Notes to the consolidated financial statements

1 Accounting policies

The Company
Rolls-Royce Holdings plc (the 'Company') is a company domiciled in the United Kingdom. The consolidated financial statements of the Company for the year ended December 31, 2011 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 8, 2012.

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, 2011 (Adopted IFRS). The Company has elected to prepare its parent company accounts under UK Generally Accepted Accounting Practices (GAAP).

The financial statements have been prepared on the historical cost basis except where Adopted IFRS requires the revaluation of financial instruments to fair value and certain other assets and liabilities on an alternative basis – most significantly post-retirement scheme liabilities are valued on the basis required by IAS 19 *Employee Benefits* – and on a going concern basis as described on page 70.

The preparation of financial statements in conformity with Adopted IFRS requires the use of certain critical accounting judgements and estimates, which are set out below.

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

Key areas of judgement
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.
- As set out in note 8, the Group has significant intangible assets. The decision as to when to commence capitalisation of development costs and whether sales of original equipment give rise to recognisable recoverable engine costs is a key judgement.
- As set out in note 23, 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 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 below. 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.

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.

1 Accounting policies (continued)

Forecasts and discount rates

The carrying values 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 as to whether there are any indications of impairment of development, participation, certification and recoverable engine costs recognised as intangible assets is dependent on forecasts of cash flows generated by the relevant assets (carrying values at December 31, 2011 **£1,442m**, December 31, 2010 £1,472m).
- 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, 2011 **£230m**, December 31, 2010 £266m). 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 values at December 31, 2011 **£368m**, December 31, 2010 £451m) 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 in the revenue recognition accounting policy below.

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 **£397m** before deferred taxation being recognised on the balance sheet at December 31, 2011 (December 31, 2010 £856m). 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 19.

Provisions

As described in the accounting policy below, the Group measures provisions (carrying value at December 31, 2011 **£502m**, December 31, 2010 £544m) 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.

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 23. 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.

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.
- 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, with the change in value 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 generally apply hedge accounting in respect of forward foreign exchange contracts held to manage the cash flow exposures of forecast transactions denominated in foreign currencies. In 2011, the Group has applied cash flow hedge accounting in respect of foreign exchange contracts entered into to hedge the cost of its investment in Engine Holding GmbH.

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 or, in the case of the cash flow hedges of the investment in Engine Holding GmbH, included in the initial carrying value of the joint venture.

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.

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).

Operating leases
Payments made and rentals received under operating lease arrangements are charged/credited to the income statement 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, property, plant and equipment and investments 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.

Cash and cash equivalents
Cash and cash equivalents include cash at bank and in hand, investments in money-market funds 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.

1 Accounting policies (continued)

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 TSR performance condition in the PSP.

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) PSP – using a pricing model adjusted to reflect non-entitlement to dividends (or equivalent) and the TSR market-based performance condition; and
iii) APRA plan deferred shares – share price on the date of the award.

See note 21 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.

Revisions to Adopted IFRS in 2011
There were no revisions to Adopted IFRS that became applicable in 2011 which had a significant impact on the Group's financial statements.

Revisions to IFRS not applicable in 2011
Standards and interpretations issued by the IASB are only applicable if endorsed by the EU. The following may be applicable in the future:

- IFRS 9 *Financial Instruments* will simplify the classification of financial assets for measurement purposes, but is not anticipated to have a significant impact on the financial statements. If endorsed, this will be effective for 2015.
- Amendments to IAS 19 *Employee Benefits* will require the financing on post-retirement benefits to be calculated on the net surplus or deficit using an 'AA' corporate bond rate. This will increase the net post-retirement scheme financing cost. This will be effective for 2013.
- IFRS 11 *Joint Arrangements* may result in certain entities currently classified as joint ventures being classified as joint operations. This would result in the Group's share of the individual assets and liabilities of these entities being included in the financial statements rather than the equity method accounting adopted under the requirements of IAS 31 *Interests in Joint Ventures*. This will not affect the Group's net assets or profit for the period. This will be effective for 2013.

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 power and 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.

Technology and operations, discussed in the business review, operate on a Group-wide basis across all the above segments. The equity accounted share of the Engine Holding GmbH business acquired during the year is shown separately.

The operating results reviewed by the Board are prepared on an underlying basis, which the Board considers reflects better the economic substance of the Group's trading during the year. The principles adopted to determine underlying results are:

Underlying revenue – 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. There is no inter-segment trading and hence all revenue is 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. In addition, adjustments have also been made to exclude one-off past-service credits on post-retirement schemes and the effect of acquisition accounting.

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-retirement 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, 2011	**Civil aerospace £m**	**Defence aerospace £m**	**Marine £m**	**Energy £m**	**Engine Holding £m**	**Total reportable segments £m**
Underlying revenue from sale of original equipment	**2,232**	**1,102**	**1,322**	**602**		**5,258**
Underlying revenue from aftermarket services	**3,340**	**1,133**	**949**	**597**		**6,019**
Total underlying revenue	**5,572**	**2,235**	**2,271**	**1,199**		**11,277**
Underlying operating profit excluding share of results of joint ventures and associates	**384**	**367**	**318**	**14**		**1,083**
Share of results of joint ventures and associates	**115**	**9**	**2**	**10**	**36**	**172**
Profit on disposal of businesses	**–**	**–**	**3**	**–**	**–**	**3**
Underlying profit before financing and taxation	**499**	**376**	**323**	**24**	**36**	**1,258**
Segment assets	**8,218**	**1,333**	**2,219**	**1,243**	**169**	**13,182**
Investments in joint ventures and associates	**403**	**(22)**	**8**	**42**	**1,249**	**1,680**
Segment liabilities	**(5,982)**	**(1,831)**	**(1,544)**	**(617)**	**–**	**(9,974)**
Net assets	**2,639**	**(520)**	**683**	**668**	**1,418**	**4,888**
Investment in intangible assets, property, plant and equipment and joint ventures and associates	**620**	**70**	**75**	**84**	**1,317**	**2,166**
Depreciation and amortisation	**267**	**48**	**57**	**38**	**–**	**410**

Year ended December 31, 2010	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Engine Holding £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	7,790	1,359	2,357	1,152		12,658
Investments in joint ventures and associates	372	(15)	6	30		393
Segment liabilities	(5,435)	(1,867)	(1,548)	(748)		(9,598)
Net assets	2,727	(523)	815	434		3,453
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

2 Segmental analysis (continued)

Reconciliation to reported results

Year ended December 31, 2011	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Revenue from sale of original equipment	**5,258**	**–**	**5,258**	**(19)**	**5,239**
Revenue from aftermarket services	**6,019**	**–**	**6,019**	**(134)**	**5,885**
Total revenue	**11,277**	**–**	**11,277**	**(153)**	**11,124**
Operating profit excluding share of results of joint ventures and associates	**1,083**	**(52)**[1]	**1,031**	**39**	**1,070**
Share of results of joint ventures and associates	**172**	**–**	**172**	**(56)**	**116**
Profit on disposal of businesses	**3**	**–**	**3**	**–**	**3**
Profit before financing and taxation	**1,258**	**(52)**	**1,206**	**(17)**	**1,189**
Net financing		**(49)**	**(49)**	**(35)**	**(84)**
Profit before taxation		**(101)**	**1,157**	**(52)**	**1,105**
Taxation		**(261)**	**(261)**	**4**	**(257)**
Profit for the year		**(362)**	**896**	**(48)**	**848**
Year ended December 31, 2010					
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		(55)	(55)	(377)	(432)
Profit before taxation		(105)	955	(253)	702
Taxation		(236)	(236)	77	(159)
Profit for the year		(341)	719	(176)	543

