

Rolls-Royce has retained its position in the DJSI for the ninth consecutive year and, with an overall score of 79 per cent, was sector leader for the Aerospace and Defence sector. The Group scored 100 per cent for environmental reporting, product impact and operational eco-efficiency and occupational health and safety.

Carbon Disclosure Project (CDP)

For the third consecutive year Rolls-Royce has been included within CDP's FTSE 350 Carbon Disclosure Leadership Index, in recognition of a 'professional approach to corporate governance in respect of climate change disclosure practices'. Our score increased from 76 in 2009 to 79 in 2010.

Ethics

We regard ethical behaviour as key to maintaining and strengthening our reputation and in support of our commitment to act with integrity, we continued the deployment of the global ethics programme launched in 2009. This is underpinned by our Global Code of Business Ethics which is issued to all employees.

Compliance and assurance

The new UK Bribery Act, which is expected to come into force in May 2011, and whose scope extends beyond UK borders, has led us to prioritise the review of the policy areas linked to anti-bribery and corruption. Policies on gifts and hospitality and commercial intermediaries were reviewed and updated during the year and agreement was given for the establishment of a new compliance organisation.

Training and awareness programme

The global ethics training programme in 2010 was incorporated into a global risk, reputation and ethics training curriculum. A tailored e-learning package on the Global Code of Business Ethics has been developed to reinforce the key ethics messages and allow employees to work through ethical dilemmas. This will be introduced in 2011.

Reporting line

An independently operated and confidential ethics reporting facility is available worldwide. This allows employees to raise issues or concerns regarding business conduct independently of the normal management chain.

Governance

The following senior corporate governance bodies are in addition to those described on pages 44 to 46:

- The Group Community Investment and Sponsorship Committee, chaired by the Chief Executive;
- The Global Diversity Steering Group, chaired by the Chief Operating Officer;
- The Sustainability Steering Group, chaired by the Director – Engineering and Technology;
- The Environment Council, chaired by the Director – Engineering and Technology; and
- The Environmental Advisory Board, chaired by a senior academic from the Massachusetts Institute of Technology.

Our people

Rolls-Royce employs 38,900 people in more than 50 countries. Our growing order book and the continuing innovation of the Group's products makes it imperative that we have a skilled workforce that is committed to delivering excellence to customers. To achieve this, we seek to create an inclusive working environment that attracts and retains the best people, enhances their flexibility, capability and motivation, and encourages them to be involved in the ongoing success of the Group.

Our workforce is dispersed globally across our business sectors:

BUSINESS SEGMENT	HEADCOUNT
Civil aerospace	19,500
Defence aerospace	6,900
Marine	9,000
Energy	3,500
TOTAL	**38,900**

Resourcing

In 2010, over 1,250 experienced professionals were recruited to support the growth of the business and, of these, nearly 50 per cent were recruited outside of the UK. During 2010, our campus teams were active at more than 40 universities in the UK, Europe, Asia and the US, and we recruited 222 graduates onto our graduate programmes from 73 universities and 25 nations worldwide.

We were ranked 26th overall in The Times newspaper's Top 100 UK Graduate Employers of 2010, achieving first position in the Engineering sector. In Singapore, we entered Singapore's Top 100 Graduate employers in 21st place.

In 2010, we recruited 220 apprentices globally. Our apprenticeship programme in the UK was graded as 'Outstanding' by Ofsted.

Learning and career development

Rolls-Royce provides all employees with access to learning that helps them deliver high performance in their current and future jobs. We have made significant improvements to the quality of our performance development review activity and in 2011 we will continue to focus on developing the right performance culture. The Global Code of Business Ethics, rolled out to managers in 2009, has been cascaded to all employees during 2010. A Global Gifts and Hospitality and Commercial Intermediaries policy compliance programme has been provided to all employees as a result of the new UK Bribery Act.

We provide over 2,400 learning solutions globally through our online learning system. The catalogue includes several hundred programmes covering health, safety and the environment, diversity, ethics and corporate and management responsibility.

By the end of 2010, employees from 55 countries had accessed the learning system with over 34,000 employees undertaking more than 94,000 days of learning. Of these, 86,000 hours consisted of online learning. We have updated our global leadership development framework in 2010 and partnered with world-class providers to ensure that the Group has a strategically focused and consistent way of managing its people.

Learning investment for 2010 was £33 million.

Engaging employees

We continue to place great value on giving a voice to our workforce. Employee opinions are obtained via a two-year rolling engagement programme. Improvement activities are then embedded into local and corporate business planning activities. In 2010, the Group conducted its second global engagement survey. Seventy-four per cent of the workforce responded, representing a continuing high level of participation in such activities.

Comprehensive feedback has been shared with teams across the Group. The general trend indicates an improvement in overall engagement levels compared to 2009 when the first global survey was undertaken.

Encouraging diversity

The Group is committed to developing a diverse workforce and equal opportunities for all. Our global governance framework for diversity includes a senior executive Global Diversity Steering Group that provides leadership and shapes strategic direction.

During 2010, we developed a number of awareness programmes to increase self awareness and promote cross-cultural working. The Group is launching a reverse mentoring programme in 2011, where our most senior executives will be reverse mentored by a colleague who is junior to them in the organisation. The aim is to give senior executives a different perspective from a colleague who can share diverse experiences and ideas.

The Group supports a number of women's networks that focus on personal and professional development as well as providing support through networking.

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

Product responsibility

Product safety is paramount and the highest standards are maintained by the application of a robust safety management system. Our role does not stop once the product has been delivered to the customer. Safety and reliability are our highest priorities and we continue to drive uncompromised levels through rigorous design processes and by providing expert through-life support.

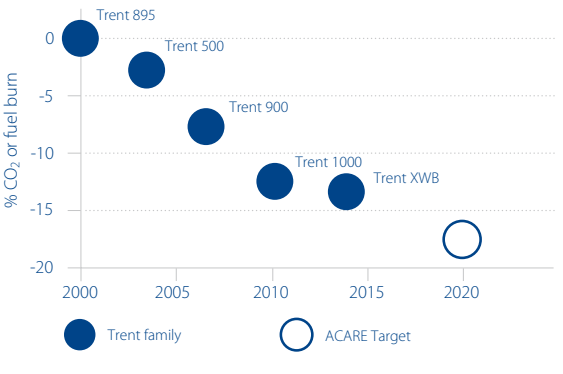
Rolls-Royce is both committed and well placed to find solutions to the substantial challenges posed by climate change. We receive independent expert advice from the Group's Environmental Advisory Board, comprising distinguished academics who are leading authorities in their respective fields, vital to the overall business strategy and design process.

The Board believes that technology must be applied on an industrial scale, through companies such as Rolls-Royce with its global reach, to achieve significant reductions in emissions. In 2010, we invested £923 million in research and development, two-thirds of which was aimed at improving the environmental performance of our products.

The aviation industry has a strong track record of addressing its environmental impact, investing consistently in product technology over the past six decades. Aircraft today are 75 per cent quieter and use 70 per cent less fuel on a passenger-kilometre basis than the earliest jet aircraft. Rolls-Royce is continuing to work on ways to further reduce the effect of aviation.

The Trent 900 and 1000 engines, for the Airbus A380 and Boeing 787 respectively, and in the future the Trent XWB for the Airbus A350 XWB, help us demonstrate progress towards meeting our Advisory Council for Aeronautics Research in Europe (ACARE) goal of a 15–20 per cent reduction in engine fuel burn by 2020 compared to 2000 levels. The Group also continues to drive for reduction in noise and improvements in air quality.

REDUCING CO_2



In the longer term, we continue to see open rotor technology as offering a potential step change in performance and we are currently targeting entry into service early in the next decade for this technology. Our civil engine product strategy for 2010–2025 means that we will have engines entering service that, on average, will reduce the fuel burn of aircraft replaced in that 15-year period by at least 15 per cent.

There is widespread interest in the possibility that the aviation industry could replace, at least in part, traditional fuels with biofuel – a synthetic fuel made from biomass. Rolls-Royce actively supports, and plays a central part in, the rigorous scientific testing and evaluation of biofuels and we support demonstrations of biofuels where they directly contribute to developing fuel specification criteria, or to the improvement of scientific understanding. However, we have to make sure that biofuel achieves the same technical and commercial standards as traditional fuels, and that its production is sustainable (taking account of such factors as impact on biodiversity, water resources, livelihoods, ecosystems and life-cycle CO_2 emissions).

Rolls-Royce, as a world leader in marine technology, is well placed to help address the requirement for significantly reduced emissions. Our latest generation Azipull thruster technology, which is up to 16 per cent more efficient than conventional marine thrusters, enables ships to use less energy and so reduce emissions. Our Bergen lean-burn reciprocating gas engine achieves up to a 90 per cent reduction in oxides of nitrogen, virtually zero emissions of sulphur and a 20 per cent improvement in CO_2 emissions, compared with a conventional diesel engine.

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

The need to drastically cut greenhouse gas emissions, combined with the increasing insecurity of oil supplies, is likely to lead to an expansion of nuclear power over the coming decades. With more than 50 years' experience in designing and supporting pressurised water reactors, we are well placed to make a significant contribution to this nuclear renaissance. We have recently established a new civil nuclear business with the aim of serving this growing global power market.

We are also leading the development of the Nuclear Advanced Manufacturing Research Centre (NAMRC), as part of the UK's Low Carbon Industrial Strategy.

Operational HS&E performance

Rolls-Royce is committed to building and maintaining a high reliability organisation; one that delivers consistently high performance across all aspects of health, safety and environmental (HS&E) management. Our objective is to achieve world-class levels of performance throughout our business and to be widely recognised for the excellence of our performance.

During 2010, the Group conducted a programme of Process Safety audits on our main manufacturing plants and test facilities. The results are being used to further strengthen our approach to assurance over process safety.

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

The Group's contribution to developing best practice through third party collaboration continues. We are taking a leading industry role in Registration, Evaluation, Authorisation and restriction of Chemicals (REACH), the latest EU chemicals regulation, and continue to work with other companies, trade bodies, sectors and regulators on implementation to ensure our continued access to materials necessary for the production and support of our products.

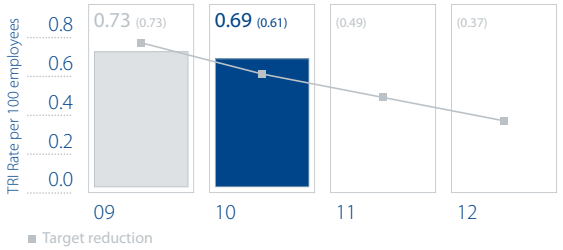
Operational performance

In 2009, we declared a new set of global targets for our HS&E performance. Progress against these will be reported in an update to our last HS&E report 'Powering a better world' planned for April 2011. We made progress against two of our key targets: reducing the Group's Total Reportable Injury (TRI) rate and greenhouse gas (GHG) emissions. Our data collection and reporting is subject to independent assurance by Deloitte LLP.

TRI

Following a reduction of 40 per cent in our TRI[1] rate during 2007–2009 we set a new target last year to reduce this by a further 50 per cent by 2012 (based on 2009). We can now report that we have reduced our TRI from 0.73 per 100 employees in 2009 to 0.69 in 2010. This represents a five per cent reduction which is slightly behind our interim target. We continue to develop global programmes focused on improving our performance.

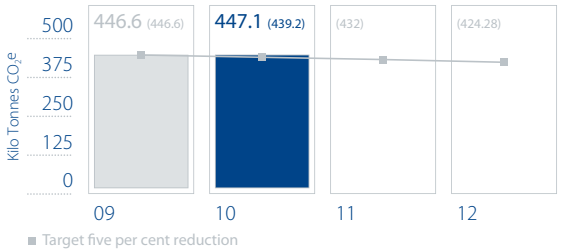
PROGRESS AGAINST TRI REDUCTION TARGET 2009–2012



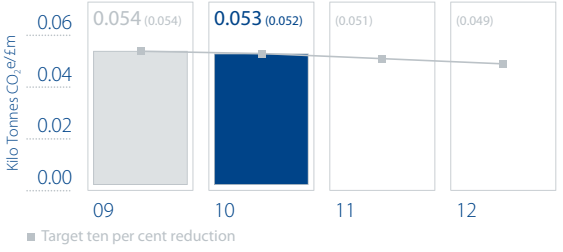
GHG

At the end of our last three-year target cycle (2007–2009) we reported a 38 per cent reduction in energy use (normalised on turnover). In addition, there was an accumulated 36 per cent reduction in absolute GHG emissions in the past decade. During 2010, we have achieved a further three per cent reduction in total Group GHG emissions (including product test and development) moving us towards our target of a ten per cent reduction (normalised) by 2012. In absolute terms, GHG emissions for our facilities (excluding product test and development) have remained at a similar level to 2009 compared with our five per cent reduction target by 2012.[2]

PROGRESS AGAINST FACILITY GHG (ABSOLUTE) EMISSION REDUCTION TARGET 2009–2012



PROGRESS AGAINST TOTAL GHG (NORMALISED) EMISSION REDUCTION TARGET 2009–2012



[1] TRI cover fatalities, lost time injuries, restricted work cases and medical treatment cases.

[2] Energy/GHG data for 2010 has been forecast based on data collected during January to October 2010. For details of the methodology see our 'Basis of Reporting' available at www.rolls-royce.com

GROUP GREENHOUSE GAS – GHG EMISSIONS FOR 2010 ($ktCO_2e$)

	2010	2009
Scope 1 (direct)	**217.3**	210.4
Scope 2 (indirect)	**363.1**	356.2
Total GHG	**580.4**	566.6

We recognise the need to make cuts in global emissions within our own operations. Individual reduction targets and budgets have been agreed for our top 25 energy consuming sites to enable us to build on previous improvements in energy efficiency. We will continue to work on ways to reduce our reliance on fossil fuels. This includes using more sustainable energy sources, like renewable and other low carbon technologies/materials within our facilities where this is cost effective and practical.

Learning from incidents

This year we have introduced a new process of notifying serious and high-potential incidents to senior management. High-potential incidents are now required to be reviewed at Chief Operating Officer level within the businesses and functions. This is intended to strengthen our learning from incidents and to prevent their reoccurrence.

Health and wellbeing

Rolls-Royce recognises the association between physical and mental health and the need for our employees to consider their personal wellbeing. A preventative occupational health strategy has been in place since 2005 and supports employee wellbeing and productivity through a series of health promotion initiatives.

In 2010, 1,300 employees took part in the 'Know your body metrics' health promotion campaign in the UK representing six per cent of the covered population.

Our Group-wide HS&E targets for the period 2009–2012 are set out opposite.

(The methodology used by the Group to collect and report HS&E performance data is set out in our 'Basis of Reporting' available at www.rolls-royce.com).

OUR TARGETS ARE:

PROTECT HEALTH

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

PREVENT INJURY

Reduce the Group TRI rate by 50 per cent by end 2012

REDUCE ENVIRONMENTAL IMPACT

Five per cent reduction in Group facility GHG by end 2012 (absolute) (excluding product development and test)

Ten per cent reduction in total Group greenhouse gas emissions by end 2012 (normalised by financial revenues) (including product development and test)

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

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

Note: A full update on our progress against these targets will be provided on www.rolls-royce.com/sustainability in April 2011. Progress against our TRI and GHG targets is provided opposite.

Suppliers

In 2010, supplier engagement has seen Rolls-Royce leading Global and Regional Supplier Forums which focused on near-term and long-term business improvements. We also hosted Regional Supplier Groups, culminating in a Global Best Practice Sharing event aimed at promoting the application of lean techniques across the supply chain.

Society

We aim to communicate effectively, protect or enhance local quality of life and be recognised as part of the local community. We also recognise that there are significant business benefits for our organisation through community investment. These benefits include recruitment and retention of staff, employee engagement and development of our reputation and brand.

Community investment

The Group has a long-standing commitment to supporting its local communities focusing on four key areas: education; environment; regeneration; and arts and culture. The Group's total contribution in these areas was approximately £5.3 million in 2010, measured using the London Benchmarking Group model.

Donations and sponsorship

The Group's charitable donations amounted to £2.3 million, of which £1.15 million were made in the UK. Rolls-Royce made charitable donations of US$970,000 in the Americas, €535,000 in Europe and £80,000 in other regions.

A further £1.1 million was contributed in sponsorships including the Smithsonian National Air and Space Museum in North America, the Brandenburg Summer Festival in Germany, and The Big Bang fair for young scientists and engineers in the UK.

Each year, the Rolls-Royce Science Prize awards £120,000 in prize money to recognise excellent and innovative science teaching in the UK. This year's winner, Teesdale School in Barnard Castle, England, received a total of £20,000 for their project in which pupils developed enrichment devices for primates in zoos.

Employee time

Employee time contributed during 2010 is estimated at a value of over £1.5 million, with more than 4,000 employees participating in activities with societal benefits.

Over 300 employees across the globe took part in 30 community and education outreach projects as part of their personal development during the year. Our programme of community projects, run by graduate and apprentice trainees, was awarded a 'Big Tick' by Business in the Community in its Awards for Excellence in 2010 in the category of 'Building Stronger Communities'.

Employee giving

Rolls-Royce finances the administration of a Payroll Giving Scheme for UK employees, enabling them to make tax-free donations to their chosen charities. During 2010, employees gave almost £460,000 to more than 500 charitable causes. In North America, employees donated US$430,000 directly from payroll to good causes through the United Way and Centraide schemes, a percentage of which is matched by the Group.

FINANCE DIRECTOR'S REVIEW

"The Group delivered a particularly resilient performance in 2010 with strong order flow delivering a record order book at the period end."

The trading performance in 2010 met the expectations of the Board and the guidance provided throughout the year, delivering a seven per cent increase in Group underlying revenues with underlying profit before tax up four per cent to £955 million. There was a cash inflow of £325 million in the year delivering a year end net cash balance of nearly £1.6 billion.

These achievements came in a year that saw the broader environment remaining difficult and unpredictable with significant macro-economic, industry and Company-specific challenges throughout 2010. It was especially pleasing that further significant milestones on major new programmes, considerable investment in product development and continued expansion of the global facilities and supply chain were also delivered along with a resilient trading outturn. This performance continues to highlight the strength of the portfolio and the benefits of the long-term and disciplined application of the power systems strategy.

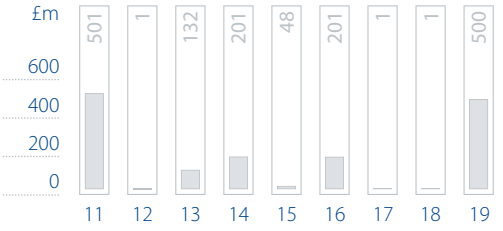
All of our businesses have been affected by the economic factors that have been prevalent in the last few years and that have had an impact on our competitors. However, the Group has significant advantages in the diversity of its businesses, both by sector and geographical dispersal. The age of our installed fleet of products, the strong positions we hold on current and future major programmes, together with the Group's services revenues have all helped to deliver significant progress in the last three years. This is demonstrated by: growth in the order book of 29 per cent; increase in underlying revenues of 39 per cent; and increase in underlying profit before tax of 19 per cent. Throughout this time, the portfolio has continued to evolve with investments totalling more than £4 billion in product development, acquisitions, capacity and facilities. This establishes a strong platform for long-term growth in revenue and productivity and hence profitability.

The results were affected by the movements in foreign exchange rates through 2010, especially the GBP/USD and the GBP/EUR which are explained in the following section.

The Group has maintained a strong financial position throughout the year and its parent company, Rolls-Royce Group plc, continues to hold strong credit ratings from both Standard & Poor's (A-, Stable) and Moody's (A3, Stable). At the year end, the Group held gross cash balances of £3.2 billion with £1.6 billion of outstanding debt commitments – a net cash position of nearly £1.6 billion with the average net cash position having improved by £336 million to £969 million in 2010.

The maturities of the Group's existing bond facilities, at around £1.6 billion, are well spread with the €750 million Eurobond due in the first half of 2011, as shown in the chart below. The Group had a further £450 million in term funding available to it that was undrawn at the year end. The Group essentially completed the refinancing of the 2011 Eurobond via the successful ten year £500 million GBP bond issued in the first half of 2009, the proceeds of which are currently held on term deposit and will be available to settle the 2011 bond when it falls due. There are no other material maturities until 2013.

MATURITY PROFILE OF THE GROUP DEBT COMMITMENTS (£m)



Foreign exchange effects on published results

Whilst continuing to influence the Group's published results in 2010, currency movements were less distortive than in prior years given that average and spot rates for the GBP/USD and GBP/EUR remained in a relatively narrow range throughout the year, as shown in the table below.

Market exchange rates	2009	**2010**
USD per GBP		
– Year end spot rate	1.615	**1.566**
– Average spot rate	1.566	**1.543**
EUR per GBP		
– Year end spot rate	1.126	**1.167**
– Average spot rate	1.123	**1.167**

These movements have influenced both the reported income statement and the cash flow and closing net cash position (as set out in the cash flow statement and note 2 in the financial statements) in the following ways:

Income statement

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

The impact of this mark to market is included in net financing in the income statement and caused a net £431 million loss, contributing to a published profit before tax of £703 million. These adjustments are non-cash, accounting adjustments required under IAS 39 *Financial Instruments: Recognition and Measurement*. As a result, reported earnings do not reflect the economic substance of derivatives that have been settled in the financial year, but do include the unrealised gains and losses on derivatives that will only affect cash flows when they are settled at some point in the future to match trading cash flows.

Underlying earnings are presented on a basis that shows the economic substance of the Group's hedging strategies in respect of transactional exchange rates and commodity price movements. Further details and information are included within the section on key performance indicators on page 8 and in note 2 of the financial statements.

Underlying profit before tax of £956 million benefited from £74 million of foreign exchange benefits compared to 2009. The achieved rate on selling USD income was around nine cents better in 2010 than 2009 and is expected to improve by a similar level in 2011. In 2010, these better achieved rates contributed £72 million of transactional benefits. In addition, the improvement in the average GBP/USD of three cents contributed net translation benefits totalling £2 million to underlying profit before tax in the year.

Cash flow and balance sheet

The Group maintains a number of currency cash balances which vary throughout the financial year. These net cash balances were improved by the effects of retranslation, causing an improvement of £17 million in the 2010 cash flow and hence the closing balance sheet net cash position.

Summary

The Group's revenues increased by six per cent in 2010 to £11,085 million with 86 per cent of revenues from customers outside the UK. Underlying revenues grew seven per cent in 2010, consisting of a three per cent improvement in original equipment revenues with services growing 13 per cent including double digit services growth in civil aerospace, marine and energy and a five per cent improvement in defence aerospace. Services activities represented 51 per cent of Group underlying revenues in 2010.

- Underlying revenues in the civil aerospace segment grew ten per cent to £4,919 million (2009 £4,481 million) with a 15 per cent improvement in service revenues and a two per cent improvement in revenues from original equipment. New engine deliveries were stable at 846 (2009 844 engines) and included a record 371 V2500 engines for the Airbus A320 family of aircraft, and a small recovery in engine deliveries for corporate and regional applications. Trent deliveries for widebody commercial aircraft totalled 185 engines including a record number, 139 of Trent 700s, for the Airbus A330 aircraft. The overall total was held back by delayed entry into service and slower production ramp up in major new applications, the Boeing 787 and Airbus A380 respectively. Services revenues grew strongly reflecting three key elements: the completion of a spares distribution and logistics arrangement with Aviall Inc, and the disposal of associated spares inventory which contributed around one third of the annual services growth; the effect of better GBP/USD achieved foreign exchange rates which represented around one third of the service improvement; and the ongoing utilisation and some limited recovery in discretionary service activity.

- Underlying defence aerospace revenues grew by six per cent to £2,123 million (2009 £2,010 million) supported by strong growth in deliveries for the military transport sector. Original equipment revenues grew six per cent and services revenues increased by five per cent over 2009. The portfolio proved to be resilient despite some modest effects from the completion of the Strategic Defence and Security Review (SDSR) in the UK and is expected to grow revenues at a similar overall rate in 2011.

