Finance Director's review
Andrew Shilston

The Group is in a sound financial position, with higher profits, lower average net debt and a record order book.

Year	£m
2000	253
2001	221
2002	344
2003	186
2004	**191**

Capital investment
Fixed asset additions at cost £m

Year	£m
2000	436
2001	475
2002	255
2003	285
2004	**345**

Underlying profit before tax £m

Year	£m
2000	125
2001	161
2002	105
2003	376
2004	**289**

Free cash flow £m

21%

Increase in underlying profit before tax over 2003

Year	%
2000	17.9
2001	19.3
2002	10.5
2003	11.6
2004	**13.3**

Underlying pre-tax return on average capital employed %

Year	£m
2000	1,323
2001	990
2002	1,090
2003	950
2004	**560**

Average net debt £m

Joint ventures: Rolls-Royce share £m

	Repair and overhaul	Financial services	Other	Total
Gross assets	107	503	532	1,142
Debt	(31)	(410)	(77)	(518)
Other liabilities	(29)	(51)	(345)	(425)
Gross liabilities	(60)	(461)	(422)	(943)
Net assets	47	42	110	199

We made good progress in 2004. Better market conditions, growing services sales and increased efficiency all contributed to our improved financial performance.

Results for the year

Underlying profit before tax* increased by 21 per cent to £345 million (2003 £285 million), and underlying earnings per share* were 14.50p (2003 12.20p). Basic earnings per share were 12.07p (2003 7.04p).

Sales increased by £294 million

Sales increased by five per cent, despite an adverse foreign currency translation impact of some £200 million.

- Civil aerospace engine deliveries increased by ten per cent to 824 engines. Civil aftermarket sales grew by 25 per cent.
- Defence aerospace turnover was stable, with a small increase in services revenues offsetting a slight reduction in original equipment sales.
- Marine sales were down four per cent. Sales in the offshore oil & gas support market sector were weaker than in 2003. However, order intake recovered somewhat in the second half of the year.
- Energy sales were flat, with sales in the oil & gas sector offsetting the effects of the depressed power generation market.

Group aftermarket services revenues grew by 14 per cent to £3.2 billion and accounted for 55 per cent of total revenues. Aftermarket revenues have grown by 12 per cent compound over the last five years.

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

Gross margin, before exceptional items, increased from 17.4 per cent to 19 per cent. Margins benefited from some improvement in market conditions, continuing growth in services sales and our focus on cost reduction.

The net interest charge reduced from £90 million to £70 million. This reflected a reduction in the level of average net debt, which was achieved through the Group's improving level of profitability and its focus on cash management.

Group interest was covered 7.6 times (2003 4.9 times), based upon underlying profit before interest, excluding joint ventures.

Restructuring charges of £37 million (2003 £10 million), which were incurred for ongoing operational improvements, were included within operating costs.

The Group made an underlying profit before tax of £345 million (2003 £285 million). After charging non-trading items, profit before tax was £306 million (2003 £180 million).

Net working capital as a percentage of sales was 6.4 per cent (2003 6.8 per cent), despite some creation of inventory ahead of the introduction of new manufacturing facilities.

* excluding exceptional and non-trading items, defined in note 2

A final payment to shareholders of 5.00p is proposed making a total of 8.18p per ordinary share (2003 8.18p). The Company will continue to issue B Shares in place of dividends in order to accelerate the recovery of its advance corporation tax.

Order book

The order book, at constant exchange rates, was £18.9 billion (2003 £17.4 billion). Items are included in the order book when a firm, signed contract exists.

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

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

Long-term service agreements, including TotalCare packages for aftermarket services, represented 39 per cent of the order book. These are long-term contracts where only the first seven years' revenue is included in the order book.

Business which has been announced but for which contracts have not yet been signed is excluded from the order book. This amounted to a further £2.4 billion at the year end (2003 £1.3 billion).

Aftermarket services

The Group continues to be successful in developing its aftermarket services activities. These accounted for 55 per cent of turnover in 2004.

In particular, TotalCare packages in the civil aerospace sector now cover 38 per cent 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. Profit is taken progressively on a prudent basis resulting in a net asset of £389 million (2003 £454 million) on the balance sheet.

Cash

The Group cash flow statement is shown on pages 54 and 55 of the financial statements.

Net debt for the year reduced by £243 million to £80 million (2003 £323 million). The average net debt level reduced from £950 million to £560 million.

The average net debt is expected to reduce further in 2005.

Net cash flow from operating activities was £640 million (2003 £673 million). Net capital expenditure used £219 million (2003 £198 million) of funds generated.

Taxation

The overall tax charge on the profit before tax was £101 million (2003 £64 million), a rate of 33 per cent (2003 36 per cent).

The tax charge was reduced by £13 million (2003 £12 million) in respect of the expected benefit of the UK research and development tax credit that was introduced with effect from April 1, 2002.