[1] Central corporate costs

Underlying adjustments

	2011				2010			
	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m	Revenue £m	Profit before financing £m	Net financing £m	Taxation £m
Underlying performance	**11,277**	**1,206**	**(49)**	**(261)**	10,866	1,010	(55)	(236)
Revenue recognised at exchange rate on date of transaction	**(153)**	**–**	**–**	**–**	219	–	–	–
Realised (gains)/losses on settled derivative contracts [1]	**–**	**(116)**	**24**	**–**	–	180	(7)	–
Net unrealised fair value changes to derivative contracts [2]	**–**	**(5)**	**(49)**	**–**	–	–	(341)	–
Effect of currency on contract accounting	**–**	**4**	**–**	**–**	–	(56)	–	–
Revaluation of trading assets and liabilities	**–**	**–**	**–**	**–**	–	–	8	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	**–**	**–**	**2**	**–**	–	–	(6)	–
Effect of acquisition accounting [3]	**–**	**(64)**	**–**	**–**	–	–	–	–
Post-retirement scheme past-service credits [4,5]	**–**	**164**	**–**	**–**	–	–	–	–
Net post-retirement scheme financing	**–**	**–**	**(12)**	**–**	–	–	(31)	–
Related tax effect	**–**	**–**	**–**	**4**	–	–	–	77
Total underlying adjustments	**(153)**	**(17)**	**(35)**	**4**	219	124	(377)	77
Reported per consolidated income statement	**11,124**	**1,189**	**(84)**	**(257)**	11,085	1,134	(432)	(159)

[1] Realised (gains)/losses on settled derivative contracts include adjustments to reflect the (gains)/losses in the same period as the related trading cash flows.
[2] Unrealised fair value changes to derivative contracts include those included in equity accounted joint ventures and exclude those for which the related trading contracts have been cancelled when the fair value changes are recognised immediately in underlying profit.
[3] The adjustment eliminates charges recognised as a result of recognising assets in acquired businesses at fair value.
[4] In 2010, the UK Government announced changes to the basis of the statutory indexation for pension increases. As a result, the relevant arrangements have been amended, resulting in a gain in the income statement of **£130m,** which has been excluded from underlying profit.
[5] The Group has agreed revised post-retirement healthcare arrangements on certain of its overseas schemes. This has resulted in a net gain in the income statement of **£34m** which has been excluded from underlying profit.

The reconciliation of underlying earnings per ordinary share is shown in note 5.

2 Segmental analysis (continued)

	2011 £m	2010 £m
Reportable segment assets	13,182	12,658
Investments in joint ventures and associates	1,680	393
Eliminations	(757)	(823)
Cash and cash equivalents and short-term investments	1,321	3,187
Fair value of swaps hedging fixed rate borrowings	106	198
Income tax assets	388	457
Post-retirement scheme surpluses	503	164
Total assets	16,423	16,234
Reportable segment liabilities	(9,974)	(9,598)
Eliminations	757	823
Borrowings	(1,204)	(1,852)
Income tax liabilities	(583)	(608)
Post-retirement scheme deficits	(900)	(1,020)
Total liabilities	(11,904)	(12,255)
Net assets	4,519	3,979

Geographical segments

The Group's revenue by destination is shown below:

	2011 £m	2010 £m
United Kingdom	1,361	1,594
Norway	374	486
Germany	409	413
Spain	189	231
Italy	183	187
France	143	101
Russia	143	133
Rest of Europe	547	830
USA	3,578	3,096
Canada	301	299
China	934	890
South Korea	210	355
Middle East and South East Asia	1,778	1,585
Rest of Asia	290	228
Africa	261	109
Australasia	228	153
Other	195	395
	11,124	11,085

In 2011, revenue (included in all reportable segments) of **£1,143m** (2010 £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:

	2011 £m	2010 £m
United Kingdom	2,980	2,925
North America	670	611
Nordic countries	902	908
Germany	1,907	625
Other	441	344
	6,900	5,413

3 Net financing

	Notes	2011 Per consolidated income statement £m	2011 *Underlying financing[1] £m*	2010 Per consolidated income statement £m	2010 *Underlying financing[1] £m*
Financing income					
Interest receivable		**20**	***20***	23	*23*
Financial RRSPs – foreign exchange differences and changes in forecast payments	17	**2**	–	–	–
Fair value gains on commodity derivatives [2]	17	–	–	29	–
Expected return on post-retirement scheme assets	19	**410**	–	400	–
Net foreign exchange gains		**24**	–	1	–
		456	***20***	453	*23*
Financing costs					
Interest payable		**(51)**	***(51)***	(63)	*(63)*
Fair value losses on foreign currency contracts [2]	17	**(21)**	–	(370)	–
Financial RRSPs – foreign exchange differences and changes in forecast payments	17	–	–	(6)	–
Financial charge relating to financial RRSPs	17	**(11)**	***(11)***	(13)	*(13)*
Fair value losses on commodity derivatives [2]	17	**(28)**	–	–	–
Interest on post-retirement scheme liabilities	19	**(422)**	–	(431)	–
Other financing charges		**(7)**	***(7)***	(2)	*(2)*
		(540)	***(69)***	(885)	*(78)*
Net financing		**(84)**	***(49)***	(432)	*(55)*
Analysed as:					
Net interest payable		**(31)**	***(31)***	(40)	*(40)*
Net post-retirement scheme financing		**(12)**	–	(31)	–
Net other financing		**(41)**	***(18)***	(361)	*(15)*
Net financing		**(84)**	***(49)***	(432)	*(55)*
[1] See note 2					
[2] Net loss on items held for trading		**(49)**	–	(341)	–

4 Taxation

	UK 2011 £m	UK 2010 £m	Overseas 2011 £m	Overseas 2010 £m	Total 2011 £m	Total 2010 £m
Current tax						
Current tax (credit)/charge for the year	**(1)**	(2)	**177**	174	**176**	172
Less double tax relief	**(2)**	(2)	–	–	**(2)**	(2)
	(3)	(4)	**177**	174	**174**	170
Adjustments in respect of prior years	**1**	1	**(8)**	2	**(7)**	3
	(2)	(3)	**169**	176	**167**	173
Deferred tax						
Charge/(credit) for the year	**69**	(53)	**37**	41	**106**	(12)
Adjustments in respect of prior years	**2**	–	**(7)**	1	**(5)**	1
Credit resulting from reduction in UK tax rate	**(11)**	(3)	–	–	**(11)**	(3)
	60	(56)	**30**	42	**90**	(14)
Recognised in the income statement	**58**	(59)	**199**	218	**257**	159

4 Taxation (continued)

Other tax (charges)/credits

	OCI		Equity	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Current tax:				
Share-based payments – direct to equity	**–**	–	**6**	–
Deferred tax:				
Net investment hedge	**(1)**	(2)	**–**	–
Movements in post-retirement schemes	**(53)**	31	**–**	–
Share-based payments – direct to equity	**–**	–	**6**	5
	(54)	29	**12**	5

Tax reconciliation

	2011 £m	2010 £m
Profit before taxation	**1,105**	702
Less share of results of joint ventures and associates (note 10)	**(116)**	(93)
Profit before taxation excluding joint ventures and associates	**989**	609
Nominal tax charge at UK corporation tax rate 26.5% (2010 28.0%)	**262**	171
UK R&D credit	**(29)**	(29)
Rate differences	**40**	16
Other permanent differences	**8**	2
Benefit to deferred tax from previously unrecognised tax losses and temporary differences	**(1)**	(5)
Tax losses in year not recognised in deferred tax	**–**	3
Adjustments in respect of prior years	**(12)**	4
Reduction in closing deferred taxes resulting from decrease in UK tax rate	**(11)**	(3)
	257	159
Underlying items (note 2)	**261**	236
Non-underlying items	**(4)**	(77)
	257	159

Deferred taxation assets and liabilities

	2011 £m	2010 £m
At January 1	**13**	(6)
Amount (charged)/credited to income statement	**(90)**	14
Amount (charged)/credited to other comprehensive income	**(54)**	29
Amount charged to equity	**6**	5
Acquisition of businesses	**(3)**	(32)
Transferred to assets held for sale	**46**	–
Exchange differences	**5**	3
At December 31	**(77)**	13
Deferred tax assets	**368**	451
Deferred tax liabilities	**(445)**	(438)
	(77)	13

4 Taxation (continued)

The analysis of the deferred tax position is as follows:

	At January 1, 2011 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Transferred to assets held for sale £m	Exchange differences £m	At December 31, 2011 £m
Intangible assets	(282)	(9)	–	–	–	46	2	(243)
Property, plant and equipment	(150)	16	–	–	–	–	(1)	(135)
Other temporary differences	(64)	(3)	(1)	6	(3)	–	4	(61)
Amounts recoverable on contracts	(229)	(21)	–	–	–	–	–	(250)
Pensions and other post-retirement scheme benefits	263	(111)	(53)	–	–	–	–	99
Foreign exchange and commodity financial assets and liabilities	94	27	–	–	–	–	–	121
Losses	317	11	–	–	–	–	–	328
Advance corporation tax	64	–	–	–	–	–	–	64
	13	(90)	(54)	6	(3)	46	5	(77)

	At January 1, 2010 £m	Recognised in income statement £m	Recognised in OCI £m	Recognised in equity £m	Acquisition of businesses £m	Transferred to assets held for sale £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

	2011 £m	2010 £m
Advance corporation tax	118	118
Losses and other unrecognised deferred tax assets	41	51
Deferred tax not recognised on unused tax losses and other items on the basis that future economic benefit is uncertain	159	169

The 2010 Emergency Budget and the 2011 Budget announced that the UK corporation tax rate will reduce from 28 per cent to 23 per cent over a period of four years from 2011. The reductions to 26 per cent effective from April 1, 2011 and 25 per cent effective from April 1, 2012 were substantively enacted on March 29, 2011 and July 5, 2011 respectively. As the rate change to 25 per cent was substantively enacted prior to the year end, the closing deferred tax assets and liabilities have been calculated at this rate. 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 2011, £11m has been credited to the income statement, £5m has been charged to the OCI and £3m has been charged directly to equity.

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 £23m and reducing the deferred tax liability by £22m.

There are no unrecognised deferred tax liabilities arising on the aggregate temporary differences associated with investments in subsidiaries, branches, associates and joint ventures (2010: £nil). Any withholding tax due on the remittance of future earnings is expected to be insignificant.

5 Earnings per ordinary share

Basic earnings per ordinary share (EPS) are calculated by dividing the profit attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the year, excluding ordinary shares held under trust, which have been treated as if they had been cancelled.

Diluted EPS are calculated by adjusting the weighted average number of ordinary shares in issue during the year for the bonus element of share options.

	2011			2010		
	Basic	Potentially dilutive share options	Diluted	Basic	Potentially dilutive share options	Diluted
Profit attributable to ordinary shareholders (£m)	850		850	539		539
Weighted average number of ordinary shares (millions)	1,850	25	1,875	1,846	24	1,870
EPS (pence)	45.95	(0.62)	45.33	29.20	(0.38)	28.82

The reconciliation between underlying EPS and basic EPS is as follows:

	2011		2010	
	Pence	£m	Pence	£m
Underlying EPS/Underlying profit attributable to ordinary shareholders	48.54	898	38.73	715
Total underlying adjustments to profit before tax (note 2)	(2.81)	(52)	(13.70)	(253)
Related tax effects	0.22	4	4.17	77
EPS/Profit attributable to ordinary shareholders	45.95	850	29.20	539
Diluted underlying EPS	47.89		38.24	

6 Employee information

	2011 Number	2010 Number
Average number of employees		
United Kingdom	21,600	21,000
Rest of the world	18,800	17,900
	40,400	38,900
Civil aerospace	20,600	19,500
Defence aerospace	6,800	6,900
Marine	9,400	9,000
Energy	3,600	3,500
	40,400	38,900

	£m	£m
Group employment costs [1]		
Wages and salaries	2,037	1,847
Social security costs	245	212
Share-based payments (note 21)	59	50
Pensions and other post-retirement scheme benefits (note 19)	23	221
	2,364	2,330

[1] Remuneration of key management personnel is shown in note 24.

7 Auditor's remuneration

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

	2011 £m	2010 £m
Fees payable to the Company's auditors for the audit of the Company's annual financial statements [1]	**0.2**	0.1
Fees payable to the Company's auditors and its associates for the audit of the Company's subsidiaries pursuant to legislation	**4.3**	4.3
Total fees payable for audit services	**4.5**	4.4
Fees payable to the Company's auditors and its associates for other services:		
Other services pursuant to legislation	**1.0**	0.5
Other services relating to taxation	**0.5**	0.5
All other services	**0.2**	–
	6.2	5.4
Fees payable in respect of the Group's pension schemes:		
Audit	**0.2**	0.2
Other services relating to taxation	**–**	0.1

[1] The level of fees payable to the Company's auditors for the audit of the Company's annual financial statements reflects the fact that limited incremental work is required in respect of the audit of these financial statements. Rolls-Royce plc, a subsidiary of the Company, is also required to prepare consolidated financial statements and the fees payable to the Company's auditors for the audit of those financial statements, including the audit of the sub-consolidation, is included in the audit of the Company's subsidiaries pursuant to legislation.

8 Intangible assets

	Goodwill £m	Certification costs and participation fees £m	Development expenditure £m	Recoverable engine costs £m	Software and other £m	Total £m
Cost:						
At January 1, 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 January 1, 2011	**1,115**	**686**	**862**	**697**	**413**	**3,773**
Exchange differences	(20)	(2)	(1)	–	(2)	(25)
Additions	–	44	93	135	95	367
Acquisitions of businesses	11	–	–	–	8	19
Transferred to assets held for sale	–	–	–	(368)	–	(368)
Disposals	–	(8)	–	–	(24)	(32)
At December 31, 2011	**1,106**	**720**	**954**	**464**	**490**	**3,734**
Accumulated amortisation:						
At January 1, 2010	7	177	205	296	75	760
Charge for the year [1]	–	13	27	55	35	130
Disposals	–	–	–	–	(1)	(1)
At January 1, 2011	**7**	**190**	**232**	**351**	**109**	**889**
Charge for the year [1]	–	15	36	62	56	169
Transferred to assets held for sale	–	–	–	(182)	–	(182)
Disposals	–	(8)	–	–	(16)	(24)
At December 31, 2011	**7**	**197**	**268**	**231**	**149**	**852**
Net book value:						
At December 31, 2011	**1,099**	**523**	**686**	**233**	**341**	**2,882**
At December 31, 2010	1,108	496	630	346	304	2,884
At January 1, 2010	984	454	546	290	198	2,472

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

8 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 (CGUs), or groups of CGUs, that are expected to benefit from the synergies of the business combination that gave rise to the goodwill as follows:

CGU or group of CGUs

	Primary reporting segment	2011 £m	2010 £m
Rolls-Royce Deutschland Ltd & Co KG	Civil aerospace	**230**	236
Commercial marine – arising from the acquisitions of Vinters plc and Scandinavian Electric Holding AS	Marine	**645**	657
Commercial marine – arising from the acquisition of ODIM ASA	Marine	**112**	114
Other	Various	**112**	101
		1,099	1,108

Goodwill has been tested for impairment during 2011 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 (2010 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 (2010 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 75 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 2.5 per cent (2010 two 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 (2010 11 per cent), based on the Group's weighted average cost of capital.
- No impairment is required on this basis. However, a combination of changes in assumptions and adverse movements in variables that are outside the Group's control (discount rate, exchange rate and airframe delays), could result in impairment in future years.

9 Property, plant and equipment

	Land and buildings £m	Plant and equipment £m	Aircraft and engines £m	In course of construction £m	Total £m
Cost:					
At January 1, 2010	806	2,387	163	276	3,632
Exchange differences	6	16	–	1	23
Additions	11	94	35	221	361
Acquisitions of businesses	17	7	–	–	24
Reclassifications	41	108	5	(154)	–
Disposals/write-offs	(4)	(74)	(14)	(2)	(94)
At January 1, 2011	**877**	**2,538**	**189**	**342**	**3,946**
Exchange differences	(4)	(13)	–	1	(16)
Additions	17	80	52	318	467
Acquisitions of businesses	–	2	–	–	2
Reclassifications	78	123	5	(206)	–
Transferred from/(to) assets held for sale	15	–	(13)	–	2
Disposals/write-offs	(2)	(84)	(17)	(1)	(104)
At December 31, 2011	**981**	**2,646**	**216**	**454**	**4,297**
Accumulated depreciation:					
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 January 1, 2011	**271**	**1,497**	**42**	**–**	**1,810**
Exchange differences	(2)	(7)	–	–	(9)
Charge for the year [1]	39	185	15	–	239
Impairment	–	–	–	2	2
Reclassifications	3	(3)	–	–	–
Transferred from/(to) assets held for sale	6	–	(7)	–	(1)
Disposals/write-offs	(2)	(74)	(6)	–	(82)
At December 31, 2011	**315**	**1,598**	**44**	**2**	**1,959**
Net book value:					
At December 31, 2011	**666**	**1,048**	**172**	**452**	**2,338**
At December 31, 2010	606	1,041	147	342	2,136
At January 1, 2010	575	1,029	129	276	2,009

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

Property, plant and equipment includes:

	2011 £m	2010 £m
Net book value of finance leased assets:		
Land and buildings	**7**	8
Plant and equipment	**5**	5
Assets held for use in operating leases:		
Cost	**235**	159
Depreciation	**(60)**	(35)
Net book value	**175**	124
Capital expenditure commitments	**196**	215
Cost of fully depreciated assets	**655**	584

The Group's share of equity accounted entities' capital commitments is **£25m** (2010 £24m).