- Underlying revenues in the marine business were stable in 2010 at £2,591 million (2009 £2,589 million) reflecting a five per cent decline from original equipment, as the subdued order cycle began to impact deliveries. This was offset by further services growth, with underlying revenues 11 per cent higher in the year benefiting from a growing installed base and new services centres commencing operation around the world.

- The energy business made significant progress again in 2010 with a 20 per cent growth in underlying revenues to £1,233 million (2009 £1,028 million), and is now more than 60 per cent higher than 2008.

Underlying profit margins before financing costs reduced slightly from 9.7 per cent in 2009 to 9.3 per cent in 2010. The reduction in margin reflected changes in revenue mix, higher levels of research and development charges,

increasing costs associated with the launch phase of major new programmes. In addition, the performance reflected the net impact of a number of positive and negative one-off items in the year including the Aviall distribution agreement and costs associated with the Trent 900 failure on an Airbus A380 which offset improvements in operational performance and productivity and the benefits of better achieved foreign exchange rates in the year.

Underlying financing costs reduced by £14 million to £54 million (2009 £68 million), primarily a function of lower finance costs associated with financial risk and revenue sharing partnerships as one of the major arrangements came to an end in late 2009.

Restructuring charges in 2010, totalled £46 million down £9 million from the prior year. These costs are included within operating costs.

The Company paid an interim dividend of £550 million on February 11, 2010.

Order book

The order book at December 31, 2010, at constant exchange rates, has remained resilient at £59.2 billion (2009 £58.3 billion). This included firm business that had been announced but for which contracts had not yet been signed of £4.5 billion (2009 £6.8 billion).

Aftermarket services agreements, including TotalCare® packages, represented 31 per cent of the order book, having increased by more than 40 per cent in the last three years. These are long-term contracts where only the first seven years' revenue is included in the order book.

Aftermarket services

The Group continues to be successful in developing its aftermarket services activities. These grew by 13 per cent on an underlying basis in 2010, reflecting increasing installed base of products across all four markets, expansion of the global services network, especially in the marine sector, and some encouraging signs of improving trends in the discretionary service spend in some large civil engine programmes. Underlying services accounted for 51 per cent of the Group revenues in 2010.

In particular, TotalCare packages in civil aerospace now cover 70 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 £920 million (2009 £970 million).

Cash

There was a cash inflow in the year of £325 million (2009 £183 million outflow) and an improvement in average net cash balances to £969 million (2009 £633 million). A modest increase in underlying profits combined with a strong working capital performance offset more than £800 million in investment in product development, operational facilities and tooling and the acquisition of ODIM ASA in the year.

These total cash investments of £842 million (2009 £688 million) in intangible assets, property, plant and equipment and acquisitions together with dividends of £550 million (2009 nil) and tax payments of £168 million (2009 £119 million) represented the major cash outflows in the period.

The net cash balance at the year end was £1,598 million (2009 £1,273 million).

Taxation

The overall tax charge on the profit before tax was £159 million (2009 £740 million), a rate of 22.6 per cent (2009 25.0 per cent).

The tax charge on underlying profit was £236 million (2009 £187 million) a rate of 24.7 per cent (2009 20.4 per cent).

The overall tax charge was reduced by £29 million in respect of the expected benefit of the UK research and development tax credit. The underlying tax rate is expected to be around 25 per cent in 2011.

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

The Group operates internationally and is subject to tax in many differing jurisdictions. As a consequence, the Group is routinely subject to tax audits and examinations which, by their nature, can take a considerable period to conclude. Provision is made for known issues based on management's interpretation of country-specific legislation and the likely outcome of negotiation or litigation. The Group believes that it has a duty to shareholders to seek

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

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

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

Pensions

The changes made to the Group's UK pension schemes over the last few years have enabled the deficit to remain stable and modest. The charges for pensions are calculated in accordance with the requirements of IAS 19 *Employee Benefits*. The Group's principal UK defined benefit schemes employ a lower risk investment strategy in which the interest rate and inflation risks are largely hedged and the exposure to equities has reduced to less than 20 per cent of scheme assets. As reported last year, the primary objective of the revised investment strategy is to reduce the volatility of the pension schemes to enable greater stability in the funding requirements. Over the last two years our three major defined benefit pension schemes have increased the assumed life expectancy of members and pensioners but, even after allowing for these changes, the overall funding level across these schemes has improved.

Further information and details of the pensions' charge and the defined benefit schemes' assets and liabilities are shown in note 17 to the financial statements. The net deficit, after taking account of deferred tax, was £593 million (2009 £590 million). Changes in this net position are affected by the assumptions made in valuing the liabilities and the market performance of the assets.

Investments

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

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

Gross research and development (R&D) investment amounted to £923 million (2009 £864 million). Net R&D charged to the income statement was £422 million (2009 £379 million). The level of self-funded investment in R&D is expected to remain at approximately four to five per cent of Group revenues in the future. The impact of this investment on the income statement will reflect the mix and maturity of individual development programmes and will result in an increase in the level of net R&D charged within the income statement in 2011.

The continued development and replacement of operational facilities contributed to the total expenditure in property, plant and equipment of £361 million (2009 £291 million). Investment in 2011 is anticipated to increase compared to the 2010 level as the investments in new facilities in the US and Singapore continue.

Investment in training was £33 million (2009 £24 million).

Intangible assets

The Group carried forward £2,884 million (2009 £2,472 million) of intangible assets. This comprised purchased goodwill of £1,108 million, engine certification costs and participation fees of £496 million, development expenditure of £630 million, recoverable engine costs of £346 million and other intangible assets of £304 million. Expenditure on intangible assets is expected to reduce modestly in 2011, largely as a result of the status of development programmes. Intangible assets of £211 million arose during the year as a result of the acquisition of ODIM ASA.

The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain reductions in assumed market share, programme timings, increases in unit cost assumptions and adverse movements in discount rates. There have been no impairments in 2010. Further details are given in note 7 of the financial statements.

Partnerships

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

Joint ventures

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

Risk and revenue sharing partnerships (RRSPs)

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

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

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

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

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

Partners that do not undertake development work or supply components are referred to as financial RRSPs and are accounted for as financial instruments as described in the accounting policies on page 57.

In 2010, the Group received other operating income of £95 million (2009 £89 million).

Payments to RRSPs are recorded within cost of sales and increase as the related programme sales increase. These payments amounted to £198 million (2009 £231 million).

The classification of financial RRSPs as financial instruments has resulted in a liability of £266 million (2009 £363 million) being recorded in the balance sheet and an associated underlying financing cost of £13 million (2009 £25 million) recorded in the income statement.

The Group also receives government launch investment in respect of certain programmes. The treatment of this investment is similar to non-financial RRSPs.

Risk management

The Board has an established, structured approach to risk management. The risk committee (see page 44) has accountability for the system of risk management and reporting the key risks and associated mitigating actions. The Director of Risk reports to the Finance Director. The Group's policy is to preserve the resources upon which its continuing reputation, viability and profitability are built, to enable the corporate objectives to be achieved through the operation of the Rolls-Royce business processes. Risks are formally identified and recorded in a corporate risk register and its subsidiary registers within the businesses. These are reviewed and updated on a regular basis, with risk mitigation plans identified for key risks. Principal risks and uncertainties are identified on pages 12 and 13 and certain financial risks are described below.

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.

During the year, the Group reviewed and amended its credit and short-term cash investment policies to reflect the state of the credit market and to ensure the Group can continue to lay-off market risks associated with its business. As a result, the Group has revised the minimum publicly assigned long-term credit rating requirements for transacting financial instruments with a counterparty from Standard & Poor's 'A-' to 'BBB+' (or the equivalent ratings from Moody's and/or Fitch) to reflect the general lower level of ratings within the banking sector.

Deposits and investments in other debt instruments continue to require a short-term rating from Standard & Poor's of 'A-1' (or the equivalent ratings from Moody's and/or Fitch).

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

All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework described on page 44.

Currency risk

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

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

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

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

i) Revenues and costs are currency matched where it is economic to do so. The Group actively seeks to source suppliers with the relevant currency cost base to avoid the risk or to flow down the risk to those suppliers that are capable of managing it. Currency risk is also a prime consideration when deciding where to locate new facilities. US dollar income converted into sterling represented 19 per cent of Group revenues in 2010 (2009 23 per cent). US dollar income converted into euros represented four per cent of Group revenues in 2010 (2009 two per cent).

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

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 2010, the Group had US$20.9 billion of forward cover (2009 US$18.8 billion).

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates. Note 15 to the financial statements includes the impact of revaluing forward currency contracts at market values on December 31, 2010, showing a negative value of £336 million (2009 negative value of £144 million) which will fluctuate with exchange rates over time. The Group has entered into these forward contracts as part of the hedging policy, described above, in order to mitigate the impact of volatile exchange rates.

Interest rate risk

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

Commodity risk

The Group has an ongoing exposure to the price of jet fuel and base metals arising from business operations. The Group's objective is to minimise the impact of price fluctuations. The exposure is hedged, on a similar basis

to that adopted for currency risks, in accordance with parameters contained in written policies set by the Board.

Counterparty credit risk

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

Funding and liquidity

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

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

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

The Group's borrowing facilities decreased during 2010 following the maturity of a US$187 million US private placement. As at December 31, 2010 the Group had total committed borrowing facilities of £2.0 billion (2009 £2.15 billion). The proceeds of the £500 million GBP bond issue in 2009 are anticipated to be fully used to pay down the debt maturities occurring in 2011. The maturity profile of the borrowing facilities is staggered to ensure that refinancing levels are manageable in the context of the business and market conditions.

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

The Group's £250 million bank revolving credit facility contains a rating price grid, which determines the borrowing margin for a given credit rating. The Group's current borrowing margin would be 20 basis points (bp) over sterling LIBOR if drawn. The borrowing margin on this facility increases by approximately 5bp per one notch rating downgrade, up to a maximum borrowing margin of 55bp. The facility was not drawn during 2010.

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

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

Credit rating

The Group's parent company, Rolls-Royce Group plc, subscribes to both Moody's Investors Service and Standard & Poor's for its official publicised credit ratings. As at December 31, 2010, Rolls-Royce Group plc's assigned long-term credit ratings were:

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

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

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

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 governance section. The contingent liabilities represent the maximum discounted aggregate gross and net exposure that the Group has in respect of delivered aircraft, regardless of the point in time at which such exposures may arise.

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

The permitted levels of gross and net exposure are limited in aggregate, by counterparty, by product type and by calendar year. At the year end, the gross level of commitments on delivered aircraft was US$991 million, comprising US$618 million for AVGs and US$373 million for credit guarantees.

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

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

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

The Group seeks to minimise the level of exposure from sales finance commitments by:

- the use of third-party non-recourse debt where appropriate;
- the transfer, sale, or reinsurance of risks; and
- ensuring the proportionate flow down of risk and exposure to relevant RRSPs.

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

Where exposures arise, the strategy has been, and continues to be, to assume where possible liquid forms of financing commitment that may be sold or transferred to third parties when the opportunity arises. Note 21 to the financial statements describes the Group's contingent liabilities. There were no material changes to the Group's gross and net contingent liabilities during 2010.

Accounting standards

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU. In 2010, the changes that have had the most significant effect on the Group's financial statements are the revisions to IFRS 3 *Business Combinations* and amendments to IAS 27 *Consolidated and Separate Financial Statements*. These amendments affect the accounting for acquisitions and transactions with non-controlling interests and have been applied to the acquisition of ODIM ASA (see note 23 to the financial statements). There is no retrospective impact.

A summary of other less significant changes, and those which have not been adopted in 2010, is included within the accounting policies in note 1 to the financial statements.

Regulatory developments

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

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

Andrew Shilston
Finance Director
February 9, 2011

OTHER MATTERS

BOARD OF DIRECTORS

Sir Simon Robertson
Non-executive Chairman
Chairman of the nominations committee
Sir Simon Robertson was appointed to the Board in 2004. He is the founder member of Simon Robertson Associates LLP and Deputy Chairman of HSBC Holdings plc. He is a non-executive director of Berry Bros & Rudd Limited and The Economist Newspaper Limited. He is a director of The Royal Opera House Covent Garden Limited and a Trustee of The Eden Project and of the Royal Opera House Endowment Fund. He is the former President of Goldman Sachs Europe Limited. He was knighted in the 2010 Queen's Birthday Honours for services to business. Age 69.

Sir John Rose
Chief Executive
A member of the nominations committee
Sir John Rose was appointed to the Board in 1992, having joined Rolls-Royce in 1984. He has been Chief Executive since 1996 and will retire from the Company at the end of March 2011. He is a Trustee of The Eden Project. Age 58.

Helen Alexander CBE
Non-executive director
Chairman of the remuneration committee and a member of the ethics and nominations committees
Helen Alexander CBE was appointed to the Board in September 2007. She is President of the CBI and Chairman of the Port of London Authority and of Incisive Media. She is a non-executive director and chair of the remuneration committee at Centrica plc and senior adviser to Bain Capital. She was CEO of the Economist Group from 1997 to 2008. She is also Chair of the Advisory Council of the Saïd Business School, Oxford; Deputy Chair of the governors of St Paul's Girls' School and a trustee of the World Wide Web Foundation. Age 53.

Peter Byrom
Non-executive director
A member of the ethics and nominations committees
Peter Byrom was appointed to the Board in 1997. He is Chairman of Domino Printing Sciences plc and is a Fellow of the Royal Aeronautical Society. He was a director of AMEC plc from 2005 to 2011 and of NM Rothschild & Sons Limited from 1977 to 1996. Age 66.

Iain C Conn
Non-executive director, Senior Independent Director
A member of the audit and nominations committees
Iain Conn was appointed to the Board in 2005. He has been an executive director of BP p.l.c. since 2004 and is Chief Executive of Refining and Marketing, having previously held a range of executive positions within the BP Group worldwide. He is Chairman of the Advisory Board of The Imperial College Business School. Age 48.

Peter Gregson
Non-executive director
A member of the remuneration and nominations committees
Peter Gregson was appointed to the Board in 2007. He is President and Vice-Chancellor of Queen's University Belfast and serves on the Northern Ireland Economic Development Forum, the Council of CBI Northern Ireland and the Steering Group of the US-Ireland Research and Development Partnership. He is a Fellow of the Royal Academy of Engineering, a Member of the Royal Irish Academy and Deputy Lieutenant of Belfast. He was formerly Professor of Aerospace Materials and Deputy Vice-Chancellor of the University of Southampton and has served on the Councils of the Royal Academy of Engineering and the Central Laboratory of the Research Councils. Age 53.

James Guyette BSc
President and Chief Executive Officer of Rolls-Royce North America Inc.
Jim Guyette was appointed to the Board in 1998 having joined Rolls-Royce in 1997. He is a director of the PrivateBank and Trust Company of Chicago, Illinois and of priceline.com Inc and he is Chairman, National Air & Space Museum, Washington DC. Until 1995 he was Executive Vice President, Marketing and Planning of United Airlines. Age 65.

John McAdam
Non-executive director
A member of the remuneration and nominations committees
John McAdam was appointed to the Board in 2008. He is Chairman of United Utilities Group PLC and of Rentokil Initial plc, the Senior Independent Director of J Sainsbury plc and a non-executive director of Sara Lee Corporation. He was the Chief Executive of ICI plc until ICI's acquisition by Akzo Nobel. Age 62.

John Neill CBE
Non-executive director
A member of the audit and nominations committees
John Neill was appointed to the Board in 2008. He is the Chief Executive of the Unipart Group of Companies. He is a member of the Council and Board of Business in the Community and is a non-executive director of Charter International plc. He is Vice President of the Society of Motor Manufacturers and Traders, BEN, the automotive industry charity and The Institute of the Motor Industry. Age 63.

John Rishton
Non-executive director
John Rishton was appointed to the Board in 2007. He served as Chairman of the audit committee and a member of the ethics and nominations committees until September 30, 2010 when the Board announced that he had been appointed to succeed Sir John Rose as Chief Executive. He will take up that role on March 31, 2011. John Rishton is currently Chief Executive Officer of Royal Ahold. He began his career in 1979 at Ford Motor Company and held a variety of positions both in the UK and in Europe. In 1994 he joined British Airways Plc where he was Chief Financial Officer from 2001 to 2005. He is a former non-executive director of Allied Domecq. Age 52.

Andrew Shilston MA, ACA, MCT
Finance Director
Andrew Shilston was appointed to the Board in 2003 having joined Rolls-Royce in 2002. He was a non-executive director of Cairn Energy PLC until May 2008 and he was Finance Director of Enterprise Oil plc from 1993 until 2002. Age 55.

Colin Smith BSc Hons, FREng, FRAeS, FIMechE
Director – Engineering and Technology
Colin Smith was appointed to the Board in 2005 having joined Rolls-Royce in 1974. He has held a variety of key positions within Engineering including Director – Research and Technology and Director of Engineering and Technology – Civil Aerospace. He is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers. Age 55.

Ian Strachan
Non-executive director
Chairman of the ethics and audit committees and a member of the nominations committee
Ian Strachan was appointed to the Board in 2003. He is a non-executive director of Xstrata plc, Transocean Inc and Caithness Petroleum Limited. He is the former Chief Executive of BTR plc, former Deputy Chief Executive and Chief Financial Officer of Rio Tinto plc, former non-executive Chairman of Instinet Group Inc and former non-executive director of Johnson Matthey plc, Commercial Union and Reuters Group plc. Age 67.

Mike Terrett
Chief Operating Officer
Mike Terrett was appointed to the Board in 2007, having joined Rolls-Royce in 1978. He has held a variety of senior positions in the development of new aero-engine programmes including Managing Director of Airlines and President and Chief Executive Officer of International Aero Engines (IAE) based in the United States. Prior to his appointment as Chief Operating Officer he was President – Civil Aerospace. He is a Member of the Institute of Mechanical Engineers and a Fellow of the Royal Aeronautical Society. Age 54.

Tim Rayner
General Counsel and Company Secretary
Tim Rayner joined Rolls-Royce in 2007 having previously been General Counsel and Company Secretary at United Utilities PLC. Age 50.

At December 31, 2010, all the directors were also directors of Rolls-Royce Group plc, the ultimate parent company. As directors of the ultimate parent company, there is no requirement to disclose their individual remuneration or their interests in the shares of Rolls-Royce group companies in this Annual report, as they are included in the Annual report of Rolls-Royce Group plc.

INTERNAL CONTROL AND RISK MANAGEMENT

The Board – system of internal control and its effectiveness

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

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

Financial reporting

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

The audit committee

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

The committee has responsibility for recommending to the Board the appointment of the external auditors and for reviewing the nature, scope and results of the annual external audit. It also approves the audit fee and, on an annual basis, assesses the effectiveness and independence of the external auditors. A resolution to reappoint the auditors, KPMG Audit Plc, and to authorise the directors to determine the auditors' remuneration, will be proposed at the 2011 Annual General Meeting (AGM). The committee keeps under review the Group's internal controls and systems for assessing and mitigating financial and non-financial risk. It also reviews and approves the business assurance work programme and ensures that this function is adequately resourced and co-ordinated with the work of the external auditors. Twice a year, the committee receives a written report on the reviews conducted throughout the Group by business assurance and reports from senior executives on the key business risks and risk systems in selected sectors.

The risk committee

The Group has established and implemented a sound risk management structure throughout the business that supports programme execution, informs decision making and, ultimately, helps to deliver better business performance.

The risk committee has accountability for the system of risk management and reports annually to the Board on the policy, process and operation of the risk management system and the principal risks facing the Group, including the treatment plans in place to manage them. The risk committee has responsibility for implementing the Board's policies on risk and internal control and reviews the results of the risk management process, which operates at all levels of the Group.

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

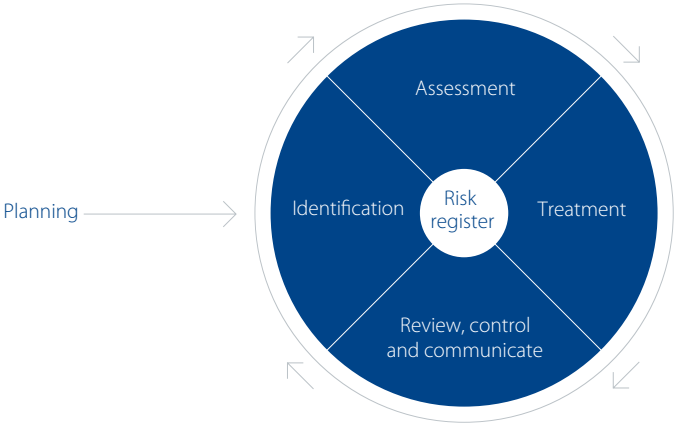
The risk committee has developed a risk policy which states that risk management is a part of every manager's responsibility and is to be embedded within the day-to-day activity.

Risk management process

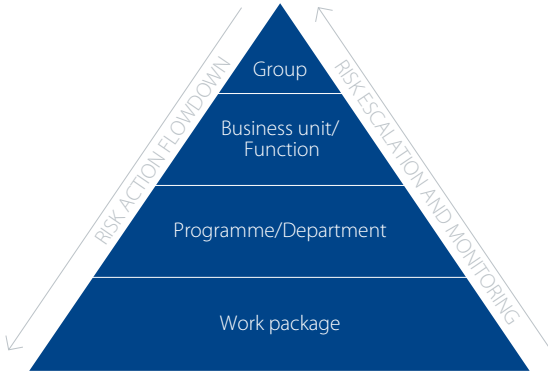
Rolls-Royce takes a proactive approach to the management of risk and recognises the risk management process as fundamental in achieving its business objectives. Throughout the Group, risks are identified, assessed and managed through an established structured approach. The Board has reviewed the risk management process.

Risks are defined as threats to the achievement of business objectives or to the continuing reputation of the Group. As part of the business cycle, each part of the Group is required to identify and record key risks together with appropriate treatment activities. Risks are documented in a framework of risk registers and are regularly reviewed and updated by management.

THE RISK MANAGEMENT PROCESS



THE RISK ESCALATION STRUCTURE



The process provides methods for escalation and aggregation at every level of the business; delegation to the appropriate levels within the organisation ensures that risk and treatment actions are owned, defined, resourced and effective. The top-level corporate risk register is an aggregation of lower-level risk registers from where risks are escalated to be reviewed by the Board. The Board also considers these risks in the context of the Group's business strategy.

This ongoing process has been in place during 2010, up to and including the date of approval of this Annual report contained within it.

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

Risk profile

The Group's risk profile has increased over the past five years which, in part, can be attributed to the increasing maturity of the processes to recognise and formally communicate risks.

The significant risks arising from economic downturn and financial market disruption in that period have been or are being addressed by comprehensive mitigation strategies and plans. The external business environment is challenging and whilst competitive pressures remain high there are some early signs of recovery across all sectors.

Had the Group remained so strongly dependent upon the civil aerospace business, then its exposure to the cyclical downturn in the economy affecting the global demand for air travel would have been much more severe. While it is still possible that there may be a 'double dip' recession, the Group has performed well to date in the recessionary environment. The benefits of a strong aftermarket business, a broad portfolio of products across all businesses and the growing influence of geographical diversification have all been factors in maintaining a strong financial performance. Continued development of the portfolio in areas such as marine, energy and civil nuclear will further mitigate the risk.

Low probability/high impact events that are beyond the range of normal expectations have attracted a substantial degree of focus in 2010. The European sovereign debt crisis threatening the euro, the April eruption of the Eyjafjallajökull volcano in Iceland, which shut down Europe's airspace for six days, and the oil spill in the Gulf of Mexico have together resulted in a much deeper consideration of the risks to organisational resilience.

The reliability of our products remains a significant exposure and recent events have highlighted the negative impact that any deficiencies could have on the Group's reputation. Management attention is on the 'safety first' culture and there is continuing engineering focus on product reliability and service lives.