The tax charge on underlying profits was £99 million (2003 £84 million), a rate of 29 per cent (2003 29 per cent).

Acquisitions and disposals

During the year the Group disposed of Rolls-Royce Gear Systems Inc. to Triumph Group Inc., resulting in a small profit that has been treated as a non-trading item (see note 31).

Pensions

For 2004, the charges for pensions costs continue to be calculated under SSAP 24 and are disclosed in note 30. Although the full implementation of FRS 17 (Post-Retirement Benefits) has been deferred pending the introduction of International Financial Reporting Standards, certain disclosures are required, including the value of pension scheme assets and liabilities using the new rules specified by FRS 17 (see note 30). Under this standard a snapshot is taken of pension fund assets and liabilities at a specific point in time, thus movements in equity markets and discount rates will create volatility in their calculation. Additionally FRS 17 requires a memorandum analysis of the profit and loss charge.

On this basis and after taking account of deferred taxation, there was a net shortfall of assets over liabilities for the UK Schemes of £805 million (2003 £855 million). This deficit is subject to prevailing equity markets and discount rates.

During the year the Vickers Group Pension Scheme and the Rolls-Royce Group Pension Scheme were subject to actuarial review. Together these two funds are around one third the size of the principal Rolls-Royce Pension Fund, for which the actuarial review was completed in 2003.

Investments

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

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

Gross research and development investment amounted to £601 million (2003 £619 million). Net research and development was £282 million (2003 £281 million). Net research and development investment is expected to remain roughly at the same percentage of sales in the future. Investment in training was £30 million (2003 £29 million).

Net capital expenditure, was £219 million (2003 £198 million) and is expected to be a little ahead of depreciation of £223 million over the next few years.

Partnerships

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

Joint ventures

Joint ventures are an integral part of our business. They are also normal business structures for companies participating in international, collaborative defence projects. They are involved in engineering and manufacturing, repair and overhaul, and financial services. They share risk and investment, bring expertise and access to markets, and provide external objectivity. Some of our joint ventures have become substantial businesses. A major proportion of the debt of the joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. The net recourse financing obligations total £12 million and are included in contingent liabilities (see note 28).

Pembroke, the Group's aircraft leasing and management joint venture is not regarded as core to the Group's strategy and, as markets permit, the Group will be seeking to extract value from this business.

Investment in the engine leasing joint venture, Rolls-Royce & Partners Finance, a core business activity, amounts to £21 million and all of its debt is non-recourse to the Group.

Risk and Revenue Sharing Partners (RRSPs)

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

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

The sharing of risk is fundamental to RRSP agreements. In general, partners share financial investment in the programme; they share market risk as they receive their return from future sales; they share currency risk as their returns are denominated in US dollars; they share sales financing obligations; they share warranty costs; and, where they are manufacturing or development partners, they share technical and cost risk.

In 2004, the Group secured new partners for the Trent 1000 engine programme. However, as the number of new programmes has reduced and in particular as Government launch investment was not sought for the Trent 1000 programme, receipts from partners have declined. In 2004, other operating income in respect of RRSP agreements amounted to £73 million (2003 £153 million) and is expected to be at a similar level in 2005.

Payments to RRSP partners are recorded within cost of sales and increase as the related programme sales increase. These payments amounted to £240 million (2003 £179 million).

Intangible assets

The Group carried forward £911 million (2003 £863 million) of intangible assets. This comprised purchased goodwill of £712 million, engine certification costs and participation fees of £145 million and application engineering costs of £54 million.

Risk management

The Board has an established, structured approach to risk management. The risk committee (see report of the directors) has accountability for the system of risk management and reporting the key risks and associated mitigating actions. The Director of Risk reports to the Finance Director. The Group's policy is to preserve the resources upon which its continuing reputation, viability and profitability are built, in order to enable the corporate objectives to be achieved through the operation of the Rolls-Royce business processes. Risks are formally identified and recorded in a corporate risk register, which is reviewed and updated on a regular basis, with risk mitigation plans identified for all significant risks.

Financial risk

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

The principal economic and market risks continue to be movements in foreign currency exchange rates, interest rates and commodity prices. The Board regularly reviews the Group's exposures and financial risk management and a specialist committee also considers these in detail. All such exposures are managed by the Group Treasury function, which reports to the Finance Director and which operates within written policies approved by the Board and within the internal control framework described in the report of the directors.

The Group's policy is to monitor and manage its exposure to counterparties. Credit limits are set to cover all financial instruments for each counterparty. The Group's policy is that where exposure is only linked to the credit quality of the counterparty, the related long-term credit rating should be A3/A or better.