10 Investments

	Joint ventures £m	Associates £m	Total equity accounted £m	Other – unlisted £m
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	–	(77)	(77)	–
Disposals	–	–	–	(46)
Share of OCI of joint ventures and associates	(16)	–	(16)	–
At January 1, 2011	**393**	**–**	**393**	**11**
Exchange differences	(62)	–	(62)	–
Additions [1]	1,329	–	1,329	–
Taxation paid by the Group	3	–	3	–
Share of retained profit	40	–	40	–
Transferred to assets held for sale	(13)	–	(13)	–
Disposals	–	–	–	(1)
Share of OCI of joint ventures and associates	(10)	–	(10)	–
At December 31, 2011	**1,680**	**–**	**1,680**	**10**

[1] On August 25, 2011, Rolls-Royce and Daimler AG (Daimler) received all the relevant regulatory approvals for the acquisition of Tognum AG (Tognum). The public tender offer by Engine Holding GmbH (Engine Holding – the jointly held acquisition vehicle) was concluded in September 2011. At December 31, 2011, Engine Holding held 99 per cent of the Tognum shares, giving the Group an effective interest of 49.5 per cent. The results for the four month period from September 2011 have been included, after taking account of acquisition fair value adjustments. Subject to certain conditions being fulfilled, the Group has the option to exercise rights that would result in Engine Holding being classified as a subsidiary and consolidated. It is anticipated that these conditions will be fulfilled during 2012. As part of the Engine Holding shareholders' agreement, Daimler has the option to sell, for a specified period at a specified price, its shares in Engine Holding to Rolls-Royce. The value of this option was not significant at December 31, 2011.

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

	Joint ventures				Associates		Total	
	Engine Holding	Other	2011 £m	2010 £m	2011 £m	2010 £m	2011 £m	2010 £m
Assets:								
Non-current assets	**1,687**	**1,529**	**3,216**	1,405	**–**	–	**3,216**	1,405
Current assets	**818**	**891**	**1,709**	1,161	**–**	–	**1,709**	1,161
Liabilities: [2]								
Current liabilities	**(477)**	**(793)**	**(1,270)**	(1,151)	**–**	–	**(1,270)**	(1,151)
Non-current liabilities	**(779)**	**(1,196)**	**(1,975)**	(1,022)	**–**	–	**(1,975)**	(1,022)
	1,249	**431**	**1,680**	393	**–**	–	**1,680**	393
[2] Liabilities include borrowings of:	**(176)**	**(1,176)**	**(1,352)**	(1,043)	**–**	–	**(1,352)**	(1,043)
Revenue	**491**	**3,055**	**3,546**	2,914	**–**	26	**3,546**	2,940
Profit before financing and taxation	**(13)**	**165**	**152**	128	**–**	1	**152**	129
Net financing	**(12)**	**(19)**	**(31)**	(19)	**–**	–	**(31)**	(19)
Taxation	**10**	**(15)**	**(5)**	(17)	**–**	–	**(5)**	(17)
Results recognised in the consolidated income statement	**(15)**	**131**	**116**	92	**–**	1	**116**	93
Dividends received	**–**	**(76)**	**(76)**	(68)	**–**	–	**(76)**	(68)
Retained profit	**(15)**	**55**	**40**	24	**–**	1	**40**	25

The principal joint ventures and associates at December 31, 2011 are listed on pages 123 and 124.

11 Inventories

	2011 £m	2010 £m
Raw materials	319	377
Work in progress	921	943
Long-term contracts work in progress	12	42
Finished goods	1,267	1,024
Payments on account	42	43
	2,561	2,429
Inventories stated at net realisable value	169	202
Amount of inventory write-down	114	135
Reversal of inventory write-down	3	2

12 Trade and other receivables

	2011 £m	2010 £m
Trade receivables	1,123	1,210
Amounts recoverable on contracts [1]	1,665	1,580
Amounts owed by joint ventures and associates	421	518
Loan to Engine Holding GmbH	169	–
Other receivables	475	449
Prepayments and accrued income	156	186
	4,009	3,943
Analysed as:		
Financial instruments (note 17):		
Trade receivables and similar items	1,655	1,801
Other non-derivative financial assets	550	419
Non-financial instruments	1,804	1,723
	4,009	3,943
Trade and other receivables expected to be recovered in more than one year:		
Trade receivables	4	7
Amounts recoverable on contracts	1,314	1,176
Amounts owed by joint ventures and associates	20	5
Other receivables	60	56
Prepayments and accrued income	28	27
	1,426	1,271

[1] The balance at December 31, 2011 includes an allowance of **£63m** (2010 £55m), 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 Airbus A400M military transport aircraft.

13 Cash and cash equivalents

	2011 £m	2010 £m
Cash at bank and in hand	1,285	1,266
Money-market funds	11	381
Short-term deposits	14	1,212
	1,310	2,859
Overdrafts (note 15)	(19)	(8)
Cash and cash equivalents per cash flow statement (page 74)	1,291	2,851
Cash held as collateral against third party obligations (note 23)	67	68

14 Assets held for sale

	2011 £m	2010 £m
Intangible assets – Recoverable engine costs	186	–
Property, plant and equipment	6	9
Investment in joint venture	13	–
Amounts recoverable on contracts	59	–
Amounts owed by joint ventures	49	–
Assets held for sale	313	9
Accruals and deferred income	(54)	–
Other payables	(26)	–
Provisions for liabilities and charges	(9)	–
Deferred tax liabilities	(46)	–
Liabilities associated with assets held for sale	(135)	–

On October 12, 2011, the Group announced an agreement to form a new partnership with Pratt & Whitney, a United Technologies Corporation company, to develop new engines for the next generation of mid-size aircraft (120-230 seats). As part of this agreement, the Group and Pratt & Whitney will restructure their participation in IAE, which produces the V2500 engine for the Airbus A320 family of aircraft. Under the terms of the agreement, which is subject to regulatory approvals, Rolls-Royce will sell its equity, programme share and related goodwill in IAE to Pratt & Whitney for US$1.5 billion.

The assets and liabilities shown above are those, included in the civil aerospace segment, that will be derecognised on the completion of the transaction. However, as Rolls-Royce will continue to be responsible for the manufacture of high-pressure compressors, fan blades as well as the provision of engine support and final assembly of 50 per cent of V2500 engines, the transaction is not considered to give rise to a discontinued operation.

15 Borrowings

	Current		Non-current		Total	
	2011 £m	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m
Unsecured						
Overdrafts	**19**	8	**–**	–	**19**	8
Bank loans	**1**	67	**204**	206	**205**	273
7 3/8% Notes 2016 £200m	**–**	–	**200**	200	**200**	200
6.38% Notes 2013 US$230m [1]	**–**	–	**160**	162	**160**	162
6.55% Notes 2015 US$83m [1]	**–**	–	**62**	60	**62**	60
4 1/2% Notes 2011 €750m [2]	**–**	642	**–**	–	**–**	642
6.75% Notes 2019 £500m	**–**	–	**557**	506	**557**	506
Secured						
Obligations under finance leases [3]	**–**	–	**1**	1	**1**	1
	20	717	**1,184**	1,135	**1,204**	1,852

1 These notes are the subject of interest rate swap agreements under which the Group has undertaken to pay floating rates of interest, and currency swaps which form a fair value hedge.
2 These notes are the subject of swap agreements under which counterparties have undertaken to pay amounts at fixed rates of interest and exchange in consideration for amounts payable at variable rates of interest and at fixed exchange rates.
3 Obligations under finance leases are secured by related leased assets.