Principal risks and uncertainties

The 'Principal risks and uncertainties', described in the table on pages 12 and 13, are among those that may have an impact on the Group's performance. This is notwithstanding other risks and uncertainties that are currently unknown to the Group, or which the Group does not presently consider to be material. The principal risks reflect the global nature of the business and the competitive and challenging business environment in which it operates. Risks, including those to the Group's reputation, are considered under four broad headings:

- business environment risks;
- strategic risks;
- financial risks; and
- operational risks.

Continuous improvement of the risk management process

Development, implementation and maintenance of the standard global process is the responsibility of a dedicated Enterprise Risk Management team, part of the Risk function, led by the Director of Risk. The team has created a comprehensive framework for the assessment of risk management process maturity that enables focused improvement actions and drives consistent application of the risk management process throughout all levels of the Group.

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

A global network of risk champions, mentors and facilitators drives the application of the standard process in each part of the business and helps to develop, embed and share best practice throughout the Group.

The risk management process is subject to continuous improvement. Over the past year, training material has been enhanced for all risk roles to ensure consistency of risk management capability for all levels of the organisation. The global uptake of risk training has more than doubled in comparison to 2009.

As the Group broadens its portfolio and enters new territories through organic growth and acquisition, it places increased emphasis on the need to understand the geopolitical risks inherent in the business. Initiatives are underway to formalise, corroborate and respond to these risks.

SHAREHOLDERS AND SHARE CAPITAL

Share capital
Throughout 2010, the Company's authorised share capital was £400 million, comprising 2,000,000,000 ordinary shares of 20p. On December 31, 2010, there were 1,630,996,508 ordinary shares in issue.

The ordinary shares are not listed.

Dividends
An interim dividend of £550 million was paid on February 11, 2010.

OTHER STATUTORY INFORMATION

Political donations
In line with its established policy, the Group made no political donations in 2010.

During the year, the contribution made by a US subsidiary towards the running expenses of a political action committee (PAC) organised by its employees was US$ nil (2009: US$24,636). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act. The Rolls-Royce PAC is independent of the Company and independent of any political party. Its funds are contributed voluntarily by employees and the Company cannot affect how they are applied. Such contributions do not require authorisation by shareholders under the Companies Act 2006 and therefore do not count towards the £25,000 Group company and £50,000 aggregate limits for political donations and expenditure for which shareholder approval will be sought at the AGM.

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

The Company had the equivalent of 60 days' purchases outstanding at December 31, 2010, based on the average daily amount invoiced by suppliers during the year.

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

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

MATERIAL LITIGATION

In 2010, Rolls-Royce commenced an action in the United States against United Technologies Corporation (UTC), the parent company of Pratt & Whitney, alleging that the GP7200 turbofan engine, UTC's geared turbofan engine, and other UTC turbofan engines infringe Rolls-Royce swept fan blade patent. A trial is expected be held in June this year. UTC subsequently commenced proceedings against Rolls-Royce in the United States and in England alleging that Trent 900, Trent 1000 and Trent XWB engines infringe its patent. Judgements in UTC's cases are expected to be handed down between 2012 and 2015.

It is not possible to comment at this stage on the amount of any damages which might be awarded in favour of, or against, Rolls-Royce although an award of damages or the financial effect of other remedies could be material. Rolls-Royce is advised that it has a strong claim against UTC and strong defences in the proceedings brought by UTC.

ANNUAL REPORT AND FINANCIAL STATEMENTS

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

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

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

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of their profit or loss for that period. In preparing each of the Group and parent company financial statements, the directors are required to:

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

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a Directors' report that complies with that law and those regulations.

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

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out on pages 1 to 27 of the business review and a summary of the principal risks affecting the business are shown on pages 12 and 13. The financial position of the Group, its cash flows, liquidity position, borrowing facilities and financial risks are described in pages 34 to 41 of the business review. In addition, notes 1, 12, 13 and 15 of the consolidated financial statements include the Group's objectives, policies and processes for financial risk management, details of its cash and cash equivalents, indebtedness and borrowing facilities and its financial instruments, hedging activities and its exposure to counterparty credit risk, liquidity risk, currency risk, interest rate risk and commodity pricing risk.

As described on page 40, the Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds, notes and finance leases. The chart on page 34 shows the maturity profile of the Group's outstanding debt facilities; a total of £501 million is due to expire in 2011. The Group has a further £450 million of term funding available that is currently undrawn.

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

Disclosure of information to auditors

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

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

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

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

Responsibility statement

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

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

ii) the Directors' report on pages 1 to 49 includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

Tim Rayner
General Counsel and Company Secretary
February 9, 2011

FINANCIAL STATEMENTS

CONSOLIDATED FINANCIAL STATEMENTS

COMPANY FINANCIAL STATEMENTS

SUBSIDIARIES AND JOINT VENTURES

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ROLLS-ROYCE plc

We have audited the financial statements of Rolls-Royce plc for the year ended December 31, 2010 set out on pages 52 to 123. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' responsibilities statement set out on page 48, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's website at www.frc.org.uk/apb/scope/UKP.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at December 31, 2010 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice;
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006; and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion, the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

A J Sykes (Senior Statutory Auditor)
for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
London
E14 5GL
February 9, 2011

CONSOLIDATED INCOME STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2010

	Notes	2010 £m	2009 £m
Revenue	2	**11,085**	10,414
Cost of sales		**(8,885)**	(8,303)
Gross profit		**2,200**	2,111
Other operating income		**95**	89
Commercial and administrative costs		**(836)**	(740)
Research and development costs		**(422)**	(379)
Share of results of joint ventures and associates	9	**93**	93
Operating profit		**1,130**	1,174
Profit/(loss) on disposal of businesses	23	**4**	(2)
Profit before financing and taxation	2	**1,134**	1,172
Financing income	3	**453**	2,276
Financing costs	3	**(884)**	(491)
Net financing		**(431)**	1,785
Profit before taxation		**703**	2,957
Taxation	4	**(159)**	(740)
Profit for the year		**544**	2,217
Attributable to:			
Ordinary shareholders		**540**	2,221
Non-controlling interests		**4**	(4)
Profit for the year		**544**	2,217

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED DECEMBER 31, 2010

	Notes	2010 £m	2009 £m
Profit for the year		**544**	2,217
Other comprehensive income (OCI)			
Foreign exchange translation differences on foreign operations		**22**	(156)
Net actuarial gains/(losses) relating to post-employment schemes	17	**157**	(1,148)
Movement in unrecognised post-retirement surplus	17	**(300)**	707
Movement in post-retirement minimum funding liability	17	**49**	40
Transfers from transition hedging reserve		**–**	(27)
Share of OCI of joint ventures and associates	9	**(16)**	20
Related tax movements	4	**29**	141
Total comprehensive income for the year		**485**	1,794
Attributable to:			
Ordinary shareholders		**481**	1,799
Non-controlling interests		**4**	(5)
Total comprehensive income for the year		**485**	1,794

CONSOLIDATED BALANCE SHEET

AT DECEMBER 31, 2010

	Notes	2010 £m	2009 £m
ASSETS			
Non-current assets			
Intangible assets	7	**2,884**	2,472
Property, plant and equipment	8	**2,136**	2,009
Investments – joint ventures and associates	9	**393**	437
Investments – other	9	**11**	58
Other financial assets	15	**371**	637
Deferred tax assets	4	**451**	360
Post-retirement scheme surpluses	17	**164**	75
		6,410	6,048
Current assets			
Inventories	10	**2,429**	2,432
Trade and other receivables	11	**3,943**	3,948
Taxation recoverable		**6**	12
Other financial assets	15	**250**	80
Short-term investments		**328**	2
Cash and cash equivalents	12	**2,858**	2,960
Assets held for sale		**9**	9
		9,823	9,443
Total assets		**16,233**	15,491
LIABILITIES			
Current liabilities			
Borrowings	13	**(651)**	(126)
Other financial liabilities	15	**(82)**	(168)
Trade and other payables	14	**(6,160)**	(5,628)
Current tax liabilities		**(170)**	(167)
Provisions for liabilities and charges	16	**(276)**	(210)
		(7,339)	(6,299)
Non-current liabilities			
Borrowings	13	**(1,135)**	(1,787)
Other financial liabilities	15	**(945)**	(868)
Trade and other payables	14	**(1,271)**	(1,145)
Deferred tax liabilities	4	**(438)**	(366)
Provisions for liabilities and charges	16	**(268)**	(232)
Post-retirement scheme deficits	17	**(1,020)**	(930)
		(5,077)	(5,328)
Total liabilities		**(12,416)**	(11,627)
Net assets		**3,817**	3,864
EQUITY			
Equity attributable to ordinary shareholders			
Called-up share capital	18	**326**	326
Share premium account		**631**	631
Hedging reserves		**(37)**	(19)
Translation reserve		**524**	503
Retained earnings		**2,369**	2,423
		3,813	3,864
Non-controlling interests		**4**	–
Total equity		**3,817**	3,864

The financial statements on pages 52 to 101 were approved by the Board on February 9, 2011 and signed on its behalf by:

Sir Simon Robertson Chairman

Andrew Shilston Finance Director

CONSOLIDATED CASH FLOW STATEMENT

FOR THE YEAR ENDED DECEMBER 31, 2010

	Notes	2010 £m	2009 £m
Reconciliation of cash flows from operating activities			
Profit before taxation		**703**	2,957
Share of results of joint ventures and associates	9	**(93)**	(93)
(Profit)/loss on disposal of businesses	23	**(4)**	2
Profit on disposal of property, plant and equipment		**(10)**	(40)
Net financing	3	**431**	(1,785)
Taxation paid		**(168)**	(119)
Amortisation of intangible assets	7	**130**	121
Depreciation of property, plant and equipment	8	**237**	194
Impairment of investments	9	**3**	–
Increase in provisions		**99**	81
Decrease in inventories		**41**	119
Decrease/(increase) in trade and other receivables		**90**	(85)
Increase/(decrease) in trade and other payables		**527**	(364)
Increase in other financial assets and liabilities		**(298)**	(303)
Additional cash funding of post-retirement schemes		**(135)**	(159)
Share-based payments	19	**50**	31
Transfers of hedge reserves to income statement	15	**–**	(27)
Dividends received from joint ventures and associates	9	**68**	77
Net cash inflow from operating activities		**1,671**	607
Cash flows from investing activities			
Additions of unlisted investments		**(1)**	(2)
Disposals of unlisted investments		**46**	–
Additions of intangible assets		**(321)**	(339)
Disposals of intangible assets		**–**	2
Purchases of property, plant and equipment		**(354)**	(258)
Disposals of property, plant and equipment		**38**	82
Acquisitions of businesses	23	**(150)**	(7)
Disposals of businesses	23	**2**	3
Investments in joint ventures and associates		**(19)**	(87)
Net cash outflow from investing activities		**(759)**	(606)
Cash flows from financing activities			
Repayment of loans		**(108)**	(10)
Proceeds from increase in loans		**2**	693
Capital element of finance lease payments		**–**	(3)
Net cash flow from (decrease)/increase in borrowings		**(106)**	680
Interest received		**11**	24
Interest paid		**(64)**	(66)
Interest element of finance lease payments		**–**	(1)
Increase in short-term investments		**(326)**	(1)
Dividends paid		**(550)**	–
Net cash (outflow)/inflow from financing activities		**(1,035)**	636
Net (decrease)/increase in cash and cash equivalents		**(123)**	637
Cash and cash equivalents at January 1		**2,956**	2,460
Exchange gains/(losses) on cash and cash equivalents		**17**	(141)
Cash and cash equivalents at December 31		**2,850**	2,956

CONSOLIDATED CASH FLOW STATEMENT (CONTINUED)

FOR THE YEAR ENDED DECEMBER 31, 2010

	2010 £m	2009 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
(Decease)/increase in cash and cash equivalents	**(123)**	637
Net cash flow from decrease/(increase) in borrowings	**106**	(680)
Cash outflow from increase in short-term investments	**326**	1
Change in net funds resulting from cash flows	**309**	(42)
Net funds (excluding cash and cash equivalents) of businesses acquired	**(1)**	–
Exchange gains/(losses) on net funds	**17**	(141)
Fair value adjustments	**26**	110
Movement in net funds	**351**	(73)
Net funds at January 1 excluding the fair value of swaps	**1,049**	1,122
Net funds at December 31 excluding the fair value of swaps	**1,400**	1,049
Fair value of swaps hedging fixed rate borrowings	**198**	224
Net funds at December 31	**1,598**	1,273

The movement in net funds (defined by the Group as including the items shown below) is as follows:

	At January 1, 2010 £m	Funds flow £m	Net funds of businesses acquired £m	Exchange differences £m	Fair value adjustments £m	Reclassi–fications £m	At December 31, 2010 £m
Cash at bank and in hand	**1,238**	**385**		**23**	**–**	**–**	**1,646**
Overdrafts	**(4)**	**(4)**		**–**	**–**	**–**	**(8)**
Short-term deposits	**1,722**	**(504)**		**(6)**	**–**	**–**	**1,212**
Cash and cash equivalents	**2,956**	**(123)**		**17**	**–**	**–**	**2,850**
Short-term investments	**2**	**326**	**–**	**–**	**–**	**–**	**328**
Other current borrowings	**(122)**	**108**	**–**	**–**	**59**	**(688)**	**(643)**
Non-current borrowings	**(1,786)**	**(2)**	**(1)**	**–**	**(33)**	**688**	**(1,134)**
Finance leases	**(1)**	**–**	**–**	**–**	**–**	**–**	**(1)**
	1,049	**309**	**(1)**	**17**	**26**	**–**	**1,400**
Fair value of swaps hedging fixed rate borrowings	**224**				**(26)**		**198**
	1,273	**309**	**(1)**	**17**	**–**	**–**	**1,598**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED DECEMBER 31, 2010

	Notes	Attributable to ordinary shareholders: Share capital £m	Share premium £m	Hedging reserves[1] £m	Translation reserve £m	Retained earnings £m	Total £m	Non-controlling interests £m	Total equity £m
At January 1, 2009		326	631	(22)	660	454	2,049	9	2,058
Profit for the year		–	–	–	–	2,221	2,221	(4)	2,217
Foreign exchange translation differences on foreign operations		–	–	–	(155)	–	(155)	(1)	(156)
Net actuarial losses relating to post-retirement schemes		–	–	–	–	(1,148)	(1,148)	–	(1,148)
Movement in unrecognised post-retirement surplus		–	–	–	–	707	707	–	707
Movement in post-retirement minimum funding liability		–	–	–	–	40	40	–	40
Transfers from transition hedging reserve		–	–	(27)	–	–	(27)	–	(27)
Share of OCI of joint ventures and associates [2]		–	–	22	(2)	–	20	–	20
Related tax movements		–	–	8	–	133	141	–	141
Total comprehensive income for the year		**–**	**–**	**3**	**(157)**	**1,953**	**1,799**	**(5)**	**1,794**
Share-based payments – direct to equity [3]		–	–	–	–	15	15	–	15
Transactions with non-controlling interests		–	–	–	–	–	–	(4)	(4)
Related tax movements	4	–	–	–	–	1	1	–	1
Other changes in equity in the year		**–**	**–**	**–**	**–**	**16**	**16**	**(4)**	**12**
At January 1, 2010		**326**	**631**	**(19)**	**503**	**2,423**	**3,864**	**–**	**3,864**
Profit for the year		–	–	–	–	540	540	4	544
Foreign exchange translation differences on foreign operations		–	–	–	22	–	22	–	22
Net actuarial gains relating to post-retirement schemes		–	–	–	–	157	157	–	157
Movement in unrecognised post-retirement surplus		–	–	–	–	(300)	(300)	–	(300)
Movement in post-retirement minimum funding liability		–	–	–	–	49	49	–	49
Share of OCI of joint ventures and associates [2]		–	–	(18)	1	1	(16)	–	(16)
Related tax movements		–	–	–	(2)	31	29	–	29
Total comprehensive income for the year		**–**	**–**	**(18)**	**21**	**478**	**481**	**4**	**485**
Dividend paid		–	–	–	–	(550)	(550)	–	(550)
Share-based payments – direct to equity [3]		–	–	–	–	13	13	–	13
Related tax movements	4	–	–	–	–	5	5	–	5
Other changes in equity in the year		**–**	**–**	**–**	**–**	**(532)**	**(532)**	–	**(532)**
At December 31, 2010		**326**	**631**	**(37)**	**524**	**2,369**	**3,813**	**4**	**3,817**

[1] See accounting policies note 1 – hedge accounting. Hedging reserves include **nil** (2009 nil, 2008 £19m) in respect of the transition hedging reserve and **£(37)m** (2009 £(19), 2008 £(41)m) in respect of the cash flow hedging reserve.

[2] Certain of the Group's joint ventures and associates hold interest rate and inflation swaps for which cash flow hedge accounting has been adopted.

[3] The share based payment – direct to equity is the net of the credit to equity in respect of the share-based payment charge to the income statement and the actual cost to the Group.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES

The Company

Rolls-Royce plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended December 31, 2010 comprise the Company and its subsidiaries (together referred to as the 'Group') and the Group's interest in jointly controlled and associated entities. The financial statements were authorised for issue by the directors on February 9, 2011.

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, 2010 (Adopted IFRS). The Company has elected to prepare its parent company accounts under UK Generally Accepted Accounting Practices (GAAP).

The financial statements have been prepared on the historical cost basis except where Adopted IFRS requires the revaluation of financial instruments to fair value and certain other assets and liabilities on an alternative basis – most significantly post-retirement scheme liabilities are valued on the basis required by IAS 19.

The Group's significant accounting policies are set out below. These accounting policies have been applied consistently to all periods presented in these consolidated financial statements and by all Group entities.

The preparation of financial statements in conformity with Adopted IFRS requires the use of certain critical accounting estimates and judgements.

The directors consider the potential key areas of judgements required to be made in applying the Group's accounting policies to be:

- A large proportion of the Group's activities relate to long-term aftermarket contracts. The determination of appropriate accounting policies for recognising revenue and costs in respect of these contracts requires judgement, in particular (i) whether an aftermarket contract is linked, for accounting purposes, to the related sale of original equipment and (ii) the appropriate measure of stage of completion of the contract.
- Where the Group participates in the financing of original equipment, judgement is required to determine whether revenue should be recognised or whether the transaction results in the consolidation of a special purpose financing entity.
- As set out in note 7, the Group has significant intangible assets. The decision as to when to commence capitalisation of development costs and whether sales of original equipment give rise to recognisable recoverable engine costs is a key judgement.
- As set out in note 21, the Group has contingent liabilities in respect of financing support provided to customers. Judgement is required to assess the likelihood of these crystallising, in order to assess whether a provision should be recognised.

Key sources of estimation uncertainty in applying the Group's accounting policies are described on page 62.

Basis of consolidation

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

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

A joint venture is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more other venturers under a contractual arrangement. An associate is an entity, being neither a subsidiary nor a joint venture, in which the Group holds a long-term interest and where the Group has a significant influence. The results of joint ventures and associates are accounted for using the equity method of accounting.

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

All intra-group transactions, balances, income and expenses are eliminated on consolidation. Adjustments are made to eliminate the profit or loss arising on transactions with joint ventures and associates to the extent of the Group's interest in the entity.

1 ACCOUNTING POLICIES (CONTINUED)

Significant accounting policies

Revenue recognition

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

Sales of products are recognised when the significant risks and rewards of ownership of the goods are transferred to the customer, the sales price agreed and the receipt of payment can be assured. On occasion, the Group may participate in the financing of engines in conjunction with airframe manufacturers, most commonly by the provision of guarantees as described in note 21. In such circumstances, the contingent obligations arising under these arrangements are taken into account in assessing whether significant risks and rewards of ownership have been transferred to the customer. Where it is judged that sufficient risks and rewards are not transferred, the transaction is treated as a leasing transaction, resulting in an operating lease between the Group and the customer. No deliveries of engines were treated as operating leases during 2010. Depending on the specific circumstances, where applicable, the financing arrangements may result in the consolidation of the entity established to facilitate the financing. Such special purpose entities will be consolidated as required by Adopted IFRS. No such entities were consolidated at December 31, 2010.

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

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

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

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

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

Risk and revenue sharing partnerships (RRSPs)

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

The Group has arrangements with partners who do not undertake development work or supply parts. Such arrangements are considered to be financial instruments as defined by IAS 32 *Financial Instruments: Presentation* and are accounted for using the amortised cost method.

Government investment

Where a government or similar body has previously invested in a development programme, the Group treats payments to that body as royalty payments, which are matched to related sales.

Government grants

Government grants are recognised in the income statement so as to match them with the related expenses that they are intended to compensate. Where grants are received in advance of the related expenses, they are included in the balance sheet as deferred income. Non-monetary grants are recognised at fair value.

Interest

Interest receivable/payable is credited/charged to the income statement using the effective interest method. Where borrowing costs are attributable to the acquisition, construction or production of a qualifying asset, such costs are capitalised as part of the specific asset.

1 ACCOUNTING POLICIES (CONTINUED)

Taxation
The tax charge on the profit or loss for the year comprises current and deferred tax. Current tax is the expected tax payable for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

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

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax is not recognised on taxable temporary differences arising on the initial recognition of goodwill or for temporary differences arising from the initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit.

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

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

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

The trading results of overseas undertakings are translated at the average exchange rates for the year. The assets and liabilities of overseas undertakings, including goodwill and fair value adjustments arising on acquisition, are translated at the exchange rates ruling at the year end. Exchange adjustments arising from the retranslation of the opening net investments, and from the translation of the profits or losses at average rates, are taken to equity.

Financial instruments
IAS 39 *Financial Instruments: Recognition and Measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different. The Group has classified its financial instruments as follows:

- Short-term investments are classified as available for sale, if designated upon initial recognition.
- Short-term deposits (principally comprising funds held with banks and other financial institutions), trade receivables and short-term investments not designated as available for sale are classified as loans and receivables.
- Borrowings, trade payables, financial RRSPs and C Shares are classified as other liabilities.
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading.

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

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

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

1 ACCOUNTING POLICIES (CONTINUED)

Hedge accounting

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

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

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

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

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

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

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

Until December 31, 2004, and as allowed by IFRS 1 *First-time Adoption of International Financial Reporting Standards*, the Group applied hedge accounting for forecast foreign exchange transactions and commodity exposures in accordance with UK GAAP. On January 1, 2005, the fair values of derivatives used for hedging these exposures were included in the transition hedging reserve. This reserve was released to the income statement based on the designation of the hedges on January 1, 2005. The reserve was fully utilised in 2009.

Purchased goodwill

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

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

Certification costs and participation fees

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

Research and development

In accordance with IAS 38 *Intangible Assets*, expenditure incurred on research and development, excluding known recoverable amounts on contracts, and contributions to shared engineering programmes, is distinguished as relating either to a research phase or to a development phase.

All research phase expenditure is charged to the income statement. For development expenditure, this is capitalised as an internally generated intangible asset only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits.

Expenditure that cannot be classified into these two categories is treated as being incurred in the research phase. The Group considers that, due to the complex nature of new equipment programmes, it is not possible to distinguish reliably between research and development activities until relatively late in the programme.

Expenditure capitalised is amortised over its useful economic life, up to a maximum of 15 years from the entry into service of the product.

1 ACCOUNTING POLICIES (CONTINUED)

Recoverable engine costs
On occasion, the Group may sell original equipment to customers at a price below its cost, on the basis that this deficit will be recovered from future aftermarket sales to the original customer. Where the Group has a contractual right to supply aftermarket parts to the customer and its intellectual rights, warranty arrangements and statutory airworthiness requirements provide reasonable control over this supply, these arrangements are considered to meet the definition of an intangible asset. Such intangible assets are recognised to the extent of the deficit and amortised on a straight-line basis over the expected period of utilisation by the original customer.