Funding and liquidity

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

The Group performed some refinancing activity during 2004 to extend its debt maturity profile and to reduce future refinancing risk. The Group successfully raised £500 million following the issuance of a seven year €750 million public bond under its Euro Medium Term Note programme. The proceeds were used to replace a number of maturing borrowing facilities or to retire other borrowing facilities early. The Group also reduced the size of its main £750 million revolving credit facility to £250 million and extended its maturity profile from 2007 to 2009. As at December 31, 2004 the Group had total committed borrowing facilities of £1.8 billion (2003 £2.2 billion).

The terms for the recently completed refinancings are substantially similar to the Group's previous 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 and no material impact on the Group's interest charge is expected to arise from a movement in the Group's credit rating.

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

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

Credit rating

The Group subscribes to both Moody's Investor Services and Standard & Poors for its official publicised credit ratings. As at December 31, 2004 the Group's assigned long-term credit ratings were:

Rating Agency	Rating	Outlook	Category
Moody's	Baa1	Negative	Investment grade
Standard & Poors	BBB	Positive	Investment grade

The Group attaches significant importance to maintaining an investment grade credit rating, which it views as necessary for the business to operate effectively.

The Group's medium term objective is to achieve, through the normal course of business, an 'A' category investment grade credit rating from both agencies.

Currency risk

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

The Group regards its interests in overseas subsidiary companies as long-term investments. The Group has tended to manage its translational exposures through the currency matching of assets and liabilities where applicable. Any mis-match is kept under regular review for materiality and subsequent decisions regarding risk mitigation.

The Group is exposed to a number of foreign currencies. The most significant transactional currency exposure is the US dollar followed by the Euro. US dollar income, net of expenditure represented 26 per cent of Group turnover in 2004 (2003 23 per cent).

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

The permitted range of the amount of cover taken is determined by the written policies set by the Board, based on known and forecast income levels. The forward cover is managed within the parameters of these policies in order to achieve the Group's objectives, having regard to the Group's view of long-term exchange rates. Forward cover is in the form of standard foreign exchange contracts and instruments on which the exchange rates achieved are dependent on future interest rates. The Group also writes currency options against a portion of the unhedged dollar income at a rate which is consistent with the Group's long-term target rate. The premium received from the sale of the options is included in the Group's achieved exchange rate. At the end of 2004 the Group had approximately US$9 billion of forward cover (2003 US$10 billion).

The consequence of this policy has been to maintain relatively stable long-term foreign exchange rates. Note 24, financial instruments, includes the impact of revaluing forward currency contracts at market values on December 31, 2004, showing a value of £986 million (2003 £724 million) which will fluctuate with exchange rates over time. The Group has entered into these forward contracts as part of the hedging policy, described above, in order to mitigate the impact of volatile exchange rates.

Interest rate risk

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

Commodity risk

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

Sales financing

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

The Group manages and monitors its sales finance related exposures to customers and products within written policies approved by the Board and within the internal framework described in the report of the directors. The permitted levels of gross and net exposure are limited in aggregate, by counterparty, by product type and by calendar year.

The Board regularly reviews the Group's sales finance related exposures and risk management activities. Each financing commitment is subject to a credit and asset review process and prior approval by the Chief Executive and the Finance Director. The Group operates a sophisticated risk-pricing model to assess risk and exposure. Costs and exposures associated with providing financing support are incorporated in any decision to secure new business.

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

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

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

Where exposures arise, the strategy has been, and continues to be, to assume where possible liquid forms of financing commitment that may be sold or transferred to third parties when the opportunity arises.

Contingent liabilities

Note 28 to the accounts describes the Group's contingent liabilities under sales financing arrangements.

The gross contingent liability reduced to £999 million (2003 £1,090 million), of which £12 million (2003 £39 million) related to sales financing support provided to joint ventures. The gross contingent liability figure is calculated by aggregating the maximum exposure on all such sales financing commitments, before applying the value of the underlying security, but offsetting sums separately insured and sums provided for in the balance sheet. In 2004 provisions against customer financing exposures were increased by £51 million and £27 million of existing provisions were utilised. Provisions of £116 million were carried forward in respect of sales financing commitments (see note 22).

The Group's contingent liabilities are divided approximately 60:40 between asset value guarantees (AVGs) and credit guarantees. They are spread over many years and relate to a number of customers and a broad product portfolio. The contingent liabilities represent the maximum 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. Exposures are not reduced to a net present value for the purposes of reporting the Group's contingent liabilities.

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

After taking account of the underlying security, the Group's net contingent liability increased slightly to £189 million (2003 £184 million). The year on year movement in reported contingent liabilities reflects the utilisation of sales finance commitments in the last year, the expiry of existing contingent liabilities through natural debt retirement or risk transfer, and, additionally in the case of net contingent liabilities, the changes in the level, form, and value of any underlying security.