16 Trade and other payables

	Current		Non-current	
	2011 £m	2010 £m	**2011 £m**	2010 £m
Payments received on account [1]	**1,396**	1,560	**487**	475
Trade payables	**1,028**	891	**–**	–
Amounts owed to joint ventures and associates	**215**	267	**1**	7
Other taxation and social security	**88**	81	**–**	–
Other payables	**1,623**	1,294	**58**	94
Accruals and deferred income	**1,886**	1,817	**768**	695
	6,236	5,910	**1,314**	1,271
1 Includes payments received on account from joint ventures and associates	**358**	258	**147**	243

Included within trade and other payables are government grants of **£104m** (2010 £44m). During the year, **£2m** (2010 £2m) of government grants were released to the income statement.

Trade and other payables are analysed as follows:

	2011 £m	2010 £m
Financial instruments (note 17):		
Trade payables and similar items	**2,356**	2,212
Other non-derivative financial liabilities	**718**	521
Non-financial instruments	**4,476**	4,448
	7,550	7,181

17 Financial instruments

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: Other £m	Total £m
At December 31, 2011									
Unlisted non-current asset investments	10	A	**–**	**10**	**–**	**–**	**–**	**–**	**10**
Trade receivables and similar items	12	B	**–**	**1,655**	**–**	**–**	**–**	**–**	**1,655**
Other non-derivative financial assets	12	B	**–**	**550**	**–**	**–**	**–**	**–**	**550**
Derivative financial assets		C	**418**	**–**	**–**	**–**	**–**	**–**	**418**
Short-term investments		B	**–**	**11**	**–**	**–**	**–**	**–**	**11**
Cash and cash equivalents	13	B	**–**	**14**	**11**	**1,285**	**–**	**–**	**1,310**
Borrowings	15	D	**–**	**–**	**–**	**–**	**–**	**(1,204)**	**(1,204)**
Derivative financial liabilities		C	**–**	**–**	**–**	**–**	**(796)**	**–**	**(796)**
Financial RRSPs		D	**–**	**–**	**–**	**–**	**–**	**(230)**	**(230)**
C Shares		B	**–**	**–**	**–**	**–**	**–**	**(4)**	**(4)**
Trade payables and similar items	16	B	**–**	**–**	**–**	**–**	**–**	**(2,356)**	**(2,356)**
Other non-derivative financial liabilities	16	B	**–**	**–**	**–**	**–**	**–**	**(718)**	**(718)**
			418	**2,240**	**11**	**1,285**	**(796)**	**(4,512)**	**(1,354)**
At December 31, 2010									
Unlisted non-current asset investments	10	A	–	11	–	–	–	–	11
Trade receivables and similar items	12	B	–	1,801	–	–	–	–	1,801
Other non-derivative financial assets	12	B	–	419	–	–	–	–	419
Derivative financial assets		C	621	–	–	–	–	–	621
Short-term investments		B	–	328	–	–	–	–	328
Cash and cash equivalents	13	B	–	1,212	381	1,266	–	–	2,859
Borrowings	15	D	–	–	–	–	–	(1,852)	(1,852)
Derivative financial liabilities		C	–	–	–	–	(761)	–	(761)
Financial RRSPs		D	–	–	–	–	–	(266)	(266)
C Shares		B	–	–	–	–	–	(23)	(23)
Trade payables and similar items	16	B	–	–	–	–	–	(2,212)	(2,212)
Other non-derivative financial liabilities	16	B	–	–	–	–	–	(521)	(521)
			621	3,771	381	1,266	(761)	(4,874)	404

Fair values equate to book values for both 2011 and 2010, with the following exceptions:

	2011 Book value £m	**2011 Fair value £m**	2010 Book value £m	2010 Fair value £m
Borrowings	**(1,204)**	**(1,371)**	(1,852)	(1,963)
Financial RRSPs	**(230)**	**(254)**	(266)	(296)

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

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

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

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

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

17 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	C Shares £m	Total £m
At December 31, 2011							
Non-current assets	**237**	**7**	**83**	**327**	**–**	**–**	**327**
Current assets	**84**	**7**	**–**	**91**	**–**	**–**	**91**
	321	**14**	**83**	**418**	**–**	**–**	**418**
Current liabilities	**(85)**	**(7)**	**–**	**(92)**	**(15)**	**(4)**	**(111)**
Non-current liabilities	**(683)**	**(19)**	**(2)**	**(704)**	**(215)**	**–**	**(919)**
	(768)	**(26)**	**(2)**	**(796)**	**(230)**	**(4)**	**(1,030)**
	(447)	**(12)**	**81**	**(378)**	**(230)**	**(4)**	**(612)**
At December 31, 2010							
Non-current assets	317	18	36	371	–	–	371
Current assets	98	10	142	250	–	–	250
	415	28	178	621	–	–	621
Current liabilities	(38)	(5)	–	(43)	(39)	(23)	(105)
Non-current liabilities	(713)	(2)	(3)	(718)	(227)	–	(945)
	(751)	(7)	(3)	(761)	(266)	(23)	(1,050)
	(336)	21	175	(140)	(266)	(23)	(429)

Derivative financial instruments

The Group uses various financial instruments to manage its exposure to movements in foreign exchange rates. Where the effectiveness of a hedging relationship in a cash flow hedge is demonstrated, changes in the fair value that are deemed effective are included in the cash flow hedge reserve and released to match actual payments on the hedged item. The Group 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 Group has currency derivatives designated as part of fair value hedges. The Group uses interest rate swaps, forward rate agreements and interest rate caps to manage its exposure to movements in interest rates.

Movements in the fair values of derivative financial assets and liabilities were as follows:

	Foreign exchange instruments £m	Commodity instruments £m	Interest rate instruments £m	Total £m
At January 1, 2010	(144)	(11)	199	44
Movements in fair value hedges [1]	7	–	(21)	(14)
Movements in other derivative contracts [2]	(370)	29	(1)	(342)
Contracts settled [3]	171	3	(2)	172
At January 1, 2011	**(336)**	**21**	**175**	**(140)**
Movements in fair value hedges [1]	2	–	83	85
Movements in cash flow hedges	(1)	–	–	(1)
Movements in other derivative contracts [2]	(21)	(28)	1	(48)
Contracts settled [3]	(91)	(5)	(178)	(274)
At December 31, 2011	**(447)**	**(12)**	**81**	**(378)**

[1] Loss on related hedged items **£85m** (2010 £14m net gain).
[2] Included in financing.
[3] Includes contracts settled in fair value hedges **£1m loss** (2010 £10m gain).

17 Financial instruments (continued)

Financial risk and revenue sharing partnerships (RRSPs)

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

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

	2011 £m	2010 £m
At January 1	**(266)**	(363)
Cash paid to partners	**46**	114
Exchange adjustments included in OCI	**(1)**	2
Financing charge [1]	**(11)**	(13)
Excluded from underlying profit:		
Exchange adjustments [1]	**1**	(6)
Changes in forecast payments [1]	**1**	–
At December 31	**(230)**	(266)

[1] Included in financing.

Risk management policies and hedging activities

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

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

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

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

Liquidity risk – The Group's policy is to hold financial investments and maintain undrawn committed facilities at a level sufficient to ensure that the Group has available funds to meet its medium-term capital and funding obligations and to meet any unforeseen obligations and opportunities. The Group holds cash and short-term investments, which together with the undrawn committed facilities, enable the Group to manage its liquidity risk. The profile of the maturity of the Group's committed facilities is discussed in additional financial information on page 36.

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 and 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.