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

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

Depreciation is provided on a straight-line basis to write off the cost, less the estimated residual value, of property, plant and equipment over their estimated useful lives. No depreciation is provided on assets in the course of construction. Estimated useful lives are as follows:

i) Land and buildings, as advised by the Group's professional advisors:
   a) Freehold buildings – five to 45 years (average 24 years).
   b) Leasehold buildings – lower of advisor's estimates or period of lease.
   c) No depreciation is provided on freehold land.
ii) Plant and equipment – five to 25 years (average 13 years).
iii) Aircraft and engines – five to 20 years (average 16 years).

Leases
i) As lessee: Assets financed by leasing agreements that give rights approximating to ownership (finance leases) are capitalised at their fair value and depreciation is provided on the basis of the Group depreciation policy. The capital elements of future obligations under finance leases are included as liabilities in the balance sheet and the current year's interest element, having been allocated to accounting periods to give a constant periodic rate of charge on the outstanding liability, is charged to the income statement. The annual payments under all other lease arrangements, known as operating leases, are charged to the income statement on a straight-line basis.

ii) As lessor: Amounts receivable under finance leases are included within receivables and represent the total amount outstanding under the lease agreements less unearned income. Finance lease income, having been allocated to accounting periods to give a constant periodic rate of return on the net investment, is included in revenue. Rentals receivable under operating leases are included in revenue on a straight-line basis.

Impairment of non-current assets
Impairment of non-current assets is considered in accordance with IAS 36 *Impairment of Assets*. Where the asset does not generate cash flows that are independent of other assets, impairment is considered for the cash-generating unit to which the asset belongs.

Goodwill and intangible assets not yet available for use are tested for impairment annually. Other intangible assets and property, plant and equipment are assessed for any indications of impairment annually. If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

Recoverable amount is the higher of value in use or fair value less costs to sell, if this is readily available. The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense.

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

1 ACCOUNTING POLICIES (CONTINUED)

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

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

Post-retirement benefits
Pensions and similar benefits (principally healthcare) are accounted for under IAS 19 *Employee Benefits*. For defined benefit plans, obligations are measured at discounted present value whilst plan assets are recorded at fair value. The service and financing costs of such plans are recognised separately in the income statement; current service costs are spread systematically over the lives of employees and financing costs are recognised in the periods in which they arise. Actuarial gains and losses are recognised immediately in the statement of comprehensive income.

Surpluses in schemes are recognised as assets only if they represent economic benefits available to the Group in the future. A liability is recognised to the extent that the minimum funding requirements in respect of past service will give rise to an unrecognisable surplus. Movements in unrecognised surpluses and minimum funding liabilities are included in the statement of comprehensive income.

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

Share-based payments
The Group provides share-based payment arrangements to certain employees. These are principally equity-settled arrangements and are measured at fair value (excluding the effect of non-market based vesting conditions) at the date of grant. The fair value is expensed on a straight-line basis over the vesting period. The amount recognised as an expense is adjusted to reflect the actual number of shares or options that will vest, except where additional shares vest as a result of the Total Shareholder Return (TSR) performance condition in the Performance Share Plan.

Cash-settled share options (grants in the International ShareSave plan) are measured at fair value at the balance sheet date. The Group recognises a liability at the balance sheet date based on these fair values, taking into account the estimated number of options that will actually vest and the relative completion of the vesting period. Changes in the value of this liability are recognised in the income statement for the year.

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

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

See note 19 for a further description of the share-based payment plans.

Contingent liabilities
In connection with the sale of its products, the Group will, on occasion, provide financing support for its customers. These arrangements fall into two categories; credit-based guarantees and asset-value guarantees. In accordance with the requirements of IAS 39 and IFRS 4 *Insurance Contracts*, credit-based guarantees are treated as insurance contracts. The Group considers asset-value guarantees to be non-financial liabilities and accordingly these are also treated as insurance contracts. Provision is made as described above.

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

Key sources of estimation uncertainty
In applying the above accounting policies, management has made appropriate estimates in many areas, and the actual outcome may differ from those calculated. The key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are set out overleaf. The estimation of the relevant assets and liabilities involves the combination of a number of assumptions. Where appropriate and practicable, sensitivities are disclosed in the relevant notes.

1 ACCOUNTING POLICIES (CONTINUED)

Current economic environment
The current economic environment could impact a number of estimates necessary to prepare the financial statements, in particular, the recoverable amount of assets and contingent liabilities. The Group has taken these factors into account in assessing the estimates set out below. These matters are discussed in more detail in the Finance Director's review.

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

- The assessment whether there are any indications of impairment of development, participation, certification and recoverable engine costs recognised as intangible assets are dependent on forecasts of cash flows generated by the relevant assets. (Carrying values at December 31, 2010 £1,472m, December 31, 2009 £1,290m.)
- The financial liabilities arising from financial risk and revenue sharing partnerships are valued at each reporting date using the amortised cost method. (Carrying values at December 31, 2010 £266m, December 31, 2009 £363m.) This involves calculating the present value of the forecast cash flows of the arrangement using the internal rate of return at the inception of the arrangement as the discount rate.
- The realisation of the deferred tax assets (carrying value at December 31, 2010 £451m, December 31, 2009 £360m) recognised is dependent on the generation of sufficient future taxable profits. The Group recognises deferred tax assets where it is more likely than not that the benefit will be realised.

Assessment of long-term contractual arrangements
The Group has long-term contracts that fall into different accounting periods. In assessing the allocation of revenues and costs to individual accounting periods, and the consequential assets and liabilities, the Group estimates the total revenues and costs forecast to arise in respect of the contract and the stage of completion based on an appropriate measure of performance as described under revenue recognition on page 60.

Post-retirement benefits
The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19. The accounting valuation, which was based on assumptions determined with independent actuarial advice, resulted in a net deficit of £856m before deferred taxation being recognised on the balance sheet at December 31, 2010 (December 31, 2009 £855m). The size of the net deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 17.

Provisions
As described in the accounting policy above, the Group measures provisions (carrying value at December 31, 2010 £544m, December 31, 2009 £442m) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates are made, taking account of information available and different possible outcomes.

Taxation
The tax payable on profits is determined based on tax laws and regulations that apply in each of the numerous jurisdictions in which the Group operates. Where the precise impact of these laws and regulations is unclear then reasonable estimates may be used to determine the tax charge included in the financial statements. If the tax eventually payable or reclaimable differs from the amounts originally estimated then the difference will be charged or credited in the financial statements for the year in which it is determined.

Revisions to Adopted IFRS in 2010
In 2010, the Group has adopted Revised IFRS 3 *Business Combinations* (including Amendments to IFRS 3 in Improvements to IFRS (2009) and amendments to IAS 27 *Consolidated and Separate Financial Statements* were applicable for 2010. The acquisition of ODIM ASA (see note 23) has been accounted for in accordance with the requirements of Revised IFRS 3. There was no retrospective impact.

No other revisions to Adopted IFRS that became applicable in 2010 had a significant impact on the Group's financial statements.

Revisions to IFRS not applicable in 2010
Standards and interpretations issued by the IASB are only applicable if endorsed by the EU. If endorsed, IFRS 9 *Financial Instruments* will be applicable from 2013. If endorsed, this standard will simplify the classification of financial assets for measurement purposes, but is not anticipated to have a significant impact on the financial statements.

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

2 SEGMENTAL ANALYSIS

The analysis by business segment is presented in accordance with IFRS 8 *Operating segments*, on the basis of those segments whose operating results are regularly reviewed by the Board (the Chief Operating Decision Maker as defined by IFRS 8), as follows:

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

Engineering and Technology, Operations and Services discussed in the business review operate on a Group-wide basis across all the above segments.

The operating results are prepared on an underlying basis that excludes items considered to be non-underlying in nature. The principles adopted are:

Underlying revenues – Where revenues are denominated in a currency other than the functional currency of the Group undertaking, these reflect the achieved exchange rates arising on settled derivative contracts and exclude the release of the foreign exchange transition hedging reserve. There is no inter-segment trading and hence all revenues are from external customers.

Underlying profit before financing – Where transactions are denominated in a currency other than the functional currency of the Group undertaking, this reflects the transactions at the achieved exchange rates on settled derivative contracts and excludes the release of the foreign exchange transition hedging reserve.

Underlying profit before taxation – In addition to those adjustments in underlying profit before financing:

- Includes amounts realised from settled derivative contracts and revaluation of relevant assets and liabilities to exchange rates forecast to be achieved from future settlement of derivative contracts.
- Excludes unrealised amounts arising from revaluations required by IAS 39 *Financial Instruments: Recognition and Measurement*, changes in value of financial RRSP contracts arising from changes in forecast payments and the net impact of financing costs related to post-employment scheme benefits.

2 SEGMENTAL ANALYSIS (CONTINUED)

This analysis also includes a reconciliation of the underlying results to those reported in the consolidated income statement.

Year ended December 31, 2010	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Total reportable segments £m
Underlying revenue from sale of original equipment	**1,892**	**1,020**	**1,719**	**691**	**5,322**
Underlying revenue from aftermarket services	**3,027**	**1,103**	**872**	**542**	**5,544**
Total underlying revenue	**4,919**	**2,123**	**2,591**	**1,233**	**10,866**
Underlying operating profit excluding share of results of joint ventures and associates	**315**	**300**	**330**	**18**	**963**
Share of results of joint ventures and associates	**77**	**9**	**2**	**5**	**93**
Profit on disposal of businesses	**–**	**–**	**–**	**4**	**4**
Underlying profit before financing and taxation	**392**	**309**	**332**	**27**	**1,060**
Segment assets	**7,783**	**1,361**	**2,360**	**1,154**	**12,658**
Investments in joint ventures and associates	**372**	**(15)**	**6**	**30**	**393**
Segment liabilities	**(5,528)**	**(1,915)**	**(1,608)**	**(774)**	**(9,825)**
Net assets	**2,627**	**(569)**	**758**	**410**	**3,226**
Investment in intangible assets, property, plant and equipment and joint ventures and associates	**568**	**53**	**65**	**16**	**702**
Depreciation and amortisation	**246**	**35**	**58**	**28**	**367**

Year ended December 31, 2009					
Underlying revenue from sale of original equipment	1,855	964	1,804	558	5,181
Underlying revenue from aftermarket services	2,626	1,046	785	470	4,927
Total underlying revenue	4,481	2,010	2,589	1,028	10,108
Underlying operating profit excluding share of results of joint ventures and associates	409	247	263	23	942
Share of results of joint ventures and associates	82	6	–	5	93
Profit/(loss) on disposal of businesses	2	–	–	(4)	(2)
Underlying profit before financing and taxation	493	253	263	24	1,033
Segment assets	7,369	1,181	2,321	1,007	11,878
Investments in joint ventures and associates	271	62	77	27	437
Segment liabilities	(4,907)	(1,572)	(1,737)	(492)	(8,708)
Net assets	2,733	(329)	661	542	3,607
Investment in intangible assets, property, plant and equipment and joint ventures and associates	522	56	122	20	720
Depreciation and amortisation	209	34	46	26	315

As noted in the Finance Director's review on page 36, 2010 profit before financing for civil aerospace includes a charge associated with the Trent 900 failure on an Airbus A380. This has reduced profit before financing by £56m.

2 SEGMENTAL ANALYSIS (CONTINUED)

Reconciliation to reported results

Year ended December 31, 2010	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Revenue from sale of original equipment	**5,322**	**–**	**5,322**	**112**	**5,434**
Revenue from aftermarket services	**5,544**	**–**	**5,544**	**107**	**5,651**
Total revenue	**10,866**	**–**	**10,866**	**219**	**11,085**
Operating profit excluding share of results of joint ventures and associates	**963**	**(50)**[1]	**913**	**124**	**1,037**
Share of results of joint ventures and associates	**93**	**–**	**93**	**–**	**93**
Profit on disposal of businesses	**4**	**–**	**4**	**–**	**4**
Profit before financing and taxation	**1,060**	**(50)**	**1,010**	**124**	**1,134**
Net financing		**(54)**	**(54)**	**(377)**	**(431)**
Profit before taxation		**(104)**	**956**	**(253)**	**703**
Taxation		**(236)**	**(236)**	**77**	**(159)**
Profit for the year		**(340)**	**720**	**(176)**	**544**

Year ended December 31, 2009					
Revenue from sale of original equipment	5,181	–	5,181	128	5,309
Revenue from aftermarket services	4,927	–	4,927	178	5,105
Total revenue	10,108	–	10,108	306	10,414
Operating profit excluding share of results of joint ventures and associates	942	(50)[1]	892	189	1,081
Share of results of joint ventures and associates	93	–	93	–	93
Loss on disposal of businesses	(2)	–	(2)	–	(2)
Profit before financing and taxation	1,033	(50)	983	189	1,172
Net financing		(68)	(68)	1,853	1,785
Profit before taxation		(118)	915	2,042	2,957
Taxation		(187)	(187)	(553)	(740)
Profit for the year		(305)	728	1,489	2,217

[1] Central corporate costs

Underlying adjustments

	2010				2009			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**10,866**	**1,010**	**(54)**	**(236)**	10,108	983	(68)	(187)
Release of transition hedging reserve	**–**	**–**	**–**	**–**	27	27	–	–
Recognise revenue at exchange rate on date of transaction	**219**	**–**	**–**	**–**	279	–	–	–
Realised losses/(gains) on settled derivative contracts [1]	**–**	**180**	**(7)**	**–**	–	274	60	–
Net unrealised fair value changes to derivative contracts [2]	**–**	**–**	**(341)**	**–**	–	14	1,835	–
Effect of currency on contract accounting	**–**	**(56)**	**–**	**–**	–	(126)	–	–
Revaluation of trading assets and liabilities	**–**	**–**	**8**	**–**	–	–	(17)	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	**–**	**–**	**(6)**	**–**	–	–	72	–
Net post-retirement scheme financing	**–**	**–**	**(31)**	**–**	–	–	(97)	–
Related tax effect	**–**	**–**	**–**	**77**	–	–	–	(553)
Total underlying adjustments	**219**	**124**	**(377)**	**77**	306	189	1,853	(553)
Reported per consolidated income statement	**11,085**	**1,134**	**(431)**	**(159)**	10,414	1,172	1,785	(740)

[1] Realised losses/(gains) on settled derivative contracts included in profit before tax:
– includes £2m of realised losses (2009 £15m) deferred from prior years;
– excludes £5m of losses (2009 gains of £6m) realised in the year on derivative contracts settled in respect of trading cash flows that occurred after the year-end and £7m of losses (2009 nil) recognised in prior years in respect of cancelled contracts;
– excludes £10m of realised gains (2009 nil) in respect of derivatives held in fair value hedges and nil (2009 £14m realised losses) in respect of derivatives held in net investment hedges.

[2] The adjustment for unrealised fair value changes included in profit before financing includes the reversal of nil (2009 £5m unrealised gains) in respect of derivative contracts held by joint venture companies and nil (2009 £9m unrealised losses) for which the related trading contracts have been cancelled and consequently the fair value loss has been recognised immediately in underlying profit.

2 SEGMENTAL ANALYSIS (CONTINUED)

	2010 £m	2009 £m
Reportable segment assets	**12,658**	11,878
Investments in joint ventures and associates	**393**	437
Eliminations	**(823)**	(457)
Cash and cash equivalents and short-term investments	**3,186**	2,962
Fair value of swaps hedging fixed rate borrowings	**198**	224
Income tax assets	**457**	372
Post-retirement scheme surpluses	**164**	75
Total assets	**16,233**	15,491
Reportable segment liabilities	**(9,825)**	(8,708)
Eliminations	**823**	457
Borrowings	**(1,786)**	(1,913)
Income tax liabilities	**(608)**	(533)
Post-retirement scheme deficits	**(1,020)**	(930)
Total liabilities	**(12,416)**	(11,627)
Net assets	**3,817**	3,864

Geographical segments

The Group's revenue by destination is shown below:

	2010 £m	2009 £m
United Kingdom	**1,594**	1,458
Norway	**486**	443
Germany	**413**	488
Spain	**231**	233
Rest of Europe	**1,251**	1,109
USA	**3,096**	2,895
Canada	**299**	275
China	**890**	640
South Korea	**355**	301
Middle East and South East Asia	**1,585**	1,689
Rest of Asia	**228**	226
Africa	**109**	144
Australasia	**153**	230
Other	**395**	283
	11,085	10,414

In 2010, revenue (included in all reportable segments) of £1,131m was received from a single customer.

The carrying amounts of the Group's non-current assets, excluding financial instruments, deferred tax assets and post-employment benefit surpluses, by the geographical area in which the assets are located, are as follows:

	2010 £m	2009 £m
United Kingdom	**2,925**	2,764
North America	**611**	467
Nordic countries	**908**	824
Germany	**625**	574
Other	**344**	289
	5,413	4,918

3 NET FINANCING

	2010		2009	
	Per consolidated income statement £m	***Underlying financing[1] £m***	Per consolidated income statement £m	*Underlying financing[1] £m*
Financing income				
Interest receivable	**23**	***23***	21	*21*
Fair value gains on foreign currency contracts (note 15) [2]	**–**	**–**	1,783	–
Financial RRSPs – foreign exchange differences and changes in forecast payments (note 15)	**–**	**–**	72	–
Fair value gains on commodity derivatives (note 15) [2]	**29**	**–**	52	–
Expected return on post-retirement scheme assets (note 17)	**400**	**–**	305	–
Net foreign exchange gains	**1**	**–**	43	–
	453	***23***	2,276	*21*
Financing costs				
Interest payable	**(62)**	***(62)***	(64)	*(64)*
Fair value losses on foreign currency contracts (note 15) [2]	**(370)**	**–**	–	–
Financial RRSPs – foreign exchange differences and changes in forecast payments (note 16)	**(6)**	**–**	–	–
Financial charge relating to financial RRSPs (note 15)	**(13)**	***(13)***	(25)	*(25)*
Interest on post-retirement scheme liabilities (note 17)	**(431)**	**–**	(402)	–
Other financing charges	**(2)**	***(2)***	–	–
	(884)	***(77)***	(491)	*(89)*
Net financing	**(431)**	***(54)***	1,785	*(68)*
Analysed as:				
Net interest payable	**(39)**	***(39)***	(43)	*(43)*
Net post-retirement scheme financing	**(31)**	**–**	(97)	–
Net other financing	**(361)**	***(15)***	1,925	*(25)*
Net financing	**(431)**	***(54)***	1,785	*(68)*

[1] See note 2

[2] Net (loss)/gain on items held for trading **(341)** **–** 1,835 –

4 TAXATION

	UK		Overseas		Total	
	2010 £m	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Current tax						
Current tax charge for the year	**(2)**	26	**174**	129	**172**	155
Less double tax relief	**(2)**	(29)	**–**	–	**(2)**	(29)
	(4)	(3)	**174**	129	**170**	126
Adjustments in respect of prior years	**1**	(4)	**2**	(23)	**3**	(27)
	(3)	(7)	**176**	106	**173**	99
Deferred tax						
(Credit)/charge for the year	**(53)**	628	**41**	21	**(12)**	649
Adjustments in respect of prior years	**–**	(12)	**1**	4	**1**	(8)
Credit arising from reduction in UK tax rate	**(3)**	–	**–**	–	**(3)**	–
	(56)	616	**42**	25	**(14)**	641
Recognised in the income statement	**(59)**	609	**218**	131	**159**	740

4 TAXATION (CONTINUED)

Other tax credits/(charges)

	OCI		Equity	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Deferred tax				
net actuarial (losses)/gains on post-retirement schemes	**(37)**	342	**–**	–
movement in unrecognised surplus on post-retirement schemes	**81**	(198)	**–**	–
movement in minimum funding liability	**(13)**	(11)	**–**	–
release of transition hedge reserve	**–**	8	**–**	–
share-based payment plans	**–**	–	**5**	1
net investment hedge	**(2)**	–	**–**	–
	29	141	**5**	1

Tax reconciliation

	2010 £m	2009 £m
Profit before taxation	**703**	2,957
Less share of results of joint ventures and associates (note 9)	**(93)**	(93)
Profit before taxation excluding joint ventures and associates	**610**	2,864
Nominal tax charge at UK corporation tax rate 28.0% (2009 28.0%)	**171**	802
UK R&D credit	**(29)**	(26)
Rate differences	**16**	7
Other permanent differences	**2**	5
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	**(5)**	(21)
Tax losses in year not recognised in deferred tax	**3**	8
Adjustments in respect of prior years	**4**	(35)
Reduction in closing deferred taxes resulting from decrease in UK tax rate	**(3)**	–
	159	740
Analysis of taxation charge:		
Underlying items (note 2)	**236**	187
Non-underlying items	**(77)**	553
	159	740

Deferred taxation assets and liabilities

	2010 £m	2009 £m
At January 1	**(6)**	497
Amount credited/(charged) to income statement	**14**	(641)
Amount credited to other comprehensive income	**29**	141
Amount credited to equity	**5**	1
Acquisition of businesses	**(32)**	–
Exchange differences	**3**	(4)
At December 31	**13**	(6)
Analysed as:		
Deferred tax assets	**451**	360
Deferred tax liabilities	**(438)**	(366)
	13	(6)

4 TAXATION (CONTINUED)

The analysis of the deferred tax position is as follows:

	At January 1, 2010 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Exchange differences £m	At December 31, 2010 £m
Intangible assets	**(250)**	**(19)**	**–**	**–**	**(11)**	**(2)**	**(282)**
Property, plant and equipment	**(160)**	**10**	**–**	**–**	**–**	**–**	**(150)**
Other temporary differences	**(22)**	**(25)**	**–**	**5**	**(21)**	**(1)**	**(64)**
Amounts recoverable on contracts	**(243)**	**14**	**–**	**–**	**–**	**–**	**(229)**
Pensions and other post-retirement scheme benefits	**265**	**(39)**	**31**	**–**	**–**	**6**	**263**
Foreign exchange and commodity financial assets and liabilities	**54**	**40**	**–**	**–**	**–**	**–**	**94**
Losses	**286**	**33**	**(2)**	**–**	**–**	**–**	**317**
Advance corporation tax	**64**	**–**	**–**	**–**	**–**	**–**	**64**
	(6)	**14**	**29**	**5**	**(32)**	**3**	**13**

	At January 1, 2009 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Exchange differences £m	At December 31, 2009 £m
Intangible assets	(200)	(53)	–	–	–	3	(250)
Property, plant and equipment	(146)	(17)	–	–	–	3	(160)
Other temporary differences	(31)	2	–	(2)	–	9	(22)
Amounts recoverable on contracts	(195)	(48)	–	–	–	–	(243)
Pensions and other post-retirement scheme benefits	168	(17)	133	–	–	(19)	265
Foreign exchange and commodity financial assets and liabilities	655	(609)	8	–	–	–	54
Losses	182	101	–	3	–	–	286
Advance corporation tax	64	–	–	–	–	–	64
	497	(641)	141	1	–	(4)	(6)

	2010 £m	2009 £m
Advance corporation tax	**118**	118
Losses and other unrecognised deferred tax assets	**51**	59
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	**169**	177

The Emergency Budget on June 22, 2010 announced that the UK corporation tax rate will reduce from 28 per cent to 24 per cent over a period of four years from 2011. The first reduction in the rate from 28 per cent to 27 per cent was substantively enacted on July 21, 2010 and will be effective from April 1, 2011. As this rate change was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been restated. The resulting charges or credits have been recognised in the income statement except to the extent that they relate to items previously charged or credited to OCI or equity.

Accordingly, in 2010, £3m has been credited to the income statement, £1m has been charged to OCI and £1m has been charged directly to equity. Had the further tax rate changes been substantively enacted before the balance sheet date, it would have had the effect of reducing the deferred tax asset and liability by £27m and £29m respectively.

5 EMPLOYEE INFORMATION

	2010	Restated* 2009
Average number of employees		
United Kingdom	**21,000**	21,300
Overseas	**17,900**	17,200
	38,900	38,500
Civil aerospace	**19,500**	19,800
Defence aerospace	**6,900**	7,100
Marine	**9,000**	8,300
Energy	**3,500**	3,300
	38,900	38,500

* Following a review of the allocation of employees in functions serving more than one segment, the 2009 figures have been restated.