In reporting the Group's contingent liability with respect to sales financing, the Group includes a net exposure stress test which incorporates the impact of a 20 per cent fall in the value of all securities compared to the Airclaims' current and future values. Application of this stress test results in a net contingent liability of £277 million (2003 £262 million).

The directors regard the possibility that there will be any significant loss arising from these contingencies as remote.

The Group took charges and made prudent provisions against exposures in 2004.

International Financial Reporting Standards

All European Union listed companies are required to adopt International Financial Reporting Standards (IFRS) for their financial statements from 2005, which will include comparative information for 2004. An initial evaluation of the impact of IFRS was provided in the 2003 Annual report. The Group has continued its preparatory work, to enable it to report under IFRS for the first time when it announces its interim 2005 results. Prior to this, it is the Group's intention to restate the 2004 results on an IFRS basis, to allow the impact to be interpreted and adequately understood.

The key areas of impact for Rolls-Royce relate to:

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

Financial instruments

As noted earlier, a significant element of the Group's trading is denominated in US dollars. In order to reduce the impact of currency volatility, the Group takes significant levels of forward cover. Currently, gains or losses which are realised on these forward exchange contracts are taken to the profit and loss account in the same period as the underlying transaction.

Year	Underlying EPS* pence
2000	19.38
2001	20.20
2002	11.10
2003	12.20
2004	**14.50**

Underlying EPS* pence

*excluding exceptional and non-trading items, defined in note 2

IAS 39 (Financial instruments) requires all hedges to be strictly designated against specific income and the hedge effectiveness tested. All such instruments are required to be revalued to market values at the balance sheet date. If the hedging criteria are not achieved, then the change in value is taken to the profit and loss account.

As contracts may be signed several years in advance of delivery, the delivery dates and hence payment dates on contracts may change and meeting the strict hedging criteria for all contracts may not be practicable, resulting in potential volatility in the reported profit and loss account and balance sheet. Similar requirements apply to instruments used to manage commodity and interest rate exposures, although for the latter, hedging criteria are more easily attainable. In assessing the adoption of IAS 39, the Group has no plans to amend the underlying policy for the economic hedging of its exposures.

Development expenditure

The Group's expenditure on self-funded research and development is of the order of £300 million per annum. Since privatisation in 1987, such expenditure has been expensed as incurred. IAS 38 (Intangible assets) requires development expenditure meeting certain recognition criteria to be capitalised. This standard is to be applied retrospectively; hence the intangible asset will include amounts expensed in previous years. Impairment testing will be required at each balance sheet date.

The key eligibility criteria for capitalisation relate to technical feasibility and the generation of future economic benefit. This is unlikely to be achieved until around the time of engine certification (or its equivalent for non-aero products).

RRSPs

The accounting treatment for the majority of RRSPs will not change under IFRS. However, certain RRSP arrangements must be treated as financial instruments under the provisions of IAS 32. Such RRSP arrangements will be re-categorised as financial liabilities and recognised at amortised cost.

Pension scheme accounting

Under IAS 19 (Employment benefits) the net position on the Group's pension schemes based on market values will be included on the balance sheet. This will be broadly in line with FRS 17 amounts disclosed in note 30.

Share options

Under IFRS 2 (Share-based payments), for all employee share schemes, a fair value calculated using an option pricing model is required to be expensed.

Goodwill

In accordance with IFRS 3 (Business combinations), the amortisation of goodwill is prohibited; instead impairment tests are required at each balance sheet date.

Share price

During the year Rolls-Royce shares increased by 39 per cent from 177.25p to 247p per share, compared to a 32 per cent increase for the aerospace and defence sector and an eight per cent increase for the FTSE100. The Company's shares ranged in price from 167.5p in January to 269p in November.

The number of shares in issue at the end of the year was 1,705 million, an increase of 38 million of which 2 million related to share options, 11 million related to scrip dividends and 25 million related to conversion of B Shares into ordinary shares.

The average number of shares in issue was 1,690 million (2003 1,647 million). Underlying earnings per share were 14.50p an increase of 19 per cent over 2003.

The proposed final payment per share, of 5.00p will result in a total payment of 8.18p per share (see report of the directors page 33).

Financial services

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

Rolls-Royce & Partners Finance, the Group's joint venture engine leasing business, owns a portfolio of 273 engines with 39 customers. The proportion of engines on lease remains high, at 99 per cent, by value.

Pembroke, the Group's joint venture aircraft leasing business, owns 28 aircraft on lease to 13 customers, 100 per cent, by value, of the owned aircraft fleet is on lease. A major refinancing of Boeing 737 aircraft was concluded during the year without parent company support and a charge of £8 million was taken in connection with Boeing 717 exposure.

Rolls-Royce Power Ventures, the Group's power project developer, has 14 power generation projects under way. The business continues to be restructured and net charges of £5 million were taken.

Andrew Shilston
Finance Director