17 Financial instruments (continued)

Derivative financial instruments

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

		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, 2011							
Foreign exchange contracts:							
Fair value hedges	**175**	**–**	**129**	**46**	**–**	**23**	**–**
Non-hedge accounted	**17,563**	**5,438**	**3,625**	**7,568**	**932**	**298**	**(768)**
Interest rate contracts:							
Fair value hedges	**701**	**–**	**148**	**53**	**500**	**83**	**–**
Non-hedge accounted	**43**	**–**	**–**	**43**	**–**	**–**	**(2)**
Commodity contracts:							
Non-hedge accounted	**220**	**68**	**59**	**93**	**–**	**14**	**(26)**
	18,702	**5,506**	**3,961**	**7,803**	**1,432**	**418**	**(796)**
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)

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

Currency analysis

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, 2011					
Currencies sold forward:					
Sterling	**–**	**814**	**–**	**147**	**961**
US dollar	**14,401**	**–**	**1,193**	**834**	**16,428**
Euro	**–**	**–**	**–**	**197**	**197**
Other	**36**	**26**	**67**	**23**	**152**
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

17 Financial instruments (continued)

Other derivative financial instruments are denominated in the following currencies:

	2011 £m	2010 £m
Sterling	510	514
US dollar	421	337
Euro	–	500
Other	33	33

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, 2011					
Assets					
Unlisted non-current investments	1	–	4	5	10
Trade receivables and similar items	204	1,201	133	117	1,655
Other non-derivative financial assets	112	87	217	134	550
Short-term investments	5	–	–	6	11
Cash and cash equivalents	50	657	367	236	1,310
	372	1,945	721	498	3,536
Liabilities					
Borrowings	(977)	(222)	(5)	–	(1,204)
Financial RRSPs	–	(173)	(57)	–	(230)
C Shares	(4)	–	–	–	(4)
Trade payables and similar items	(1,095)	(812)	(275)	(174)	(2,356)
Other non-derivative financial liabilities	(252)	(308)	(18)	(140)	(718)
	(2,328)	(1,515)	(355)	(314)	(4,512)
	(1,956)	430	366	184	(976)
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 and cash equivalents	1,299	634	473	453	2,859
	2,092	1,800	727	799	5,418
Liabilities					
Borrowings	(972)	(222)	(656)	(2)	(1,852)
Financial RRSPs	–	(208)	(58)	–	(266)
C Shares	(23)	–	–	–	(23)
Trade payables and similar items	(1,040)	(705)	(219)	(248)	(2,212)
Other non-derivative financial liabilities	(211)	(166)	(35)	(109)	(521)
	(2,246)	(1,301)	(968)	(359)	(4,874)
	(154)	499	(241)	440	544

17 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, 2011					
Sterling	**–**	**1**	**–**	**3**	**4**
US dollar	**3**	**–**	**(2)**	**10**	**11**
Euro	**(1)**	**(1)**	**–**	**–**	**(2)**
Other	**1**	**4**	**1**	**3**	**9**
At December 31, 2010					
Sterling	–	3	1	1	5
US dollar	1	–	(1)	16	16
Euro	–	(1)	–	(1)	(2)
Other	1	–	1	2	4

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, 2011					
Unlisted non-current asset investments	**10**	**–**	**–**	**–**	**10**
Trade receivables and similar items	**1,377**	**184**	**68**	**26**	**1,655**
Other non-derivative financial assets	**532**	**15**	**–**	**3**	**550**
Derivative financial assets	**418**	**–**	**–**	**–**	**418**
Short-term investments	**11**	**–**	**–**	**–**	**11**
Cash and cash equivalents	**1,310**	**–**	**–**	**–**	**1,310**
	3,658	**199**	**68**	**29**	**3,954**
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 and cash equivalents	2,859	–	–	–	2,859
	5,720	199	87	33	6,039

17 Financial instruments (continued)

Contractual maturity analysis of financial liabilities

	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 values £m
At December 31, 2011						
Borrowings	**(85)**	**(213)**	**(608)**	**(603)**	**305**	**(1,204)**
Derivative financial liabilities	**(92)**	**(199)**	**(419)**	**(48)**	**(38)**	**(796)**
Financial RRSPs	**(37)**	**(37)**	**(91)**	**(127)**	**62**	**(230)**
C Shares	**(4)**	**–**	**–**	**–**	**–**	**(4)**
Trade payables and similar items	**(2,353)**	**(1)**	**(1)**	**(1)**	**–**	**(2,356)**
Other non-derivative financial liabilities	**(715)**	**(2)**	**–**	**(1)**	**–**	**(718)**
	(3,286)	**(452)**	**(1,119)**	**(780)**	**329**	**(5,308)**
At December 31, 2010						
Borrowings	(812)	(68)	(575)	(887)	490	(1,852)
Derivative financial liabilities	(43)	(110)	(525)	(8)	(75)	(761)
Financial RRSPs	(47)	(39)	(110)	(152)	82	(266)
C Shares	(23)	–	–	–	–	(23)
Trade payables and similar items	(2,199)	(7)	(4)	(2)	–	(2,212)
Other non-derivative financial liabilities	(516)	(3)	(1)	(1)	–	(521)
	(3,640)	(227)	(1,215)	(1,050)	497	(5,635)

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.

			2011 Period in which interest rate reprices				
	Effective interest rate %	Total £m	6 months or less £m	6-12 months £m	1-2 years £m	2-5 years £m	More than 5 years £m
Short-term investments [1]	4.3782%	**11**	**9**	**2**	**–**	**–**	**–**
Cash and cash equivalents [2]		**1,310**	**1,310**	**–**	**–**	**–**	**–**
Unsecured bank loans							
€2m floating rate loan	0.5000%	**(2)**	**–**	**–**	**–**	**–**	**(2)**
€5m floating rate loan	EURIBOR +0.75	**(3)**	**(3)**	**–**	**–**	**–**	**–**
Overdrafts [3]		**(19)**	**(19)**	**–**	**–**	**–**	**–**
Interest rate swaps	10.8775%	**–**	**10**	**–**	**–**	**(10)**	**–**
£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%	**(160)**	**–**	**–**	**(160)**	**–**	**–**
Effect of interest rate swaps	USD LIBOR + 1.26	**–**	**(160)**	**–**	**160**	**–**	**–**
6.55% Notes 2015 US$83m	6.5500%	**(62)**	**–**	**–**	**–**	**(62)**	**–**
Effect of interest rate swaps	USD LIBOR + 1.24	**–**	**(62)**	**–**	**–**	**62**	**–**
6.75% Notes 2019 £500m	6.7500%	**(557)**	**–**	**–**	**–**	**–**	**(557)**
Effect of interest rate swaps	GBP LIBOR + 2.9824	**–**	**(557)**	**–**	**–**	**–**	**557**
Other secured							
Obligations under finance leases	5.0000%	**(1)**	**–**	**–**	**–**	**–**	**(1)**
		117	**328**	**2**	**–**	**(210)**	**(3)**

17 Financial instruments (continued)

	Effective interest rate %	Total £m	2010 Period in which interest rate reprices: 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 and cash equivalents [2]		2,859	2,859	–	–	–	–
Unsecured bank loans							
£66m floating rate loan	GBP LIBOR + 0.7	(66)	(66)	–	–	–	–
€5m floating rate loan	EURIBOR + 0.5	(5)	(5)	–	–	–	–
Overdrafts [3]		(8)	(8)	–	–	–	–
75m Indian rupee fixed rate loan	11.2467%	(1)	(1)	–	–	–	–
Effect of interest rate swaps	7.2237%	(1)	12	–	–	(13)	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–	–	–	–
Unsecured bond issues							
$7\frac{3}{8}\%$ 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	–
$4\frac{1}{2}\%$ 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)
		1,335	1,548	1	–	(13)	(201)

1 Interest on the short-term investments are at fixed rates.
2 Cash and cash equivalents comprises bank balances and demand deposits and earns interest at rates based on daily deposit rates.
3 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:

	2011 £m	2010 £m
Expiring in one to two years	**–**	250
Expiring after two years	**1,200**	200
	1,200	450

17 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, 2011 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 **£1,083m** lower (2010 £989m). 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 **£886m** higher (2010 £809m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2011 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 **£93m** lower (2010 £82m). 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 **£78m** higher (2010 £66m). There would have been no change to the underlying results that exclude unrealised gains and losses on foreign exchange derivatives.