	£m	£m
Group employment costs [1]		
Wages and salaries	**1,847**	1,725
Social security costs	**212**	194
Share-based payments (note 19)	**50**	31
Pensions and other post-retirement scheme benefits (note 17)	**221**	263
	2,330	2,213

[1] Remuneration of key management personnel is shown in note 22.

6 AUDITORS' REMUNERATION

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

	2010 £m	2009 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements [1]	**1.7**	0.1
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**2.6**	4.1
Total fees payable for audit services	**4.3**	4.2
Fees payable to the Company's auditors and its associates for other services:		
Other services pursuant to legislation	**0.2**	0.6
Other services relating to taxation	**0.5**	0.4
	5.0	5.2
Fees payable in respect of the Group's pension schemes:		
Audit	**0.2**	0.2
Other services relating to taxation	**0.1**	0.1

7 INTANGIBLE ASSETS

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
Cost:						
At January 1, 2009	1,013	568	632	463	254	2,930
Exchange differences	(28)	(3)	(2)	–	(2)	(35)
Additions	–	66	121	123	32	342
Acquisitions of businesses	6	–	–	–	–	6
Disposals	–	–	–	–	(11)	(11)
At January 1, 2010	**991**	**631**	**751**	**586**	**273**	**3,232**
Exchange differences	6	(2)	–	–	(1)	3
Additions	–	57	111	111	46	325
Acquisitions of businesses	118	–	–	–	96	214
Disposals	–	–	–	–	(1)	(1)
At December 31, 2010	**1,115**	**686**	**862**	**697**	**413**	**3,773**
Accumulated amortisation:						
At January 1, 2009	5	165	176	250	48	644
Exchange differences	–	(1)	–	–	(1)	(2)
Charge for the year [1]	2	13	29	46	31	121
Disposals	–	–	–	–	(3)	(3)
At January 1, 2010	**7**	**177**	**205**	**296**	**75**	**760**
Charge for the year [1]	–	13	27	55	35	130
Disposals	–	–	–	–	(1)	(1)
At December 31, 2010	**7**	**190**	**232**	**351**	**109**	**889**
Net book value:						
At December 31, 2010	**1,108**	**496**	**630**	**346**	**304**	**2,884**
At December 31, 2009	984	454	546	290	198	2,472
At January 1, 2009	1,008	403	456	213	206	2,286

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

7 INTANGIBLE ASSETS (CONTINUED)

Goodwill

In accordance with the requirements of IAS 36 *Impairment of Assets*, goodwill is allocated to the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the business combination that gave rise to the goodwill as follows:

Cash-generating unit (CGU) or group of CGUs

	Primary reporting segment	2010 £m	2009 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**236**	244
Commercial marine – arising from the acquisitions of Vinters plc and Scandinavian Electric Holdings AS	Marine	**657**	645
Commercial marine – arising from the acquisition of ODIM ASA	Marine	**114**	–
Other	Various	**101**	95
		1,108	984

Goodwill has been tested for impairment during 2010 on the following basis:

- The carrying value of goodwill has been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions. Given the long-term and established nature of many of the Group's products (product lives are often measured in decades), these forecast the next ten years. Growth rates for the period not covered by the forecasts are based on a range of growth rates (2.0–2.5 per cent) that reflect the products, industries and countries in which the relevant CGU or group of CGUs operate.
- The key assumptions for the impairment tests are the discount rate and, in the cash flow projections, the programme assumptions, the growth rates and the impact of foreign exchange rates on the relationship between selling prices and costs. Impairment tests are performed using prevailing exchange rates.
- The pre-tax cash flow projections have been discounted at 13 per cent (2009 13 per cent), based on the Group's weighted average cost of capital.

The principal value in use assumptions for goodwill balances considered to be individually significant are:

- Rolls-Royce Deutschland Ltd & Co KG – Volume of engine deliveries, flying hours of installed fleet and cost escalation, these are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposure is on translating US dollar income into euros. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at 2.5 per cent (2009 2.5 per cent). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 45 per cent to cause an impairment of this balance.
- Vinters plc – Volume of equipment deliveries, capture of aftermarket and cost escalation, these are based on current and known future programmes, estimates of customers' fleet requirements and long-term economic forecasts. The principal foreign exchange exposures are on translating income in a variety of non-functional currencies into Norwegian Kroner. For the purposes of the impairment test only, cash flows beyond the ten-year forecasts are assumed to grow at two per cent (2009 four per cent). The directors do not consider that any reasonably possible change in the key assumptions would cause the value in use of the goodwill to fall below its carrying value. The overall level of business would need to reduce by more than 80 per cent to cause an impairment of this balance.

Other intangible assets

Certification costs and participation fees, development costs and recoverable engine costs have been reviewed for impairment in accordance with the requirements of IAS 36 Impairment of Assets. Where an impairment test was considered necessary, it has been performed on the following basis:

- The carrying values have been assessed by reference to value in use. These have been estimated using cash flows from the most recent forecasts prepared by management, which are consistent with past experience and external sources of information on market conditions over the lives of the respective programmes.
- The key assumptions underlying cash flow projections are assumed market share, programme timings, unit cost assumptions, discount rates, and foreign exchange rates.
- The pre-tax cash flow projections have been discounted at 11 per cent (2009 11 per cent), based on the Group's weighted average cost of capital.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Company's control (discount rate, exchange rate and airframe delays), could result in impairment in future years.

8 PROPERTY, PLANT AND EQUIPMENT

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At January 1, 2009	787	2,350	171	245	3,553
Exchange differences	(17)	(43)	(2)	(8)	(70)
Additions	22	94	20	155	291
Reclassifications	30	78	5	(113)	–
Transferred to assets held for sale	(12)	–	–	–	(12)
Disposals/write-offs	(4)	(92)	(31)	(3)	(130)
At January 1, 2010	**806**	**2,387**	**163**	**276**	**3,632**
Exchange differences	6	16	–	1	23
Additions	11	94	35	221	361
Acquisition of businesses	17	7	–	–	24
Reclassifications	41	108	5	(154)	–
Disposals/write-offs	(4)	(74)	(14)	(2)	(94)
At December 31, 2010	**877**	**2,538**	**189**	**342**	**3,946**
Accumulated depreciation:					
At January 1, 2009	218	1,308	32	–	1,558
Exchange differences	(2)	(25)	(1)	–	(28)
Charge for the year [1]	25	156	8	–	189
Impairment	4	1	–	–	5
Transferred to assets held for sale	(12)	–	–	–	(12)
Disposals/write-offs	(2)	(82)	(5)	–	(89)
At January 1, 2010	**231**	**1,358**	**34**	**–**	**1,623**
Exchange differences	4	11	–	–	15
Charge for the year [1]	37	190	10	–	237
Disposals/write-offs	(1)	(62)	(2)	–	(65)
At December 31, 2010	**271**	**1,497**	**42**	**–**	**1,810**
Net book value:					
At December 31, 2010	**606**	**1,041**	**147**	**342**	**2,136**
At December 31, 2009	575	1,029	129	276	2,009
At January 1, 2009	569	1,042	139	245	1,995

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

8 PROPERTY, PLANT AND EQUIPMENT (CONTINUED)

Property, plant and equipment includes:

	2010 £m	2009 £m
Net book value of finance leased assets:		
Land and buildings	**8**	9
Plant and equipment	**5**	6
Aircraft and engines	**–**	–
Assets held for use in operating leases:		
Cost	**159**	133
Depreciation	**(35)**	(31)
Net book value	**124**	102
Capital expenditure commitments	**215**	146
Cost of fully depreciated assets	**584**	473

9 INVESTMENTS

	Equity accounted			
	Joint ventures £m	Associates £m	Total £m	Other unlisted £m
At January 1, 2009	345	–	345	53
Exchange differences	(33)	4	(29)	–
Additions	16	71	87	2
Taxation paid by the Group	2	–	2	–
Impairment	(1)	–	(1)	(1)
Share of retained profit	18	(1)	17	–
Transferred to other investments	(4)	–	(4)	4
Share of OCI of joint ventures and associates	20	–	20	–
At January 1, 2010	**363**	**74**	**437**	**58**
Exchange differences	**4**	**2**	**6**	**–**
Additions	**16**	**–**	**16**	**1**
Taxation paid by the Group	**3**	**–**	**3**	**–**
Impairment	**(1)**	**–**	**(1)**	**(2)**
Share of retained profit	**24**	**1**	**25**	**–**
Transferred to subsidiary [1]	**–**	**(77)**	**(77)**	**–**
Disposals	**–**	**–**	**–**	**(46)**
Share of OCI of joint ventures and associates	**(16)**	**–**	**(16)**	**–**
At December 31, 2010	**393**	**–**	**393**	**11**

[1] During the year, the Group acquired the 67 per cent of the shares of ODIM ASA that it did not already own – see note 23.

9 INVESTMENTS (CONTINUED)

The summarised aggregated financial information of the Group's share of equity accounted investments is as follows:

	Joint ventures		Associates		Total	
	2010 £m	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Assets:						
Non-current assets	**1,405**	1,143	**–**	69	**1,405**	1,212
Current assets	**1,161**	812	**–**	38	**1,161**	850
Liabilities: [2]						
Current liabilities	**(1,151)**	(709)	**–**	(20)	**(1,151)**	(729)
Non-current liabilities	**(1,022)**	(883)	**–**	(13)	**(1,022)**	(896)
	393	363	**–**	74	**393**	437
[2] Liabilities include borrowings of:	**(1,043)**	(816)	**–**	(5)	**(1,043)**	(821)

	Joint ventures		Associates		Total	
	2010 £m	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Revenue	**2,914**	2,555	**26**	15	**2,940**	2,570
Profit before financing and taxation	**128**	132	**1**	–	**129**	132
Net financing	**(19)**	(26)	**–**	(1)	**(19)**	(27)
Taxation	**(17)**	(12)	**–**	–	**(17)**	(12)
Profit for the year recognised in the consolidated income statement	**92**	94	**1**	(1)	**93**	93
Dividends received	**(68)**	(77)	**–**	–	**(68)**	(77)
Retained profit	**24**	17	**1**	(1)	**25**	16

The principal joint ventures are listed on pages 125 and 126.

10 INVENTORIES

	2010 £m	2009 £m
Raw materials	**377**	358
Work in progress	**943**	820
Long-term contracts work in progress	**42**	61
Finished goods	**1,024**	1,163
Payments on account	**43**	30
	2,429	2,432
Inventories stated at net realisable value	**202**	138
Amount of inventory write-down	**135**	83
Reversal of inventory write-down	**2**	5

11 TRADE AND OTHER RECEIVABLES

	2010 £m	2009 £m
Trade receivables	**1,210**	1,285
Amounts recoverable on contracts [1]	**1,580**	1,524
Amounts owed by joint ventures and associates	**518**	502
Amounts owed by parent undertaking	**-**	71
Other receivables	**449**	401
Prepayments and accrued income	**186**	165
	3,943	3,948
Analysed as:		
Financial instruments (note 15):		
Trade receivables and similar items	**1,801**	1,837
Other non-derivative financial assets	**419**	382
Non-financial instruments	**1,723**	1,729
	3,943	3,948
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	**7**	9
Amounts recoverable on contracts	**1,176**	1,178
Amounts owed by joint ventures and associates	**5**	14
Other receivables	**56**	35
Prepayments and accrued income	**27**	30
	1,271	1,266

[1] The balance at December 31, 2010 includes an allowance of **£55m** (2009 £43m), being the directors' best estimate of the loss that will occur from the Group's contract with EPI Europrop International GmbH to participate in the development of the TP400 engine for the A400M military transport aircraft.

12 CASH AND CASH EQUIVALENTS

	2010 £m	2009 £m
Cash at bank and in hand	**1,646**	1,238
Short-term deposits	**1,212**	1,722
	2,858	2,960
Overdrafts (note 13)	**(8)**	(4)
Cash and cash equivalents per cash flow statement (page 54)	**2,850**	2,956
Cash held as collateral against third party obligations (note 21)	**68**	77

13 BORROWINGS

	Current		Non-current		Total	
	2010 £m	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Unsecured						
Overdrafts	**8**	4	**–**	–	**8**	4
Bank loans	**1**	2	**206**	204	**207**	206
7 3/8% Notes 2016 £200m	**–**	–	**200**	200	**200**	200
5.84% Notes 2010 US$187m [1]	**–**	120	**–**	–	**–**	120
6.38% Notes 2013 US$230m [1]	**–**	–	**162**	155	**162**	155
6.55% Notes 2015 US$83m [1]	**–**	–	**60**	57	**60**	57
4 1/2% Notes 2011 €750m [2]	**642**	–	**–**	677	**642**	677
6.75% Notes 2019 £500m [3]	**–**	–	**506**	493	**506**	493
Secured						
Obligations under finance leases (note 20) [4]	**–**	–	**1**	1	**1**	1
	651	126	**1,135**	1,787	**1,786**	1,913

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

[2] These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable at variable rates of interest and at fixed exchange rates.

[3] These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest in consideration for amounts payable at variable rates of interest.

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

14 TRADE AND OTHER PAYABLES

	Current		Non-current	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Payments received on account [1]	**1,560**	1,550	**475**	544
Trade payables	**891**	863	**–**	–
Amounts owed to parent undertaking	**250**	–	**–**	–
Amounts owed to joint ventures and associates	**267**	276	**7**	2
Other taxation and social security	**81**	71	**–**	–
Other payables	**1,294**	1,086	**94**	71
Accruals and deferred income	**1,817**	1,782	**695**	528
	6,160	5,628	**1,271**	1,145
[1] Includes payments received on account from joint ventures and associates	**258**	200	**243**	259

Included within trade and other payables are government grants of **£44m** (2009 £31m). During the year, **£2m** (2009 £2m) of government grants were released to the income statement.

Analysed as:

	2010 £m	2009 £m
Financial instruments (note 15):		
Trade payables and similar items	**2,212**	2,142
Other non-derivative financial liabilities	**521**	381
Non-financial instruments	**4,698**	4,250
	7,431	6,773

15 FINANCIAL INSTRUMENTS

This note should be read in conjunction with the Finance Director's review on pages 34 to 41.

Carrying values and fair values of financial instruments

	Notes	Basis for determining fair value	Assets: Held for trading £m	Assets: Loans and receivables £m	Assets: Available for sale £m	Assets: Cash £m	Liabilities: Held for trading £m	Liabilities: Amortised cost £m	Total £m
At December 31, 2010									
Unlisted non-current asset investments	9	A	**–**	**11**	**–**	**–**	**–**	**–**	**11**
Trade receivables and similar items	11	B	**–**	**1,801**	**–**	**–**	**–**	**–**	**1,801**
Other non-derivative financial assets	11	B	**–**	**419**	**–**	**–**	**–**	**–**	**419**
Derivative financial assets		C	**621**	**–**	**–**	**–**	**–**	**–**	**621**
Short-term investments		B	**–**	**328**	**–**	**–**	**–**	**–**	**328**
Cash at bank and in hand	12	B	**–**	**–**	**–**	**1,646**	**–**	**–**	**1,646**
Short-term deposits	12	B	**–**	**1,212**	**–**	**–**	**–**	**–**	**1,212**
Borrowings	13	D	**–**	**–**	**–**	**–**	**–**	**(1,786)**	**(1,786)**
Derivative financial liabilities		C	**–**	**–**	**–**	**–**	**(761)**	**–**	**(761)**
Financial RRSPs		D	**–**	**–**	**–**	**–**	**–**	**(266)**	**(266)**
Trade payables and similar items	14	B	**–**	**–**	**–**	**–**	**–**	**(2,212)**	**(2,212)**
Other non-derivative financial liabilities	14	B	**–**	**–**	**–**	**–**	**–**	**(521)**	**(521)**
			621	**3,771**	**–**	**1,646**	**(761)**	**(4,785)**	**492**
At December 31, 2009									
Unlisted non-current asset investments	9	A	–	58	–	–	–	–	58
Trade receivables and similar items	11	B	–	1,837	–	–	–	–	1,837
Other non-derivative financial assets	11	B	–	382	–	–	–	–	382
Derivative financial assets		C	717	–	–	–	–	–	717
Short-term investments		B	–	–	2	–	–	–	2
Cash at bank and in hand	12	B	–	–	–	1,238	–	–	1,238
Short-term deposits	12	B	–	1,722	–	–	–	–	1,722
Borrowings	13	D	–	–	–	–	–	(1,913)	(1,913)
Derivative financial liabilities		C	–	–	–	–	(673)	–	(673)
Financial RRSPs		D	–	–	–	–	–	(363)	(363)
Trade payables and similar items	14	B	–	–	–	–	–	(2,142)	(2,142)
Other non-derivative financial liabilities	14	B	–	–	–	–	–	(381)	(381)
			717	3,999	2	1,238	(673)	(4,812)	484

Fair values equate to book values for both 2010 and 2009, with the following exceptions:

	2010 Book value £m	2010 Fair value £m	2009 Book value £m	2009 Fair value £m
Borrowings	**(1,786)**	**(1,897)**	(1,913)	(2,012)
Financial RRSPs	**(266)**	**(296)**	(363)	(390)

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

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

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

C Fair values of derivative financial assets and liabilities are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. These financial instruments are included on the balance sheet at fair value, derived from observable market prices (Level 2 as defined by IFRS 7 *Financial Instruments: Disclosures*).

D Borrowing and financial RRSPs are carried at amortised cost. Fair values are estimated by discounting expected future contractual cash flows using prevailing interest rate curves. Amounts denominated in foreign currencies are valued at the exchange rate prevailing at the balance sheet date. For financial RRSPs, the contractual cash flows are based on future trading activity, which is estimated based on latest forecasts.

15 FINANCIAL INSTRUMENTS (CONTINUED)

Carrying values of other financial assets and liabilities

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Total derivatives £m	Financial RRSPs £m	Total £m
At December 31, 2010						
Non-current assets	**317**	**18**	**36**	**371**	**–**	**371**
Current assets	**98**	**10**	**142**	**250**	**–**	**250**
Current liabilities	**(38)**	**(5)**	**–**	**(43)**	**(39)**	**(82)**
Non-current liabilities	**(713)**	**(2)**	**(3)**	**(718)**	**(227)**	**(945)**
	(336)	**21**	**175**	**(140)**	**(266)**	**(406)**
At December 31, 2009						
Non-current assets	429	11	197	637	–	637
Current assets	72	4	4	80	–	80
Current liabilities	(56)	(12)	–	(68)	(100)	(168)
Non-current liabilities	(589)	(14)	(2)	(605)	(263)	(868)
	(144)	(11)	199	44	(363)	(319)

Foreign exchange and commodity financial instruments

The Group uses various financial instruments to manage its exposure to movements in foreign exchange rates. The Group uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals). 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 dollars, the Group has currency derivatives designated as part of fair value hedges.

The fair values of foreign exchange and commodity instruments were as follows:

	Foreign exchange instruments £m	Commodity instruments £m
At January 1, 2009	(2,181)	(89)
Movements in fair value hedges [1,2]	(33)	–
Movements in net investment hedges	(14)	–
Movements in other derivative contracts [1]	1,783	52
Contracts settled	301	26
At January 1, 2010	**(144)**	**(11)**
Movements in fair value hedges [1,2]	**7**	**–**
Movements in other derivative contracts	**(370)**	**29**
Contracts settled [3]	**171**	**3**
At December 31, 2010	**(336)**	**21**

[1] Included in financing.

[2] Loss on related hedged items **£7m** (2009 £33m gain).

[3] Includes settlement of contracts held in fair value hedge relationships of **£10m** (2009 nil).

15 FINANCIAL INSTRUMENTS (CONTINUED)

Interest rate financial instruments

The Group uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates.

The fair values of interest rate financial instruments were as follows:

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m
At January 1, 2009	274	278	(4)
Movements in fair values [1,2]	(75)	(77)	2
At January 1, 2010	**199**	**201**	**(2)**
Movements in fair values [1,2]	**(22)**	**(21)**	**(1)**
Contracts settled	**(2)**	**(2)**	**–**
At December 31, 2010	**175**	**178**	**(3)**

[1] Included in financing.

[2] Gain on related hedged items **£21m** (2009 £77m gain).

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.

The amortised cost values of financial RRSPs were as follows:

	2010 £m	2009 £m
At January 1	**(363)**	(455)
Cash paid to partners	**114**	55
Additions	**–**	(15)
Exchange adjustments included in OCI	**2**	6
Financing charge [1]	**(13)**	(26)
Excluded from underlying profit:		
Exchange adjustments [1]	**(6)**	45
Restructuring of financial RRSP agreements and changes in forecast payments [1]	**–**	27
At December 31	**(266)**	(363)

[1] Included in financing, excluding **nil** (2009 £1m) of finance charge capitalised in intangible assets.

Risk management policies and hedging activities

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

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

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

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

15 FINANCIAL INSTRUMENTS (CONTINUED)

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

Credit risk – The Group is exposed to credit risk to the extent of non-payment by either its customers or the counterparties of its financial instruments. The effective monitoring and controlling of credit risk is a key component of the Group's risk management activities. The Group has credit policies covering both trading and financial exposures. Credit risks arising from treasury activities are managed by a central treasury function in accordance with the Group credit policy. The objective of the policy is to diversify and minimise the Group's exposure to credit risk from its treasury activities by ensuring the Group transacts strictly with 'BBB+' or higher rated financial institutions based on pre-established limits per financial institution. At the balance sheet date, there were no significant concentrations of credit risk to individual customers or counterparties. The maximum exposure to credit risk at the balance sheet date is represented by the carrying value of each financial asset, including derivative financial instruments.

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

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

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

Derivative financial instruments

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

		Expected maturity				Fair value	
	Nominal amount £m	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Assets £m	Liabilities £m
At December 31, 2010							
Foreign exchange contracts:							
Fair value hedges	**175**	**–**	**–**	**175**	**–**	**20**	**–**
Non-hedge accounted	**15,561**	**3,806**	**3,285**	**7,427**	**1,043**	**395**	**(751)**
Interest rate contracts:							
Fair value hedges	**1,200**	**500**	**–**	**200**	**500**	**178**	**–**
Non-hedge accounted	**46**	**–**	**–**	**46**	**–**	**–**	**(3)**
Commodity contracts:							
Non-hedge accounted	**138**	**60**	**43**	**35**	**–**	**28**	**(7)**
	17,120	**4,366**	**3,328**	**7,883**	**1,543**	**621**	**(761)**
At December 31, 2009							
Foreign exchange contracts:							
Fair value hedges	280	106	–	128	46	23	–
Non-hedge accounted	14,203	3,544	3,184	6,573	902	478	(645)
Interest rate contracts:							
Fair value hedges	809	116	500	142	51	201	–
Non-hedge accounted	35	20	–	–	15	–	(2)
Commodity contracts:							
Non-hedge accounted	169	62	59	48	–	15	(26)
	15,496	3,848	3,743	6,891	1,014	717	(673)

As described above, all derivative financial instruments are entered into for risk management purposes, although these may not be designated as hedging relationships for accounting purposes.