At December 31, 2011 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 **£15m** lower (2010 £11m). 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 **£15m** higher (2010 £11m). There would have been no change to the underlying results that exclude unrealised gains and losses on commodity derivatives.

At December 31, 2011 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 101.

C Shares and payments to shareholders

The Company (and Rolls-Royce Group plc, the previous holding company) issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend. C Shares in respect of a year are issued in the following year. Shareholders are able to redeem any number of their C Shares for cash. Any C Shares retained attract a dividend of 75 per cent of LIBOR on the 0.1p nominal value of each share, paid on a twice-yearly basis, and have limited voting rights. In certain circumstances the Company has the option to compulsorily redeem the C Shares, at any time, if the aggregate number of C Shares in issue is less than ten per cent of the aggregate number of C Shares issued, or on the acquisition or capital restructuring of the Company. As part of the scheme of arrangement described on page 76, all outstanding C Shares were compulsorily redeemed on April 6, 2011.

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

	2011		2010	
	Millions	**Nominal value £m**	Millions	Nominal value £m
Issued and fully paid				
At January 1	**23,380**	**23**	12,577	13
Issued	**299,522**	**300**	278,115	278
Redeemed	**(316,531)**	**(317)**	(267,312)	(267)
Held in employee share trust	**(1,999)**	**(2)**	–	–
At December 31	**4,372**	**4**	23,380	23

Payments to shareholders in respect of the year represent the value of C Shares to be issued in respect of the results for the year. Issues of C Shares prior to the scheme of arrangement (May 23, 2011) were made by Rolls-Royce Group plc and subsequently by Rolls-Royce Holding plc. Issues of C Shares were declared as follows:

	2011		2010	
	Pence per share	**£m**	Pence per share	£m
Interim	**6.9**	**129**	6.4	119
Final	**10.6**	**199**	9.6	180
	17.5	**328**	16.0	299

18 Provisions for liabilities and charges

	At January 1, 2011 £m	Exchange differences £m	Transferred to assets held for sale £m	Acquisitions of businesses £m	Unused amounts reversed £m	Charged to income statement £m	Utilised £m	At December 31, 2011 £m
Warranty and guarantees	298	(5)	–	–	(21)	72	(59)	285
Contract loss	72	–	–	1	(1)	11	(31)	52
Restructuring	14	–	–	–	(5)	1	(4)	6
Customer financing	78	–	(9)	–	–	14	(2)	81
Insurance	55	–	–	–	–	7	(11)	51
Other	27	–	–	–	(7)	10	(3)	27
	544	(5)	(9)	1	(34)	115	(110)	502
Current liabilities	276							276
Non-current liabilities	268							226

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 'Customer financing' in the Finance Director's review on page 16. The related contingent liabilities arising from these guarantees and the sensitivity to movements in the value of the underlying security are discussed in note 23. It is estimated that the provision will be utilised as follows:

	2011 £m	2010 £m
Potential claims with specific claim dates:		
In one year or less	12	8
In more than one year but less than five years	62	47
In more than five years	6	6
Potential claims that may arise at any time up to the date of expiry of the guarantee:		
Up to one year	–	9
Up to five years	1	5
Thereafter	–	3
	81	78

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.

19 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, 2011. 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	April 5, 2010
Vickers Group Pension Scheme	March 31, 2010

Amounts recognised in the income statement

	2011			2010		
	UK schemes £m	**Overseas schemes £m**	**Total £m**	UK schemes £m	Overseas schemes £m	Total £m
Defined benefit schemes:						
Current service cost	**119**	**34**	**153**	118	34	152
Past-service (credit)/cost	**(126)**	**(68)**	**(194)**	–	1	1
Curtailment	**–**	**(2)**	**(2)**	–	(6)	(6)
	(7)	**(36)**	**(43)**	118	29	147
Defined contribution schemes	**16**	**38**	**54**	11	32	43
Operating cost	**9**	**2**	**11**	129	61	190
Financing in respect of defined benefit schemes:						
Expected return on assets	**(381)**	**(29)**	**(410)**	(374)	(26)	(400)
Interest on liabilities	**372**	**50**	**422**	375	56	431
	(9)	**21**	**12**	1	30	31
Total income statement charge	**–**	**23**	**23**	130	91	221

The operating cost is charged as follows:

	Defined benefit		**Defined contribution**		**Total**	
	2011 £m	2010 £m	**2011 £m**	2010 £m	**2011 £m**	2010 £m
Cost of sales – included in underlying profit	**114**	106	**38**	31	**152**	137
Cost of sales – excluded from underlying profit	**(204)**	–	**–**	–	**(204)**	–
Commercial and administrative costs	**36**	31	**12**	9	**48**	40
Research and development	**11**	10	**4**	3	**15**	13
	(43)	147	**54**	43	**11**	190

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** (2010 £35m) in the year.

Amounts recognised in the other comprehensive income

	2011 £m	2010 £m
Actuarial gain on scheme assets	**1,426**	460
Experience losses on scheme liabilities	**(720)**	(303)
Movement in unrecognised surplus	**(683)**	(300)
Movement in minimum funding liability	**100**	49
	123	(94)

19 Post-retirement benefits (continued)

Defined benefit schemes

Assumptions

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

	2011		2010	
	UK schemes %	Overseas schemes %	UK schemes %	Overseas schemes %
Rate of increase in salaries	**4.2**	**4.0**	4.7	3.9
Rate of increase of pensions in payment	**1.7**	**1.7**	3.0	1.7
Discount rate	**4.7**	**4.5**	5.5	5.4
Expected rate of return on scheme assets	**3.4**	**5.6**	5.0	7.2
Inflation assumption [1]	**3.1**	**2.5**	3.6	2.5

[1] For the UK schemes, this is the assumption for the Retail Price Index. The Consumer Price Index is assumed to be one per cent lower.

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 overseas schemes, the rate is determined as the market yield at the average duration of the forecast benefit payments. The discount rates above are the weighted average of those for each scheme, based on the value of their respective liabilities.

The overall expected rate of return is calculated by weighting the individual returns expected from each asset class (see 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 range of life expectancies in the principal UK schemes are as follows:

Life expectancy from age 65	
Current pensioner	22.2 years
Future pensioner currently aged 45	24.3 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 **five** per cent over **6.3** years.

19 Post-retirement benefits (continued)

Amounts recognised in the balance sheet

	2011			2010		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Present value of funded obligations	(7,713)	(557)	(8,270)	(7,039)	(484)	(7,523)
Fair value of scheme assets	9,519	497	10,016	7,783	434	8,217
	1,806	(60)	1,746	744	(50)	694
Present value of unfunded obligations	–	(495)	(495)	–	(579)	(579)
Unrecognised past-service credit [1]	–	(94)	(94)	–	–	–
Unrecognised surplus [2]	(1,318)	–	(1,318)	(628)	(7)	(635)
Minimum funding liability [3]	(236)	–	(236)	(336)	–	(336)
Net asset/(liability) recognised in the balance sheet	252	(649)	(397)	(220)	(636)	(856)
Post-retirement scheme surpluses	495	8	503	164	–	164
Post-retirement scheme deficits	(243)	(657)	(900)	(384)	(636)	(1,020)

1 The unrecognised past-service credit has arisen as a result of revisions to post-retirement healthcare schemes. It will be amortised over the remaining service lives of the participants (12.3 years).
2 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.
3 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.