15 FINANCIAL INSTRUMENTS (CONTINUED)

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

	Currencies purchased forward				
	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At December 31, 2010					
Currencies sold forward:					
Sterling	**–**	**175**	**–**	**35**	**210**
US dollar	**13,195**	**–**	**1,161**	**642**	**14,998**
Euro	**–**	**–**	**–**	**285**	**285**
Other	**76**	**35**	**106**	**26**	**243**
At December 31, 2009					
Currencies sold forward:					
Sterling	–	280	–	77	357
US dollar	11,508	–	1,094	810	13,412
Euro	–	–	–	371	371
Other	54	116	129	44	343

Other derivative financial instruments are denominated in the following currencies:

	2010 £m	2009 £m
Sterling	**514**	15
US dollar	**337**	498
Euro	**500**	500
Other	**33**	–

15 FINANCIAL INSTRUMENTS (CONTINUED)

Non-derivative financial instruments

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

	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At December 31, 2010					
Assets					
Unlisted non-current investments	**1**	**–**	**4**	**6**	**11**
Trade receivables and similar items	**312**	**1,120**	**210**	**159**	**1,801**
Other non-derivative financial assets	**155**	**46**	**40**	**178**	**419**
Short-term investments	**325**	**–**	**–**	**3**	**328**
Cash at bank and in hand	**445**	**614**	**156**	**431**	**1,646**
Short-term deposits	**853**	**20**	**317**	**22**	**1,212**
	2,091	**1,800**	**727**	**799**	**5,417**
Liabilities					
Borrowings	**(906)**	**(222)**	**(656)**	**(2)**	**(1,786)**
Financial RRSPs	**–**	**(208)**	**(58)**	**–**	**(266)**
Trade payables and similar items	**(1,040)**	**(705)**	**(219)**	**(248)**	**(2,212)**
Other non-derivative financial liabilities	**(211)**	**(166)**	**(35)**	**(109)**	**(521)**
	(2,157)	**(1,301)**	**(968)**	**(359)**	**(4,875)**
	(66)	**499**	**(241)**	**440**	**632**
At December 31, 2009					
Assets					
Unlisted non-current investments	49	–	4	5	58
Trade receivables and similar items	242	1,175	225	195	1,837
Other non-derivative financial assets	130	54	40	158	382
Short-term investments	–	–	–	2	2
Cash at bank and in hand	488	366	129	255	1,238
Short-term deposits	1,517	1	192	12	1,722
	2,426	1,596	590	627	5,239
Liabilities					
Borrowings	(893)	(332)	(683)	(5)	(1,913)
Financial RRSPs	–	(303)	(60)	–	(363)
Trade payables and similar items	(886)	(811)	(221)	(224)	(2,142)
Other non-derivative financial liabilities	(187)	(86)	(23)	(85)	(381)
	(1,966)	(1,532)	(987)	(314)	(4,799)
	460	64	(397)	313	440

15 FINANCIAL INSTRUMENTS (CONTINUED)

Currency exposures

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

Functional currency of Group operation	Sterling £m	US dollar £m	Euro £m	Other £m	Total £m
At December 31, 2010					
Sterling	**–**	**3**	**1**	**1**	**5**
US dollar	**1**	**–**	**(1)**	**16**	**16**
Euro	**–**	**(1)**	**–**	**(1)**	**(2)**
Other	**1**	**–**	**1**	**2**	**4**
At December 31, 2009					
Sterling	–	2	–	(2)	–
US dollar	9	–	(6)	4	7
Other	–	4	(1)	4	7

Ageing beyond contractual due date

The ageing beyond contractual due date of the Group's financial assets is:

	Within terms £m	Up to three months overdue £m	Between three months and one year overdue £m	More than one year overdue £m	Total £m
At December 31, 2010					
Unlisted non-current asset investments	**11**	**–**	**–**	**–**	**11**
Trade receivables and similar items	**1,505**	**180**	**86**	**30**	**1,801**
Other non-derivative financial assets	**396**	**19**	**1**	**3**	**419**
Derivative financial assets	**621**	**–**	**–**	**–**	**621**
Short-term investments	**328**	**–**	**–**	**–**	**328**
Cash at bank and in hand	**1,646**	**–**	**–**	**–**	**1,646**
Short-term deposits	**1,212**	**–**	**–**	**–**	**1,212**
	5,719	**199**	**87**	**33**	**6,038**
At December 31, 2009					
Unlisted non-current asset investments	58	–	–	–	58
Trade receivables and similar items	1,509	237	67	24	1,837
Other non-derivative financial assets	363	14	3	2	382
Derivative financial assets	717	–	–	–	717
Short-term investments	2	–	–	–	2
Cash at bank and in hand	1,238	–	–	–	1,238
Short-term deposits	1,722	–	–	–	1,722
	5,609	251	70	26	5,956

15 FINANCIAL INSTRUMENTS (CONTINUED)

Contractual maturity analysis

	Gross values					
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £m	Discounting £m	Carrying value £m
At December 31, 2010						
Borrowings	**(746)**	**(68)**	**(575)**	**(887)**	**490**	**(1,786)**
Derivative financial liabilities	**(43)**	**(110)**	**(525)**	**(8)**	**(75)**	**(761)**
Financial RRSPs	**(47)**	**(39)**	**(110)**	**(152)**	**82**	**(266)**
Trade payables and similar items	**(2,199)**	**(7)**	**(4)**	**(2)**	**–**	**(2,212)**
Other non-derivative financial liabilities	**(516)**	**(3)**	**(1)**	**(1)**	**–**	**(521)**
	(3,551)	**(227)**	**(1,215)**	**(1,050)**	**497**	**(5,546)**
At December 31, 2009						
Borrowings	(112)	(903)	(366)	(1,183)	651	(1,913)
Derivative financial liabilities	(66)	(55)	(424)	(113)	(15)	(673)
Financial RRSPs	(118)	(45)	(109)	(179)	88	(363)
Trade payables and similar items	(2,139)	(2)	(1)	–	–	(2,142)
Other non-derivative financial liabilities	(377)	(2)	(1)	(1)	–	(381)
	(2,812)	(1,007)	(901)	(1,476)	724	(5,472)

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.

			2010				
			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]	1.1654%	**328**	327	1	–	–	–
Cash at bank and in hand [2]		**1,646**	1,646	–	–	–	–
Short-term deposits [3]		**1,212**	1,212	–	–	–	–
Unsecured bank loans							
€5m floating rate loan	EURIBOR + 0.5	**(5)**	(5)	–	–	–	–
Overdrafts [4]		**(8)**	(8)	–	–	–	–
75m Indian Rupee Fixed Rate Loan	11.2467%	**(1)**	(1)	–	–	–	–
Interest rate swaps	7.2237%	**(1)**	12	–	–	(13)	–
£200m floating rate loan	GBP LIBOR + 0.267	**(200)**	(200)	–	–	–	–
Unsecured bond issues							
7 3/8% Notes 2016 £200m	7.3750%	**(200)**	–	–	–	–	(200)
6.38% Notes 2013 US$230m	6.3800%	**(162)**	–	–	–	(162)	–
Effect of interest rate swaps	USD LIBOR + 1.26	**–**	(162)	–	–	162	–
6.55% Notes 2015 US$83m	6.5500%	**(60)**	–	–	–	(60)	–
Effect of interest rate swaps	USD LIBOR + 1.24	**–**	(60)	–	–	60	–
4 1/2% Notes 2011 €750m	4.5000%	**(642)**	(642)	–	–	–	–
Effect of interest rate swaps	GBP LIBOR + 0.911	**–**	–	–	–	–	–
6.75% Notes 2019 £500m	6.7500%	**(506)**	–	–	–	–	(506)
Effect of interest rate swaps	GBP LIBOR + 2.98	**–**	(506)	–	–	–	506
Other secured							
Obligations under finance leases	5.0000%	**(1)**	–	–	–	–	(1)
		1,400	1,613	1	–	(13)	(201)

15 FINANCIAL INSTRUMENTS (CONTINUED)

			2009				
			Period in which interest rate reprices				
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments [1]	8.6744%	2	2	–	–	–	-
Cash at bank and in hand [2]		1,238	1,238	–	–	–	–
Short-term deposits [3]		1,722	1,722	–	–	–	–
Unsecured bank loans							
€2.5m floating rate loan	EURIBOR + 1.2	(1)	(1)	–	–	–	–
€5m floating rate loan	EURIBOR + 0.5	(4)	(4)	–	–	–	–
Overdrafts [4]		(4)	(4)	–	–	–	–
75m Indian Rupee Fixed Rate Loan	9.8167%	(1)	(1)	–	–	–	–
Interest rate swaps	6.1814%	–	15	–	–	–	(15)
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–	–	–	–
Unsecured bond issues							
7 3/8% Notes 2016 £200m	7.3750%	(200)	–	–	–	–	(200)
5.84% Notes 2010 US$187m	5.8400%	(120)	–	(120)	–	–	–
Effect of interest rate swaps	USD LIBOR + 1.159	–	(120)	120	–	–	–
6.38% Notes 2013 US$230m	6.3800%	(155)	–	–	–	(155)	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(155)	–	–	155	–
6.55% Notes 2015 US$83m	6.5500%	(57)	–	–	–	–	(57)
Effect of interest rate swaps	USD LIBOR + 1.24	–	(57)	–	–	–	57
4 1/2% Notes 2011 €750m	4.5000%	(677)	–	–	(677)	–	–
Effect of interest rate swaps	GBP LIBOR + 0.911	–	(677)	–	677	–	–
6.75% Notes 2019 £500m	6.7500%	(493)	–	–	–	–	(493)
Other secured							
Obligations under finance leases	5.0000%	(1)	–	–	–	–	(1)
		1,049	1,758	-	–	–	(709)

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

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

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

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

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

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

	2010 £m	2009 £m
Expiring in one to two years	**250**	–
Expiring after two years	**200**	450
	450	450

15 FINANCIAL INSTRUMENTS (CONTINUED)

Sensitivity analysis

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

At December 31, 2010 if sterling had weakened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been £989m lower (2009 £864m). If sterling had strengthened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been £809m higher (2009 £707m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2010 if the euro had weakened ten per cent against the US dollar with all other variables held constant, profit after tax and equity for the year would have been £82m lower (2009 £88m). If the euro had strengthened ten per cent against the US dollar with all other variables held constant, profit after tax for the year and equity would have been £66m higher (2009 £72m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2010 if the price of commodities had been ten per cent lower, with all other variables remaining constant, profit after tax for the year and equity would have been £11m lower (2009 £11m), arising mainly as the result of lower fair value gains on derivative contracts. If the price of commodities had been ten per cent higher, with all other variables remaining constant, profit after tax and equity would have been £11m higher (2009 £11m), arising mainly as the result of higher fair value gains on derivative contracts. There would have been no change to the underlying results that exclude unrealised gains and losses on commodity derivatives.

At December 31, 2010 the Group had no material sensitivity to changes in interest rates on that date. The main interest rate sensitivity for the Group arises as a result of the gross up of net cash and this is mitigated as described under the interest rate risk management policies on page 39.

16 PROVISIONS FOR LIABILITIES AND CHARGES

	At January 1, 2010 £m	Exchange differences £m	Acquisitions/ disposals of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2010 £m
Warranty and guarantees	**224**	**3**	**2**	**(5)**	**107**	**(33)**	**298**
Contract loss	**58**	**1**	**–**	**(6)**	**31**	**(12)**	**72**
Restructuring	**8**	**–**	**–**	**(2)**	**14**	**(6)**	**14**
Customer financing	**71**	**–**	**–**	**–**	**16**	**(9)**	**78**
Insurance	**45**	**–**	**–**	**–**	**14**	**(4)**	**55**
Other	**36**	**1**	**–**	**(4)**	**3**	**(9)**	**27**
	442	**5**	**2**	**(17)**	**185**	**(73)**	**544**

Analysed as:

	2010 £m	2009 £m
Current liabilities	**276**	210
Non-current liabilities	**268**	232
	544	442

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

Provisions for contract loss and restructuring are generally expected to be utilised within two years.

Customer financing provisions cover guarantees provided for asset value and/or financing. These guarantees are considered to be insurance contracts in nature and provision is made in accordance with IFRS 4 *Insurance Contracts* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. These guarantees, the risks arising and the process used to assess the extent of the risk are described under the heading 'Sales financing' in the Finance Director's review on page 40. The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 21. It is estimated that the provision will be utilised as follows:

	2010 £m	2009 £m
Potential claims with specific claim dates:		
In one year or less	**8**	3
In more than one year but less than five years	**47**	20
In more than five years	**6**	21
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	**9**	19
Up to five years	**5**	4
Thereafter	**3**	4
	78	71

The Group's captive insurance company retains a portion of the exposures it insures on behalf of the remainder of the Group. Significant delays occur in the notification and settlement of claims and judgement is involved in assessing outstanding liabilities, the ultimate cost and timing of which cannot be known with certainty at the balance sheet date. The insurance provisions are based on information currently available, however it is inherent in the nature of the business that ultimate liabilities may vary. Provisions for outstanding claims are established to cover the outstanding expected liability as well as claims incurred but not yet reported.

Other provisions comprise a number of liabilities with varying expected utilisation rates.

17 POST-RETIREMENT BENEFITS

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

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

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

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2010. The most recent funding valuations of the main UK schemes were:

Scheme	Valuation date
Rolls-Royce Pension Fund	March 31, 2009
Rolls-Royce Group Pension Scheme (provisional)	April 5, 2010
Vickers Group Pension Scheme (provisional)	March 31, 2010

Amounts recognised in the income statement

	2010			2009		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost	**118**	**34**	**152**	94	29	123
Past service cost	**–**	**1**	**1**	2	4	6
Curtailment	**–**	**(6)**	**(6)**	–	–	–
	118	**29**	**147**	96	33	129
Defined contribution schemes	**11**	**32**	**43**	8	29	37
Operating cost	**129**	**61**	**190**	104	62	166
Financing in respect of defined benefit schemes:						
Expected return on assets	**(374)**	**(26)**	**(400)**	(285)	(20)	(305)
Interest on liabilities	**375**	**56**	**431**	355	47	402
	1	**30**	**31**	70	27	97
Total income statement charge	**130**	**91**	**221**	174	89	263

The operating cost is charged as follows:

	Defined benefit		Defined contribution		Total	
	2010 £m	2009 £m	**2010 £m**	2009 £m	**2010 £m**	2009 £m
Cost of sales	**106**	94	**31**	27	**137**	121
Commercial and administrative costs	**31**	26	**9**	7	**40**	33
Research and development	**10**	9	**3**	3	**13**	12
	147	129	**43**	37	**190**	166

The Group operates a PaySave scheme in the UK. This is a salary sacrifice scheme under which employees elect to stop making employee contributions and the Group makes additional contributions in return for a reduction in gross contractual pay. As a result, there is a decrease in wages and salaries and a corresponding increase in pension costs of **£35m** (2009 £36m) in the year.

Amounts recognised in other comprehensive income

	2010 £m	2009 £m
Actuarial gain/(loss) on scheme assets	**460**	(270)
Experience losses on scheme liabilities	**(303)**	(878)
Movement in unrecognised surplus	**(300)**	707
Movement in minimum funding liability	**49**	40
	(94)	(401)

17 POST-RETIREMENT BENEFITS (CONTINUED)

Defined benefit schemes

Assumptions

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

	2010		2009	
	UK schemes %	**Overseas schemes %**	UK schemes %	Overseas schemes %
Rate of increase in salaries	**4.7**	**3.9**	4.7	4.0
Rate of increase of pensions in payment [1]	**3.0**	**1.7**	3.3	2.2
Discount rate	**5.5**	**5.4**	5.7	5.9
Expected rate of return on scheme assets	**5.0**	**7.2**	5.4	7.4
Inflation assumption	**3.6**	**2.5**	3.6	2.6

[1] Benefits from UK schemes accruing after April 5, 2005 are assumed to increase in payment at a rate of 1.9 per cent.

The discount rates are determined by reference to the market yields on 'AA' rated corporate bonds. For the main UK schemes, the rate is determined by using the profile of forecast benefit payments to derive a weighted average discount rate from the yield curve. For less significant UK schemes and overseas schemes, the rate is determined as the market yield at the average duration of the forecast benefit payments. The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities.

The assumptions have not been adjusted to reflect the UK Government's announcement in 2010 to change the basis for the indexation of occupational pension schemes from the Retail Prices Index to the Consumer Price Index.

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

The mortality assumptions adopted for the UK pension schemes are derived from the SAP actuarial tables, with 80 per cent of long cohort and an underpin of one per cent, published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant scheme's actual experience. The resulting life expectancies in the principal UK schemes are as follows:

Life expectancy from age 65	
Current pensioner	22.4 years
Future pensioner currently aged 45	24.2 years

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

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

The future costs of healthcare benefits are based on an assumed healthcare costs trend rate of 8.4 per cent, grading down to 5.0 per cent over five years.

Amounts recognised in the balance sheet

	2010			2009		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	**(7,039)**	**(484)**	**(7,523)**	(6,714)	(406)	(7,120)
Fair value of scheme assets	**7,783**	**434**	**8,217**	7,048	354	7,402
	744	**(50)**	**694**	334	(52)	282
Present value of unfunded obligations	**–**	**(579)**	**(579)**	–	(417)	(417)
Unrecognised surplus [1]	**(628)**	**(7)**	**(635)**	(329)	(6)	(335)
Minimum funding liability [2]	**(336)**	**–**	**(336)**	(385)	–	(385)
Net liability recognised in the balance sheet	**(220)**	**(636)**	**(856)**	(380)	(475)	(855)
Analysed as:						
Post-retirement scheme surpluses	**164**	**–**	**164**	75	–	75
Post-retirement scheme deficits	**(384)**	**(636)**	**(1,020)**	(455)	(475)	(930)
	(220)	**(636)**	**(856)**	(380)	(475)	(855)

[1] Where a surplus has arisen on a scheme, in accordance with IAS 19 and IFRIC 14, the surplus is recognised as an asset only if it represents an unconditional economic benefit available to the Group in the future. Any surplus in excess of this benefit is not recognised in the balance sheet.

[2] A minimum funding liability arises where the statutory funding requirements require future contributions in respect of past service that will result in a future unrecognisable surplus.

17 POST-RETIREMENT BENEFITS (CONTINUED)

Changes in present value of defined benefit obligations

	2010			2009		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
At January 1	**(6,714)**	**(823)**	**(7,537)**	(5,719)	(827)	(6,546)
Exchange differences	**–**	**(27)**	**(27)**	–	67	67
Current service cost	**(118)**	**(34)**	**(152)**	(94)	(29)	(123)
Past service cost	**–**	**(1)**	**(1)**	(2)	(4)	(6)
Finance cost	**(375)**	**(56)**	**(431)**	(355)	(47)	(402)
Contributions by employees	**(3)**	**(2)**	**(5)**	(3)	(3)	(6)
Benefits paid out	**313**	**35**	**348**	324	33	357
Actuarial losses	**(142)**	**(161)**	**(303)**	(865)	(13)	(878)
Curtailment	**–**	**6**	**6**	–	–	–
At December 31	**(7,039)**	**(1,063)**	**(8,102)**	(6,714)	(823)	(7,537)
Funded schemes	**(7,039)**	**(484)**	**(7,523)**	(6,714)	(406)	(7,120)
Unfunded schemes	**–**	**(579)**	**(579)**	–	(417)	(417)

Changes in fair value of scheme assets

	2010			2009		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
At January 1	**7,048**	**354**	**7,402**	7,163	283	7,446
Exchange differences	**–**	**16**	**16**	–	(16)	(16)
Expected return on assets	**374**	**26**	**400**	285	20	305
Contributions by employer	**227**	**55**	**282**	232	56	288
Contributions by employees	**3**	**2**	**5**	3	3	6
Benefits paid out	**(313)**	**(35)**	**(348)**	(324)	(33)	(357)
Actuarial gains/(losses)	**444**	**16**	**460**	(311)	41	(270)
At December 31	**7,783**	**434**	**8,217**	7,048	354	7,402
Actual return on scheme assets	**818**	**42**	**860**	(26)	61	35

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

	2010		2009	
	Expected rate of return %	**Market value £m**	Expected rate of return %	Market value £m
UK schemes:				
LDI portfolios [1]	**4.5**	**6,383**	5.0	5,736
Equities	**7.5**	**1,204**	7.8	1,107
Sovereign debt	**4.2**	**23**	4.5	18
Corporate bonds	**5.2**	**22**	5.5	8
Other	**4.2**	**151**	4.6	179
	5.0	**7,783**	5.4	7,048
Overseas schemes:				
Equities	**9.3**	**237**	9.3	194
Corporate bonds	**4.5**	**170**	4.7	136
Other	**6.9**	**27**	6.5	24
	7.2	**434**	7.4	354

[1] A portfolio of gilts and swap contracts, backed by LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group.

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

17 POST-RETIREMENT BENEFITS (CONTINUED)

The expected rates of return on other individual categories of scheme assets are determined by reference to gilt yields. In the UK, equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25 per cent and 1.0 per cent per annum respectively.

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

Future contributions

The Group expects to contribute approximately £300m to its defined benefit schemes in 2011.

Sensitivities

The revised investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. A reduction of 0.25 per cent in the discount rate would increase the obligations of the principal UK defined benefit schemes by approximately £259m. An equivalent movement in interest rates would increase the fair value of the assets by approximately £343m. The difference arises largely due to differences in the principal methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is in excess of 90 per cent. The principle remaining risks relate to the assumptions for mortality and increases in salaries. If the age ratings in respect of the principal UK defined benefit schemes were increased by one year, the scheme liabilities would increase by £119m. If the rate of increase in salaries were 0.5 per cent higher, scheme liabilities would increase by £132m.

The defined benefit obligation relating to post-retirement medical benefits would increase by £72m if the healthcare trend rate increases by one per cent, and reduce by £58m if it decreases by one per cent. The pension expense relating to post-retirement medical benefits, comprising service cost and interest cost, would increase by £7m if the healthcare trend increases by one per cent, and reduce by £5m if it decreases by one per cent.

History of defined benefit schemes

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

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Balance sheet					
Present value of defined benefit obligations	**(8,102)**	(7,537)	(6,546)	(6,912)	(6,899)
Fair value of scheme assets	**8,217**	7,402	7,446	6,903	5,906
Unrecognised surpluses	**(635)**	(335)	(1,042)	(114)	(2)
Minimum funding liabilities	**(336)**	(385)	(425)	–	–
Deficit	**(856)**	(855)	(567)	(123)	(995)
Experience gains/losses					
Actuarial gains/(losses) on scheme assets	**460**	(270)	178	161	132
Experience (losses)/gains on scheme liabilities	**(303)**	(878)	766	350	470
Movement in unrecognised surpluses	**(300)**	707	(928)	(112)	–
Recognition of minimum funding liability on January 1, 2008	**–**	–	(491)	–	–
Movement in minimum funding liabilities	**49**	40	66	–	–
Total amount recognised in OCI	**(94)**	(401)	(409)	399	602
Cumulative amounts recognised in OCI since January 1, 2004	**(192)**	(98)	303	712	313

18 SHARE CAPITAL

	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid		
At January 1, 2009 and December 31, 2010	1,631	326

19 SHARE-BASED PAYMENTS

Effect of share-based payment transactions on the Group's results and financial position

	2010 £m	2009 £m
Total expense recognised for equity-settled share-based payment expense	**47**	30
Total expense recognised for cash-settled share-based payment expense	**3**	1
Share-based payment expense recognised in the consolidated income statement	**50**	31
Liability for cash-settled share-based payment expense	**5**	2

Share-based payment plans in operation during the year

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

Performance Share Plan (PSP)

This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market-based performance condition (Total Shareholder Return – TSR) over a three-year period.

ShareSave share option plan (ShareSave)

Based on a three- five-year monthly savings contract, eligible employees are granted share options with an exercise price of up to 20 per cent below the share price when the contract is entered into. Vesting of the options is not subject to the achievement of a performance target. In the UK, the plan is HM Revenue & Customs approved. Overseas, employees in 33 countries participate in cash-settled ShareSave plans through arrangements which provide broadly comparable benefits to the UK plan.

Executive Share Option Plan (ESOP)

This plan involved the grant of market value share options to participants. It terminated in 2009 and no further grants may be made. Remaining options under the plan are subject to a non-market based performance condition (growth in EPS) and have a maximum contractual life of ten years.

Annual Performance Related Award (APRA) plan deferred shares

A proportion of the APRA annual incentive scheme is delivered in the form of a deferred share award. The release of deferred share awards is not dependent on the achievement of any further performance conditions, other than that participants remain employed by the Group for two years from the date of the award in order to retain the full number of shares. During the two-year deferral period, participants are entitled to receive dividends, or equivalent, on the deferred shares.

19 SHARE-BASED PAYMENTS (CONTINUED)

Movements in the Group's share-based payment plans during the year

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at January 1, 2009	29.7	303	2.1	177	13.2	2.8
Granted	11.9	387	–	–	10.1	2.3
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(2.3)	352	(0.2)	209	(0.7)	(0.1)
Exercised	(11.9)	192	(0.7)	213	(4.2)	(1.7)
Outstanding at December 31, 2009	27.4	384	1.2	154	18.4	3.4
Exercisable at December 31, 2009	–	–	1.2	154	–	–
Outstanding at January 1, 2010	**27.4**	**384**	**1.2**	**154**	**18.4**	**3.4**
Granted	**–**	**–**	**–**	**–**	**5.5**	**1.1**
Additional entitlements arising from TSR performance	**–**	**–**	**–**	**–**	**0.6**	**–**
Additional shares accrued from reinvestment of C Shares	**–**	**–**	**–**	**–**	**–**	**0.1**
Forfeited	**(0.8)**	**395**	**–**	**–**	**(0.4)**	**(0.1)**
Exercised	**(0.1)**	**366**	**(0.5)**	**190**	**(4.6)**	**(1.4)**
Outstanding at December 31, 2010	**26.5**	**384**	**0.7**	**125**	**19.5**	**3.1**
Exercisable at December 31, 2010	**–**	**–**	**0.7**	**125**	**–**	**–**

As share options are exercised throughout the year, the weighted average share price during the year of **579p** (2009 386p) is representative of the weighted average share price at the date of exercise. The closing share price at December 31, 2010 was **623p**, (2009 483.5p).

The average remaining contractual life of exercisable options is **1.7 years** (2009 2.1 years).

Share options outstanding

	ShareSave		ESOP		Total	
Exercise price (pence)	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years
At December 31, 2010						
0 –99	**–**	**–**	**0.4**	**2.2**	**0.4**	**2.2**
100 –199	**–**	**–**	**0.1**	**1.2**	**0.1**	**1.2**
200 –299	**4.5**	**0.1**	**0.2**	**0.3**	**4.7**	**0.1**
300 –399	**11.6**	**3.2**	**–**	**–**	**11.6**	**3.2**
400 –499	**10.4**	**1.3**	**–**	**–**	**10.4**	**1.3**
	26.5	**2.0**	**0.7**	**1.7**	**27.2**	**1.9**
At December 31, 2009						
0 –99	–	–	0.5	3.2	0.5	3.2
100 –199	–	–	0.2	1.7	0.2	1.7
200 –299	4.6	1.1	0.5	1.2	5.1	1.1
300 –399	11.9	4.2	–	–	11.9	4.2
400 –499	10.9	2.3	–	–	10.9	2.3
	27.4	2.9	1.2	2.1	28.6	2.9

The range of exercise prices of options outstanding at December 31, 2010 was between **77p** and **416p** (2009 77p and 416p). For ShareSave it was between **298p** and **416p** (2009 298p and 416p) and for ESOP it was between **77p** and **218p** (2009 77p and 218p).

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to 30 directors and senior executives were outstanding at December 31, 2010.

19 SHARE-BASED PAYMENTS (CONTINUED)

Fair values of share-based payment plans

The weighted average fair value per share of equity-settled share-based payment plans granted during the year, estimated at the date of grants are as follows:

	2010	2009
PSP – 25% TSR uplift	**586p**	253p
PSP – 50% TSR uplift	**654p**	282p
ShareSave – 3 year grant	**n/a**	144p
ShareSave – 5 year grant	**n/a**	167p
APRA	**537p**	290p

In estimating these fair values, the following assumptions were used:

	PSP		Sharesave
	2010	2009	2009
Weighted average share price	**545p**	260p	462p
Exercise price	**n/a**	n/a	387p
Expected dividends	**14.6p**	14.7p	14.3p
Expected volatility	**33%**	32%	36%
Correlation	**35%**	35%	n/a
Expected life – PSP	**3 years**	3 years	n/a
Expected life – 3 year ShareSave	**n/a**	n/a	3.3 –3.8 years
Expected life – 5 year ShareSave	**n/a**	n/a	5.3 –5.8 years
Risk free interest rate	**1.9%**	1.9%	2.4%

Expected volatility is based on the historical volatility of the Rolls-Royce Group plc's share price over the seven years prior to the grant or award date. Expected dividends are based on the Rolls-Royce Group plc's payments to shareholders in respect of the previous year.

PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition, based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies, which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value of the award relative to the share price at the date of grant.

ShareSave

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

APRA

The fair value of shares awarded under APRA is calculated as the share price on the date of the award, excluding expected dividends.

20 OPERATING AND FINANCE LEASES

Operating leases

Leases as lessee

	2010 £m	2009 £m
Rentals paid – hire of plant and machinery	**82**	68
– hire of other assets	**20**	24
Non-cancellable operating lease rentals are payable as follows:		
Within one year	**92**	82
Between one and five years	**265**	182
After five years	**215**	123
	572	387

Leases as lessor

	2010 £m	2009 £m
Rentals received – credited within revenue from aftermarket services	**29**	22
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	**3**	5
Between one and five years	**10**	11
After five years	**3**	5
	16	21

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

- Sublease payments of **£23m** (2009 £18m) and sublease receipts of **£11m** (2009 £11m) were recognised in the income statement in the year.
- Purchase options exist on aero engines, land and buildings and plant and equipment, with the period to the purchase option date varying between one to five years.
- Renewal options exist on aero engines, land and buildings and plant and equipment, with the period to the renewal option varying between one to 21 years, at terms to be negotiated upon renewal.
- Escalation clauses exist on some leases and are linked to LIBOR.
- The total future minimum sublease payments expected to be made is **£18m** (2009 £14m) and sublease receipts expected to be received is **£3m** (2009 £4m).

Finance leases

Finance lease liabilities are payable as follows:

	2010			2009		
	Payments £m	Interest £m	Principal £m	Payments £m	Interest £m	Principal £m
Between one and five years	**1**	**–**	**1**	1	–	1

There were no contingent rents recognised as an expense in the year or prior year and there are no minimum sublease receipts under non-cancellable subleases (2009 £4m).

21 CONTINGENT LIABILITIES AND CONTINGENT ASSETS

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

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

The discounted values of contingent liabilities relating to delivered aircraft and other arrangements where financing is in place, less insurance arrangements and relevant provisions, were:

	2010		2009	
	£m	***$m***	£m	*$m*
Gross contingent liabilities	**633**	***991***	704	*1,137*
Contingent liabilities net of relevant security [1]	**121**	***190***	134	*217*
Contingent liabilities net of relevant security reduced by 20% [2]	**200**	***314***	233	*376*
[1] Security includes unrestricted cash collateral of:	**68**	***106***	77	*124*

[2] Although sensitivity calculations are complex, the reduction of relevant security by 20 per cent illustrates the sensitivity of the contingent liability to changes in this assumption.

There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

Contingent liabilities exist in respect of guarantees provided by the Group in the ordinary course of business for product delivery, performance and reliability. The Group has, in the normal course of business, entered into arrangements in respect of export finance, performance bonds, countertrade obligations and minor miscellaneous items. Various Group undertakings are parties to legal actions and claims which arise in the ordinary course of business, some of which are for substantial amounts. These include claims, which are yet to be substantiated, received by EPI Europrop International GmbH (EPI) in which the Group is a partner, which is developing the TP400 engine for the Airbus A400M aircraft. As a consequence of the insolvency of an insurer, as previously reported, the Group is no longer fully insured against known and potential claims from employees who worked for certain of the Group's UK based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot be precisely 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.

In 2010, the Launch Nations reconfirmed their commitment to the A400M programme; however, the Launch Nations and Airbus remain in final negotiations to modify the existing agreement. EPI and Airbus are simultaneously in negotiations to modify their agreement in support of the A400M. The timing and outcome of these negotiations, and their possible impact on EPI and the Group, therefore remain uncertain. In the event that the programme were cancelled, at December 31, 2010, the Group's balance sheet did not include any net assets that would require impairment (2009 £17m).

As noted on page 47 of the business review, Rolls-Royce has commenced an action in respect of its swept fan blade patent. Subsequent proceedings have commenced against Rolls-Royce alleging patent infringement. It is not possible, at this stage, to estimate the amount of any damages which might be awarded in favour of, or against, Rolls-Royce.

22 RELATED PARTY TRANSACTIONS

	2010 £m	2009 £m
Sales of goods and services to joint ventures and associates	**2,681**	2,136
Purchases of goods and services from joint ventures and associates	**(2,163)**	(1,900)
Operating lease payments to joint ventures and associates	**(58)**	(45)
Guarantees of joint ventures' and associates' borrowings	**43**	15
Dividends received from joint ventures and associates	**68**	77
RRSP receipts from joint ventures and associates	**12**	7
Other income received from joint ventures and associates	**79**	52

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

In the course of normal operations, related party transactions entered into by the Group have been contracted on an arms-length basis.

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

	2010 £m	2009 £m
Salaries and short-term benefits	**13**	11
Post-retirement schemes	**2**	2
Share-based payments	**8**	4
	23	17

23 ACQUISITIONS AND DISPOSALS

On April 7, 2010, the Group acquired 67 per cent of the issued share capital of ODIM ASA (ODIM). Together with the 33 per cent of the issued share capital already held, this gave Rolls-Royce control of 100 per cent of ODIM. ODIM is a Norwegian marine technology company which develops and sells advanced automated handling systems for seismic and offshore vessels. ODIM's technology and unique subsea and deepwater capability complement the Group's existing activities. Integrating ODIM's innovative technology and highly skilled people into the Group will optimise the Group's offering and provide the global customer base with a wider range of products and services in this important market segment.

Recognised amounts of identifiable assets acquired and liabilities assumed

	ODIM £m	Other £m	Total £m
Intangible assets – software and other	96	–	96
Property, plant and equipment	24	–	24
Inventories	16	–	16
Trade and other receivables	57	–	57
Cash and cash equivalents	12	–	12
Trade and other payables	(46)	–	(46)
Current tax liabilities	(3)	–	(3)
Borrowings	(1)	–	(1)
Deferred tax liabilities	(32)	–	(32)
Provisions	(2)	–	(2)
Total identifiable assets and liabilities	121	–	121
Goodwill arising	115	3	118
Total consideration	236	3	239
Satisfied by:			
Cash consideration	159	3	162
Existing 33 per cent shareholding	77	–	77
	236	3	239
Net cash outflow arising on acquisition:			
Cash consideration			162
Less: cash and cash equivalents acquired			(12)
Cash outflow per cash flow statement			150
Identifiable intangible assets comprise:			
Technology, patents and licenses			45
Customer relationships			46
Other			5
			96

The fair value of the Group's 33 per cent interest in ODIM before the acquisition was £77m. The Group recognised a gain of £3m as a result of remeasuring this interest, which is included in the share of results of joint ventures and associates in the consolidated income statement for the year ended December 31, 2010.

The goodwill arising on acquisition of ODIM amounting to £115m (which is not tax-deductible) consists of anticipated synergies and the assembled workforce. The synergies principally arise from:

- increases in revenue from the combination of the routes to market; and
- cost savings from the combination of the supply chain and central functions.

The gross contractual value of trade and other receivables acquired is £58m. At the acquisition date, it is estimated that contractual cash flows of £1m will not be collected.

Acquisition related costs (included in commercial and administrative costs) in the consolidated income statement for the year ended December 31, 2010, amounted to £2m.

23 ACQUISITIONS AND DISPOSALS (CONTINUED)

The acquisition of the controlling interest in ODIM contributed £205m of revenue and a £16m loss before tax (including amortisation of intangible assets arising on acquisition) to the Group's results for the period between the date of acquisition and December 31, 2010.

If the acquisition of ODIM had been completed on January 1, 2010, the Group's revenues and profit before tax would have been £11,132m and £696m respectively.

During the year the Group disposed of its interests in a number of small businesses, as summarised below:

	Total £m
Inventories	4
Provisions for liabilities and charges	(4)
Net assets	–
Profit on disposal of businesses	4
Proceeds deferred at December 31, 2010	(4)
Disposal proceeds	–
Receipt of proceeds deferred at December 31, 2009	2
Cash inflow per cash flow statement	2

COMPANY FINANCIAL STATEMENTS

DECEMBER 31, 2010

COMPANY BALANCE SHEET

AT DECEMBER 31, 2010

	Notes	2010 £m	2009 £m
Fixed assets			
Intangible assets	3	**607**	569
Tangible assets	4	**1,038**	1,041
Investments – subsidiary undertakings	5	**1,753**	1,750
– joint ventures	5	**53**	51
– other	5	**–**	49
		3,451	3,460
Current assets			
Stocks	6	**1,227**	1,240
Debtors – amounts falling due within one year	7	**1,748**	2,183
– amounts falling due after one year	7	**878**	932
Other financial assets – amounts falling due within one year	10	**259**	114
– amounts falling due after one year	10	**376**	646
Short-term deposits		**1,432**	1,644
Cash at bank and in hand		**644**	663
Assets held for resale		**9**	9
		6,573	7,431
Creditors – amounts falling due within one year			
Borrowings	8	**(770)**	(511)
Other financial liabilities	10	**(145)**	(158)
Other creditors	9	**(5,164)**	(5,093)
		(6,079)	(5,762)
Net current assets		**494**	1,669
Total assets less current liabilities		**3,945**	5,129
Creditors – amounts falling due after one year			
Borrowings	8	**(1,128)**	(1,782)
Other financial liabilities	10	**(986)**	(896)
Other creditors	9	**(713)**	(773)
		(2,827)	(3,451)
Provisions for liabilities and charges	11	**(123)**	(99)
Net assets excluding post-retirement schemes		**995**	1,579
Post retirement schemes – surpluses	13	**458**	237
– deficits	13	**(35)**	(50)
Net assets		**1,418**	1,766
Capital and reserves			
Called-up share capital	14	**326**	326
Share premium account	15	**631**	631
Revaluation reserve	15	**41**	47
Other reserves	15	**167**	167
Profit and loss account	15	**253**	595
Total shareholders' funds		**1,418**	1,766

The financial statements on pages 103 to 123 were approved by the Board on February 9, 2011 and signed on its behalf by:

Sir Simon Robertson Chairman

Andrew Shilston Finance Director

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

FOR THE YEAR ENDED DECEMBER 31, 2010

	2010 £m	2009 £m
Profit attributable to the shareholders of Rolls-Royce plc	**31**	1,937
Net actuarial gains/(losses) on post retirement schemes	**302**	(1,176)
Movement in unrecognised post-retirement surplus	**(89)**	491
Related tax movements	**(51)**	192
Total recognised gains relating to the year	**193**	1,444

RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

FOR THE YEAR ENDED DECEMBER 31, 2010

	2010 £m	2009 £m
At January 1	**1,766**	331
Total recognised gains for the year	**193**	1,444
Dividend paid	**(550)**	–
Transfer from transition hedging reserve	**–**	(27)
Share-based payments – direct to equity	**9**	11
Related tax movements	**–**	7
At December 31	**1,418**	1,766

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1 ACCOUNTING POLICIES

Basis of accounting

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

As permitted by the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements.

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

Revenue recognition

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

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

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

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

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

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

Government investment

Where a government or similar body invests in a development programme, the Company treats payments to that body as royalty payments, which are matched to related sales.

Risk and revenue sharing partnerships (RRSPs)

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

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

Research and development

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

1 ACCOUNTING POLICIES (CONTINUED)

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

Taxation
Provision for taxation is made at the current rate and for deferred taxation at the projected rate on all timing differences that have originated, but not reversed at the balance sheet date. Deferred tax is calculated using the enacted or substantively enacted rates that are expected to apply when the asset or liability is settled.

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

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

Financial instruments
FRS 26 *Financial instruments: Recognition and measurement* requires the classification of financial instruments into separate categories for which the accounting requirement is different. The Company has classified its financial instruments as follows:
- Fixed deposits, principally comprising funds held with banks and other financial institutions, are classified as loans and receivables.
- Investments (other than interests in joint ventures and fixed deposits) and short-term deposits (other than fixed deposits) are classified as available for sale.
- Borrowings, trade creditors and financial RRSPs are classified as other liabilities.
- Derivatives, comprising foreign exchange contracts, interest rate swaps and commodity swaps are classified as held for trading.

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

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

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

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

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

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

1 ACCOUNTING POLICIES (CONTINUED)

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

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

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

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

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

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

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

i) Land and buildings, as advised by the Group's professional advisors:
   a) Freehold buildings – five to 45 years (average 24 years).
   b) Leasehold land and buildings – lower of valuers' estimates or period of lease.
   c) No depreciation is provided in respect of freehold land.
ii) Plant and equipment – five to 25 years (average 13 years).
iii) Aircraft and engines – five to 20 years (average 16 year).
iv) No depreciation is provided on assets in the course of construction.

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

Intangible assets not yet available for use are tested for impairment annually. Other fixed assets are assessed for any indications of impairment annually. If any indication of impairment is identified, an impairment test is performed to estimate the recoverable amount.

Recoverable amount is the higher of value in use or fair value less costs to sell, if this is readily available. The value in use is the present value of future cash flows using a pre-tax discount rate that reflects the time value of money and the risk specific to the asset.

If the recoverable amount of an asset (or income-generating unit) is estimated to be below the carrying value, the carrying value is reduced to the recoverable amount and the impairment loss recognised as an expense.

1 ACCOUNTING POLICIES (CONTINUED)

Accounting for leases

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

ii) As lessor: Amounts receivable under finance leases are included under debtors and represent the total amount outstanding under lease agreements less unearned income. Finance lease income, having been allocated to accounting periods to give a constant periodic rate of return on the net cash investment, is included in turnover. Rentals receivable under operating leases are included in turnover on a straight-line basis.

Stock

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

Provisions

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

Post-retirement benefits

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

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

Share-based payments

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

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

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

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

2 EMOLUMENTS OF DIRECTORS

	2010		2009	
	Highest paid director[1] £000	Other directors £000	Highest paid director[1] £000	Other directors £000
Aggregate emoluments excluding deferred share plans	**1,737**	**4,628**	1,110	3,638
Aggregate amounts relating to deferred share plans	**1,701**	**2,685**	837	1,361
Aggregate value of Company contributions to Company defined contribution pensions schemes	**–**	**539**	–	524
Accrued pension of highest paid director	**453**	**–**	450	–
Gains realised on exercise of share options [2]	**–**	**713**	–	51

	2010 Number	2009 Number
Number of directors with accruing retirement benefits:		
Defined contribution schemes	**2**	2
Defined benefit schemes [3]	**2**	2
Number of directors with enhanced protection rights within defined benefit schemes	**2**	2
Number of directors exercising share options	**1**	2
Number of directors receiving shares as part of long-term incentives schemes	**5**	5

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

[2] Includes gains under the ShareSave plan.

[3] Two directors were contributing members of both defined contribution and defined benefit schemes (2009 two directors).

3 INTANGIBLE ASSETS

	Certification costs and participation fees £m	Software and other £m	Total £m
Cost:			
At January 1, 2010	**564**	**233**	**797**
Additions	38	39	77
At December 31, 2010	**602**	**272**	**874**
Accumulated amortisation:			
At January 1, 2010	**165**	**63**	**228**
Charge for the year	16	23	39
At December 31, 2010	**181**	**86**	**267**
Net book value:			
At December 31, 2010	**421**	**186**	**607**
At January 1, 2010	399	170	569

4 TANGIBLE ASSETS

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost or valuation:					
At January 1, 2010	**402**	**1,322**	**35**	**137**	**1,896**
Additions	3	49	12	84	148
Reclassifications	10	70	3	(83)	–
Disposals/write-offs	(1)	(52)	(14)	(1)	(68)
At December 31, 2010	**414**	**1,389**	**36**	**137**	**1,976**
Accumulated depreciation:					
At January 1, 2010	**117**	**733**	**5**	**–**	**855**
Charge for the year	15	110	4	–	129
Disposals/write-offs	–	(45)	(1)	–	(46)
At December 31, 2010	**132**	**798**	**8**	**–**	**938**
Net book value:					
At December 31, 2010	**282**	**591**	**28**	**137**	**1,038**
At January 1, 2010	285	589	30	137	1,041

Tangible fixed assets include:	2010 £m	2009 £m
Net book value of finance leased assets	**12**	13
Non-depreciable land	**47**	47
Land and buildings at cost or valuation comprise:		
Cost	**263**	250
Valuation at December 31, 1996	**151**	152
	414	402
On an historical cost basis the net book value of land and buildings would have been as follows:		
Cost	**394**	386
Depreciation	**(153)**	(148)
	241	238
Capital expenditure commitments	**76**	82

5 INVESTMENTS

	Subsidiary undertakings[1]			Joint ventures[2]	Other
	Shares at cost £m	Shares at cost £m	Loans £m	Total £m	Unlisted investments at cost £m
At January 1, 2010	**1,750**	**46**	**5**	**51**	**49**
Additions	3	2	–	2	–
Impairment	–	–	–	–	(3)
Disposals	–	–	–	–	(46)
At December 31, 2010	**1,753**	**48**	**5**	**53**	**–**

[1] The principal subsidiary undertakings are listed on page 124.

[2] The principal joint ventures are listed on pages 125 and 126.

The Company has guaranteed the uncalled share capital of Nightingale Insurance Limited, one of its subsidiaries. At December 31, 2010, this guarantee was £25m (2009 £25m).

6 STOCKS

	2010 £m	2009 £m
Raw materials	**132**	106
Work in progress	**415**	303
Long-term contracts work in progress	**5**	15
Finished goods	**651**	800
Payments on account	**24**	16
	1,227	1,240

7 DEBTORS

	Falling due within one year		Falling due after one year	
	2010 £m	2009 £m	2010 £m	2009 £m
Trade debtors	**371**	315	**–**	1
Amounts recoverable on contracts	**9**	78	**481**	609
Amounts owed by – subsidiary undertakings	**650**	1,040	**–**	–
– joint ventures	**470**	455	**4**	5
– parent undertaking	**–**	72	**–**	–
Deferred tax assets (note 12)	**–**	–	**373**	292
Other debtors	**148**	146	**–**	–
Prepayments and accrued income	**100**	77	**20**	25
	1,748	2,183	**878**	932

8 BORROWINGS

	Falling due within one year		Falling due after one year	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Unsecured				
Overdrafts	**128**	391	**–**	–
Bank loans	**–**	–	**200**	200
7 3/8% Notes 2016 £200m	**–**	–	**200**	200
5.84% Notes 2010 US$187m [1]	**–**	120	**–**	–
6.38% Notes 2013 US$230m [1]	**–**	–	**162**	155
6.55% Notes 2015 US$83m [1]	**–**	–	**60**	57
4 1/2% Notes 2011 €750m [2]	**642**	–	**–**	677
6.75% Notes 2019 £500m [3]	**–**	–	**506**	493
	770	511	**1,128**	1,782
Repayable – otherwise than by installments				
Between one and two years			**–**	677
Between two and five years			**422**	355
After five years			**706**	750
			1,128	1,782

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

[2] These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable at variable rates of interest and at fixed exchange rates.

[3] These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest in consideration for amounts payable at variable rates of interest.

9 OTHER CREDITORS

	Falling due within one year		Falling due after one year	
	2010 £m	2009 £m	**2010 £m**	2009 £m
Payments received on account [1]	**388**	387	**464**	525
Trade creditors	**431**	426	**–**	–
Amounts owed to – subsidiary undertakings	**2,014**	2,211	**–**	–
– joint ventures	**251**	258	**3**	2
– parent	**249**	–	**–**	–
Corporate taxation	**99**	95	**–**	–
Other taxation and social security	**17**	38	**–**	–
Other creditors	**909**	832	**91**	69
Accruals and deferred income	**806**	846	**155**	177
	5,164	5,093	**713**	773
[1] Includes payments received on account from joint ventures	**160**	161	**243**	259

10 OTHER FINANCIAL ASSETS AND LIABILITIES

Details of the Company's policies on the use of financial instruments are given in the accounting policies on pages 34 to 41.

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

	Foreign exchange contracts £m	Commodity contracts £m	Interest rate contracts £m	Financial RRSPs £m	Total £m
At December 31, 2010					
Assets – amounts falling due within one year	**107**	**10**	**142**	**–**	**259**
– amounts falling due after one year	**322**	**18**	**36**	**–**	**376**
Liabilities – amounts falling due within one year	**(86)**	**(5)**	**–**	**(54)**	**(145)**
– amounts falling due after one year	**(745)**	**(2)**	**(3)**	**(236)**	**(986)**
	(402)	**21**	**175**	**(290)**	**(496)**
At December 31, 2009					
Assets – amounts falling due within one year	106	4	4	–	114
– amounts falling due after one year	438	11	197	–	646
Liabilities – amounts falling due within one year	(97)	(11)	–	(50)	(158)
– amounts falling due after one year	(617)	(15)	(2)	(262)	(896)
	(170)	(11)	199	(312)	(294)

Foreign exchange and commodity financial instruments

The Company uses various financial instruments to manage its exposure to movements in foreign exchange rates. The Company uses commodity swaps to manage its exposure to movements in the price of commodities (jet fuel and base metals). To hedge the currency risk associated with a borrowing denominated in US dollars, the Company has currency derivatives designated as part of fair value hedges.

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

	Foreign exchange instruments £m	Commodity instruments £m
At January 1, 2009	(1,952)	(89)
Movements in derivative contracts not in accounting hedging relationships	1,562	52
Movements in fair value hedges [1]	(33)	–
Contracts settled	253	26
At January 1, 2010	**(170)**	**(11)**
Movements in derivative contracts not in accounting hedging relationships	**(398)**	**29**
Movements in fair value hedges [1]	**7**	**–**
Contracts settled	**159**	**3**
At December 31, 2010	**(402)**	**21**

[1] Loss on related hedged items **£7m** (2009 £33m profit).

10 OTHER FINANCIAL ASSETS AND LIABILITIES (CONTINUED)

Interest rate financial instruments

The Company uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates.

The fair values of interest rate financial instruments were as follows:

	Total £m	Included in fair value hedging relationships £m	Other interest rate financial instruments £m
At January 1, 2009	274	278	(4)
Movements in fair values [1]	(75)	(77)	2
At January 1, 2010	**199**	**201**	**(2)**
Movements in fair values [1]	**(22)**	**(21)**	**(1)**
Contracts settled	**(2)**	**(2)**	**–**
At December 31, 2010	**175**	**178**	**(3)**

[1] Profit on related hedged items **£21m** (2009 £77 profit).

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

Financial risk and revenue sharing partnerships (RRSPs)

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

The amortised cost values of financial RRSPs were as follows:

	2010 £m	2009 £m
At January 1	**(312)**	(385)
Cash paid to partners	**59**	57
Financing charge	**(20)**	(22)
Exchange adjustments	**(6)**	44
Changes in forecast payments	**(11)**	(6)
At December 31	**(290)**	(312)

11 PROVISIONS FOR LIABILITIES AND CHARGES

	At January 1, 2010 £m	Unused amounts reversed £m	Charged to profit and loss account £m	Utilised £m	At December 31, 2010 £m
Warranties and guarantees	**29**	**–**	**13**	**(3)**	**39**
Contract loss	**5**	**(1)**	**3**	**–**	**7**
Customer financing	**57**	**–**	**16**	**(9)**	**64**
Restructuring	**8**	**(3)**	**14**	**(6)**	**13**
	99	**(4)**	**46**	**(18)**	**123**

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

Provisions for contract loss and restructuring are generally expected to be utilised within two years.

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

12 DEFERRED TAXATION

	£m
At January 1, 2010	**220**
Amount credited to profit and loss account	47
Amount charged to statement of total recognised gains and losses	(51)
At December 31, 2010	**216**

There are other deferred tax assets totalling £102m (2009 £102m) that have not been recognised on the basis that their future economic benefit is uncertain.

The Emergency Budget on 22 June 2010 announced that the UK corporation tax rate will reduce from 28 per cent to 24 per cent over a period of four years from 2011. The first reduction in the rate from 28 per cent to 27 per cent was substantively enacted on 21 July 2010 and will be effective from 1 April 2011. As this rate change was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been restated. The resulting charges or credits have been recognised in the income statement except to the extent that they relate to items previously charged or credited to reserves. Accordingly, in 2010, £15m has been charged to the profit and loss account and £9m has been credited to the STRGL. Had the further tax rate changes been substantively enacted on or before the balance sheet date, it would have had the effect of reducing the deferred tax asset by £17m.

The analysis of the deferred tax position is as follows:

	2010 £m	2009 £m
Fixed asset timing differences	**(111)**	(117)
Other timing differences	**27**	45
Pensions and other post-retirement scheme benefits	**(157)**	(72)
Foreign exchange and commodity financial assets and liabilities	**94**	54
Losses	**302**	249
Advance corporation tax	**61**	61
	216	220
Included within:		
Debtors – amounts falling due after one year	**373**	292
Post-retirement scheme – surpluses	**(170)**	(92)
– deficits	**13**	20
	216	220

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

13 POST-RETIREMENT BENEFITS

Defined benefit schemes

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

The valuations of the defined benefit schemes are based on the most recent funding valuations, updated by the scheme actuaries to December 31, 2010. The most recent funding valuations of the main schemes were:

Scheme	Valuation date
Rolls-Royce Pension Fund	March 31, 2009
Rolls-Royce Group Pension Scheme (provisional)	April 5, 2010
Vickers Group Pension Scheme (provisional)	March 31, 2010

13 POST-RETIREMENT BENEFITS (CONTINUED)

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

	2010 %	2009 %
Rate of increase in salaries	**4.7**	4.7
Rate of increase of pensions in payment [1]	**3.0**	3.3
Discount rate	**5.5**	5.7
Expected rate of return on scheme assets	**5.0**	5.4
Inflation assumption	**3.6**	3.6

[1] Benefits accruing after April 5, 2005 are assumed to increase at a rate of 1.9 per cent.

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

The assumptions have not been adjusted to reflect the UK Government's announcement in 2010 to change the basis for the indexation of occupational pension schemes from the Retail Prices Index to the Consumer Price Index.

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

The mortality assumptions adopted for the pension schemes are derived from the SAPS actuarial tables, with 80 per cent of long cohort and an underpin of one per cent, published by the Institute of Actuaries, projected forward and, where appropriate, adjusted to take account of the relevant scheme's actual experience. The resulting range of life expectancies in the principal schemes are as follows:

Life expectancy from age 65

Current pensioner	22.4 years
Future pensioner currently aged 45	24.2 years

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

Amounts recognised in the balance sheet

	2010 £m	2009 £m
Present value of funded obligations	**(7,039)**	(6,714)
Fair value of scheme assets	**7,783**	7,048
Unrecognised surplus [1]	**(164)**	(75)
Surplus	**580**	259
Related deferred tax liability	**(157)**	(72)
Net asset recognised in the balance sheet	**423**	187
Analysed as:		
Post-retirement scheme surpluses	**458**	237
Post-retirement scheme deficits	**(35)**	(50)
	423	187

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

13 POST-RETIREMENT BENEFITS (CONTINUED)

Changes in present value of defined benefit obligations

	2010 £m	2009 £m
At January 1	**(6,714)**	(5,719)
Current service cost	**(118)**	(94)
Past service cost	**–**	(2)
Finance cost	**(375)**	(355)
Contributions by employees	**(3)**	(3)
Benefits paid out	**313**	324
Actuarial losses	**(142)**	(865)
At December 31	**(7,039)**	(6,714)

Changes in fair value of scheme assets

	2010 £m	2009 £m
At January 1	**7,048**	7,163
Expected return on assets	**374**	285
Contributions by employer	**227**	232
Contributions by employees	**3**	3
Benefits paid out	**(313)**	(324)
Actuarial gains/(losses)	**444**	(311)
At December 31	**7,783**	7,048
Actual return on plan assets	**818**	(26)

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

	2010		2009	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
LDI portfolio [1]	**4.5**	**6,383**	5.0	5,736
Equities	**7.5**	**1,204**	7.8	1,107
Sovereign debt	**4.2**	**23**	4.5	18
Corporate bonds	**5.2**	**22**	5.5	8
Other	**4.2**	**151**	4.6	179
	5.0	**7,783**	5.4	7,048

1 A portfolio of gilt and swap contracts, backed by LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

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

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

The expected rates of return on other individual categories of scheme assets are determined by reference to gilt yields. Equities and corporate bonds are assumed to generate returns that exceed the return from gilts by 3.25 per cent and 1.0 per cent per annum respectively.

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

Future contributions

The Company expects to contribute approximately £255m to its defined benefit schemes in 2011.

13 POST-RETIREMENT BENEFITS (CONTINUED)

Sensitivities

The investment strategies are designed to hedge the risks from interest rates and inflation on an economic basis. A reduction of 0.25 per cent in the discount rate would increase the obligations of the defined benefit schemes by approximately £259m. An equivalent movement in interest rates would increase the fair value of the assets by approximately £343m. The difference arises largely due to differences in the methods used to value the obligations for accounting and economic purposes. On an economic basis the correlation is in excess of 90 per cent. The principle remaining risks relate to the assumptions for mortality and increases in salaries. If the age ratings in respect of the defined benefit schemes were increased by one year, the scheme liabilities would increase by £119m. If the rate of increase in salaries were 0.5 per cent higher, scheme liabilities would increase by £132m.

History of defined benefit schemes

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

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Balance sheet					
Present value of defined benefit obligations	**(7,039)**	(6,714)	(5,719)	(6,335)	(5,785)
Fair value of scheme assets	**7,783**	7,048	7,163	6,626	5,101
Unrecognised surplus	**(164)**	(75)	(566)	(113)	–
Surplus/(deficit)	**580**	259	878	178	(684)
Experience gains/(losses)					
Actuarial gains on scheme assets	**444**	(311)	264	157	114
Experience (losses)/gains on scheme liabilities	**(142)**	(865)	776	309	477
Movement in unrecognised surplus	**(89)**	491	(453)	(113)	–
Total amount recognised in the statement of total recognised gains and losses	**213**	(685)	587	353	591
Cumulative amount recognised in the statement of total recognised gains and losses [1]	**(280)**	(493)	192	(395)	(748)

[1] Since January 1, 2002

Defined contribution schemes

The Company operates a number of defined contribution schemes. The total expense recognised in the profit and loss account was £9m (2009 £7m).

14 SHARE CAPITAL

	Ordinary shares of 20p each Millions	**Nominal value £m**
Issued and fully paid		
At January 1, 2009 and December 31, 2010	1,631	326

15 MOVEMENTS IN CAPITAL AND RESERVES

		Non-distributable reserves				
	Share capital £m	**Share premium £m**	**Revaluation reserve £m**	**Other reserves £m**	**Profit and loss account £m**	**Total equity £m**
At January 1, 2010	**326**	**631**	**47**	**167**	**595**	**1,766**
Total recognised gains relating to the year	**–**	**–**	**–**	**–**	**193**	**193**
Dividend paid	**–**	**–**	**–**	**–**	**(550)**	**(550)**
Transfers between reserves	**–**	**–**	**(6)**	**–**	**6**	**–**
Share-based payments – direct to reserves	**–**	**–**	**–**	**–**	**9**	**9**
At December 31, 2010	**326**	**631**	**41**	**167**	**253**	**1,418**

16 OPERATING LEASE ANNUAL COMMITMENTS

	2010 £m	2009 £m
Leases of land and buildings which expire:		
Between one and five years	**4**	3
After five years	**1**	1
Other leases which expire:		
Within one year	**1**	1
Between one and five years	**4**	4

17 SHARE-BASED PAYMENTS

Effect of share-based payment transactions on the Company's results

	2010 £m	2009 £m
Total expense recognised for equity settled share-based payment transactions	**28**	19

Share-based payment plans in operation during the year

During the year, the Company participated in the following share-based payment plans operated by Rolls-Royce Group plc:

Performance Share Plan (PSP)

This plan involves the award of shares to participants subject to performance conditions. Vesting of the performance shares is based on the achievement of both non-market based conditions (EPS and cash flow per share) and a market based performance condition (Total Shareholder Return – TSR) over a three-year period.

ShareSave share option plan

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

Executive Share Option Plan (ESOP)

This plan involved the grant of market value share options to participants. It terminated in 2009 and no further grants may be made. Remaining options under the plan are subject to a non-market based performance condition (growth in EPS) and have a maximum contractual life of ten years.

Annual Performance Related Award (APRA) plan deferred shares

A proportion of the APRA annual incentive scheme is delivered in the form of a deferred share award. The release of deferred share awards is not dependent on the achievement of any further performance conditions other than that participants remain employed by the Company for two years from the date of the award in order to retain the full number of shares. During the two year deferral period, participants are entitled to receive dividends, or equivalent, on the deferred shares.

17 SHARE-BASED PAYMENTS (CONTINUED)

Movements in the Company's share-based payment plans during the year

	ShareSave		ESOP		PSP	APRA
	Number Millions	Weighted average exercise price Pence	Number Millions	Weighted average exercise price Pence	Number Millions	Number Millions
Outstanding at January 1, 2009	18.9	288	0.9	176	7.8	1.4
Granted	7.5	387	–	–	6.0	1.2
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(1.3)	353	–	–	(0.5)	–
Exercised	(7.6)	171	(0.3)	205	(2.6)	(1.0)
Outstanding at December 31, 2009	17.5	381	0.6	165	10.7	1.7
Exercisable at December 31, 2009	–	–	0.6	165	–	–
Outstanding at January 1, 2010	**17.5**	**381**	**0.6**	**165**	**10.7**	**1.7**
Granted	**–**	**–**	**–**	**–**	**3.2**	**0.6**
Additional entitlements arising from TSR performance	**–**	**–**	**–**	**–**	**0.4**	**–**
Forfeited	**(0.4)**	**393**	**–**	**–**	**–**	**–**
Exercised	**(0.8)**	**426**	**(0.3)**	**186**	**(3.1)**	**(0.7)**
Outstanding at December 31, 2010	**16.3**	**380**	**0.3**	**132**	**11.2**	**1.6**
Exercisable at December 31, 2010	**–**	**–**	**0.3**	**132**	**–**	**–**

As share options are exercised throughout the year, the weighted average share price during the year of **579p** (2009 386p) is representative of the weighted average share price at the date of exercise. The closing share price at December 31, 2010 was **623p**, (2009 483.5p).

The average remaining contractual life of exercisable options is **1.6 years** (2009 2.0 years).

Share options outstanding

	ShareSave		ESOP		Total	
Exercise price (pence)	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years	Number Millions	Weighted average remaining contractual life Years
At December 31, 2010						
0 – 99	**–**	**–**	**0.1**	**2.2**	**0.1**	**2.2**
100 – 199	**–**	**–**	**0.1**	**1.2**	**0.1**	**1.2**
200 – 299	**3.1**	**0.1**	**0.1**	**0.3**	**3.2**	**0.1**
300 – 399	**7.1**	**3.3**	**–**	**–**	**7.1**	**3.3**
400 – 499	**6.1**	**1.5**	**–**	**–**	**6.1**	**1.5**
	16.3	**2.0**	**0.3**	**1.6**	**16.6**	**2.0**
At December 31, 2009						
0 – 99	–	–	0.2	3.2	0.2	3.2
100 – 199	–	–	0.1	2.0	0.1	2.0
200 – 299	3.9	1.1	0.3	1.2	4.2	1.1
300 – 399	7.3	4.3	–	–	7.3	4.3
400 – 499	6.3	2.4	–	–	6.3	2.4
	17.5	2.9	0.6	2.0	18.1	2.9

The range of exercise prices of options outstanding at December 31, 2010 was between **77p** and **416p** (2009 77p and 416p). For ShareSave it was between **298p** and **416p** (2009 298p and 416p) and for ESOP it was between **77p** and **218p** (2009 77p and 218p).

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to 16 directors and senior executives were outstanding at December 31, 2010.

17 SHARE-BASED PAYMENTS (CONTINUED)

Fair values of share-based payment plans

The weighted average fair values per share of equity-settled share-based payment plans granted during the year, estimated at the date of grant are as follows:

	2010	2009
PSP – 25% TSR uplift	**586p**	253p
PSP – 50% TSR uplift	**654p**	282p
ShareSave – 3 year grant	**n/a**	144p
ShareSave – 5 year grant	**n/a**	167p
APRA	**537p**	290p

In estimating these fair values, the following assumptions were used:

	PSP		ShareSave
	2010	2009	2009
Weighted average share price	**545p**	260p	462p
Exercise price	**n/a**	n/a	387p
Expected dividends	**14.6p**	14.7p	14.3p
Expected volatility	**33%**	32%	36%
Correlation	**35%**	35%	n/a
Expected life – PSP	**3 years**	3 years	n/a
Expected life – 3 year ShareSave	**n/a**	n/a	3.3 – 3.8 years
Expected life – 5 year ShareSave	**n/a**	n/a	5.3 – 5.8 years
Risk free interest rate	**1.9%**	1.9%	2.4%

Expected volatility is based on the historical volatility of Rolls-Royce Group plc's share price over the seven years prior to the grant or award date. Expected dividends are based on Rolls-Royce Group plc's payments to shareholders in respect of the previous year.

PSP

The fair value of shares awarded under the PSP is calculated using a pricing model that takes account of the non-entitlement to dividends (or equivalent) during the vesting period and the market-based performance condition, based on expectations about volatility and the correlation of share price returns in the group of FTSE 100 companies, which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value of the award relative to the share price at the date of grant.

ShareSave

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

APRA

The fair value of shares awarded under APRA is calculated as the share price on the date of the award, excluding expected dividends.

18 CONTINGENT LIABILITIES AND CONTINGENT ASSETS

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

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

The discounted value of the total gross contingent liabilities relating to financing arrangements on all delivered aircraft less insurance arrangements and relevant provisions were:

	2010		2009	
	£m	***$m***	£m	*$m*
Gross contingent liabilities	**633**	***991***	704	*1,137*
Contingent liabilities net of relevant security [1]	**121**	***190***	134	*217*
Contingent liabilities net of relevant security reduced by 50% [2]	**200**	***314***	233	*376*
[1] Unrestricted cash collateral held as security	**68**	***106***	77	*124*

[2] Although sensitivity calculations are complex, the reduction of the relevant security by 20 per cent illustrates the sensitivity of the contingent liability to changes in this assumption.

There are also net contingent liabilities in respect of undelivered aircraft, but it is not considered practicable to estimate these as deliveries can be many years in the future, and the relevant financing will only be put in place at the appropriate time.

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

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee. At December 31, 2010, there were Company guarantees in respect of joint ventures amounting to £43m (2009 £15m).

The Company participates in a Cash Pooling Arrangement. Under the Pooling Arrangement the Company benefits from more favourable interest rates than would be available outside of the Pooling Arrangement as well as more streamlined treasury functions. As part of the Pooling Arrangement, the Company cross-guarantees the borrowings of other pooling participants. At December 31, 2010 these guarantees amounted to £22m (2009 £35m).

As noted on page 47 of the business review, Rolls-Royce has commenced an action in respect of its swept fan blade patent. Subsequent proceedings have commenced against Rolls-Royce alleging patent infringement. It is not possible, at this stage, to estimate the amount of any damages which might be awarded in favour of, or against, Rolls-Royce.

19 RELATED PARTY TRANSACTIONS

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

There are no significant related party transactions with non wholly owned group companies

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

20 ULTIMATE HOLDING COMPANY

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

PRINCIPAL SUBSIDIARY UNDERTAKINGS

AT DECEMBER 31, 2010

INCORPORATED WITHIN THE UK – DIRECTLY HELD UNLESS MARKED*

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

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

INCORPORATED OVERSEAS – DIRECTLY HELD UNLESS MARKED*

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

The above companies operate principally in the country of their incorporation.
The effective Group interest is 100 per cent.

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

PRINCIPAL JOINT VENTURES

AT DECEMBER 31, 2010

JOINT VENTURES

INCORPORATED WITHIN THE UK – DIRECTLY HELD UNLESS MARKED*

	Class	% of class held	% of total equity held
Airtanker Holdings Limited Strategic tanker aircraft PFI project	Ordinary	20	20
Airtanker Services Limited Provision of aftermarket services for strategic tanker aircraft	Ordinary	22	22
Alpha Partners Leasing Limited Aero engine leasing	A Ordinary B Ordinary	100 –	50
Composite Technology & Applications Limited Development of aero engine fan blades	A Ordinary B Ordinary	100 –	51
Genistics Holdings Limited Trailer-mounted field mobile generator sets	A Ordinary B Ordinary	100 –	50
Rolls-Royce Goodrich Engine Control Systems Limited* Development and manufacture of aero engine controls	Ordinary	50	50
Rolls-Royce Snecma Limited (UK & France) Aero engine collaboration	A Shares B Shares	– 100	50
Rolls-Royce Turbomeca Limited (UK & France) Aero engine collaboration	A Shares B Shares	– 100	50
Rolls Wood Group (Repair and Overhauls) Limited Industrial gas turbine repair and overhaul	A Ordinary B Ordinary	100 –	50
TRT Limited Aero engine turbine blade repair services	A Ordinary B Ordinary	– 100	49.5
Turbine Surface Technologies Limited Aero engine turbine surface coatings	A Ordinary B Ordinary	– 100	50
Turbo-Union Limited (UK, Germany & Italy) RB199 engine collaboration	Ordinary A Shares	40 37.5	40

JOINT VENTURES

INCORPORATED OVERSEAS – DIRECTLY HELD UNLESS MARKED*

		Class	% of class held	% of total equity held
China	Xian XR Aero Components Co Limited Manufacturing facility for aero engine parts	Ordinary	49	49
Germany	EPI Europrop International GmbH (effective interest 35.5%) A400M engine collaboration	Ordinary	28	28
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%) EJ200 engine collaboration	Ordinary	33	33
Germany	MTU, Turbomeca, Rolls-Royce Gmbh (UK, France & Germany) MTR390 engine collaboration	Ordinary	33.3	33.3
Germany	N3 Engine Overhaul Services Verwaltungsgesellschaft mbH* Aero engine repair and overhaul	Ordinary	50	50
Hong Kong	Hong Kong Aero Engine Services Limited* Aero engine repair and overhaul	Ordinary	45	45
India	International Aerospace Manufacturing Private Limited* Manufacture of compressor shrouds, compressor rings, turbine blades and nozzel guide vanes	Ordinary	50	50
Israel	Techjet Aerofoils Limited* Manufacture of compressor aerofoils for gas turbines	A Ordinary B Ordinary	50 50	50
Malaysia	Advanced Gas Turbine Solutions Sdn Bhd* Industrial gas turbine aftermarket services	Ordinary	49	49
Singapore	International Engine Component Overhaul Pte Limited* Aero engine repair and overhaul	Ordinary	50	50
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%)* Aero engine repair and overhaul	Ordinary	30	30
Spain	Industria de Turbo Propulsores SA Aero engine component manufacture and maintenance	Ordinary	46.9	46.9
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & US) V2500 engine collaboration	A Shares B Shares C Shares D Shares	100 – – –	32.5
US	Alpha Leasing (US) LLC, Alpha Leasing (US) (No2) LLC, Alpha Leasing (US) (No4) LLC, Alpha Leasing (US) (No.5) LLC, Alpha Leasing (US) (No.6) LLC, Alpha Leasing (US) (No.7) LLC Rolls-Royce & Partners Finance (US) LLC, Rolls-Royce & Partners Finance (US) (No.2) LLC* Aero engine leasing	Partnerships	50	–
US	Exostar LLC* Business to business internet exchange	Partnership	17.6	–
US	GE Rolls-Royce Fighter Engine Team LLC* F136 development engine for the Joint Strike Fighter program	Partnership	40	–
US	Texas Aero Engine Services, LLC* Aero engine repair and overhaul	Partnership	50	–
US	Williams-Rolls Inc. (UK & US)* Small aero engine collaboration	Common	15	15

UNINCORPORATED OVERSEAS – HELD BY SUBSIDIARY UNDERTAKING

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

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

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