Changes in present value of defined benefit obligations

	2011			2010		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At January 1	(7,039)	(1,063)	(8,102)	(6,714)	(823)	(7,537)
Exchange differences	–	–	–	–	(27)	(27)
Current service cost	(119)	(34)	(153)	(118)	(34)	(152)
Past-service credit/(cost)	126	162	288	–	(1)	(1)
Finance cost	(372)	(50)	(422)	(375)	(56)	(431)
Contributions by employees	(4)	(3)	(7)	(3)	(2)	(5)
Benefits paid out	312	37	349	313	35	348
Actuarial losses	(617)	(103)	(720)	(142)	(161)	(303)
Curtailment	–	2	2	–	6	6
At December 31	(7,713)	(1,052)	(8,765)	(7,039)	(1,063)	(8,102)
Funded schemes	(7,713)	(557)	(8,270)	(7,039)	(484)	(7,523)
Unfunded schemes	–	(495)	(495)	–	(579)	(579)

Changes in fair value of scheme assets

	2011			2010		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
At January 1	7,783	434	8,217	7,048	354	7,402
Exchange differences	–	1	1	–	16	16
Expected return on assets	381	29	410	374	26	400
Contributions by employer	256	48	304	227	55	282
Contributions by employees	4	3	7	3	2	5
Benefits paid out	(312)	(37)	(349)	(313)	(35)	(348)
Actuarial gains	1,407	19	1,426	444	16	460
At December 31	9,519	497	10,016	7,783	434	8,217
Actual return on scheme assets	1,788	48	1,836	818	42	860

19 Post-retirement benefits (continued)

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

	2011		2010	
	Expected rate of return %	Market value £m	Expected rate of return %	Market value £m
UK schemes:				
Liability driven investment (LDI) portfolios [1]	3.1	8,330	4.5	6,383
Longevity swap [2]	4.7	(79)	–	–
Equities	6.0	1,004	7.5	1,204
Sovereign debt	2.8	159	4.2	23
Corporate bonds	4.0	13	5.2	22
Other	2.8	92	4.2	151
	3.4	9,519	5.0	7,783
Overseas schemes:				
LDI portfolios [1]	5.3	291	–	–
Equities	7.9	118	9.3	237
Corporate bonds	4.0	83	4.5	170
Other	2.5	5	6.9	27
	5.6	497	7.2	434

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.

2 Under the longevity swap, the Rolls-Royce Pension Fund has agreed an average life expectancy of pensioners with a counterparty. If pensioners live longer than expected the counterparty will make payments to the Fund to offset the additional cost of paying pensioners. If the reverse applies the cost of paying pensioners will be reduced but the scheme will be required to make payments to the counterparty.

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

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

The expected rates of return on other individual categories of scheme assets are determined by reference to gilt yields. In the UK, equities and corporate bonds are assumed to generate returns that exceed the return from gilts by **3.25** per cent and **1.20** 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 **£290m** to its defined benefit schemes in 2012.

Sensitivities
For the most significant schemes, 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 principal UK defined benefit schemes by approximately **£298m**. An equivalent movement in interest rates would increase the fair value of the assets by approximately **£463m**. 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 approximately **95** per cent. The principal remaining risks relate to the assumptions for mortality and increases in salaries. If the age ratings in respect of the principal UK defined benefit schemes were increased by one year, the scheme liabilities would increase by **£163m** and there would be a corresponding increase in the value of the longevity swap of **£62m**. If the rate of increase in salaries were 0.5 per cent higher, scheme liabilities would increase by **£127m**.

The defined benefit obligation relating to post-retirement medical benefits would increase by **£45m** if the healthcare trend rate increases by one per cent, and reduce by **£56m** 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 **£4m** if the healthcare trend increases by one per cent, and reduce by **£5m** if it decreases by one per cent.

19 Post-retirement benefits (continued)

History of defined benefit schemes

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

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Balance sheet					
Present value of defined benefit obligations	**(8,765)**	(8,102)	(7,537)	(6,546)	(6,912)
Fair value of scheme assets	**10,016**	8,217	7,402	7,446	6,903
Unrecognised past-service credit	**(94)**	–	–	–	–
Unrecognised surpluses	**(1,318)**	(635)	(335)	(1,042)	(114)
Minimum funding liabilities	**(236)**	(336)	(385)	(425)	–
Deficit	**(397)**	(856)	(855)	(567)	(123)
Experience gains/(losses)					
Actuarial gains/(losses) on scheme assets	**1,426**	460	(270)	178	161
Experience (losses)/gains on scheme liabilities	**(720)**	(303)	(878)	766	350
Movement in unrecognised surpluses	**(683)**	(300)	707	(928)	(112)
Recognition of minimum funding liability on January 1, 2008	**–**	–	–	(491)	–
Movement in minimum funding liabilities	**100**	49	40	66	–
Total amount recognised in OCI	**123**	(94)	(401)	(409)	399
Cumulative amounts recognised in OCI since January 1, 2004	**(69)**	(192)	(98)	303	712

20 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each [1] Millions	Nominal value £m
Issued and fully paid					
Rolls-Royce Group plc					
At January 1, 2010	1	–	–	1,854	371
Proceeds from shares issued for share option schemes	–	–	–	18	3
At January 1, 2011	**1**	**–**	**–**	**1,872**	**374**
Proceeds from shares issued for share option schemes	–	–	–	–	–
At May 23, 2011	1	–	–	1,872	374
Rolls-Royce Holdings plc					
On formation of Rolls-Royce Holdings plc	–	50,000	–	–	–
Scheme of arrangement – issue of ordinary shares of 150p each [2]	1	–	–	1,872	2,808
Capital reduction to ordinary shares of 20p each [2]	–	–	–	–	(2,434)
Proceeds from shares issued for share option schemes	–	–	–	–	–
Redemption of shares	–	(50,000)	–	–	–
At December 31, 2011	**1**	**–**	**–**	**1,872**	**374**

[1] Unless otherwise stated
[2] See page 76

The rights attaching to each class of share are set out on page 66.

In accordance with IAS 32 *Financial Instruments: Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 17.

21 Share-based payments

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

	2011 £m	2010 £m
Total expense recognised for equity-settled share-based payments transactions	**52**	47
Total expense recognised for cash-settled share-based payments transactions	**7**	3
Share-based payments recognised in the consolidated income statement	**59**	50
Liability for cash-settled share-based payment transactions	**9**	5

Share-based payment plans in operation during the year

Performance Share Plan (PSP)

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

ShareSave share option plan (ShareSave)

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

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, 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	–	–
Outstanding at January 1, 2011	**26.5**	**384**	**0.7**	**125**	**19.5**	**3.1**
Granted	10.6	525	–	–	5.3	2.6
Additional entitlements arising from TSR performance	–	–	–	–	1.1	–
Additional shares accrued from reinvestment of C Shares	–	–	–	–	–	0.1
Forfeited	(0.9)	387	–	–	(0.7)	(0.1)
Exercised	(8.7)	357	(0.2)	207	(5.7)	(2.4)
Outstanding at December 31, 2011	**27.5**	**447**	**0.5**	**100**	**19.5**	**3.3**
Exercisable at December 31, 2011	**–**	**–**	**0.5**	**100**	**–**	**–**

21 Share-based payments (continued)

As share options are exercised throughout the year, the weighted average share price during the year of **642p** (2010 579p) is representative of the weighted average share price at the date of exercise. The closing price at December 31, 2011 was **746.5p** (2010 623p).

The average remaining contractual life of exercisable options is **one** year (2010 1.7 years).

Share options outstanding

	ShareSave		ESOP		Total	
Exercise prices (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, 2011						
0 – 99	**–**	**–**	**0.4**	**1.2**	**0.4**	**1.2**
100 – 199	**–**	**–**	**0.1**	**0.2**	**0.1**	**0.2**
300 – 399	**10.8**	**2.3**	**–**	**–**	**10.8**	**2.3**
400 – 499	**6.0**	**1.1**	**–**	**–**	**6.0**	**1.1**
500 – 599	**10.7**	**4.2**	**–**	**–**	**10.7**	**4.2**
	27.5	**2.7**	**0.5**	**1.0**	**28.0**	**2.7**
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

The range of exercise prices of options outstanding at December 31, 2011 was: for ShareSave between **387p** and **525p** (2010 298p and 416p); and for ESOP it was between **77p** and **188p** (2010 77p and 218p).

Under the terms of the Rolls-Royce 1999 Executive Share Option Plan, options granted to 20 directors and senior executives were outstanding at December 31, 2011.

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 grant, are as follows:

	2011	2010
PSP – 25% TSR uplift	**662p**	586p
PSP – 50% TSR uplift	**737p**	654p
ShareSave – 3 year grant	**210p**	n/a
ShareSave – 5 year grant	**238p**	n/a
APRA	**612p**	537p

21 Share-based payments (continued)

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

	PSP		ShareSave
	2011	2010	**2011**
Weighted average share price	**612p**	545p	**691p**
Exercise price	**n/a**	n/a	**525p**
Expected dividends	**15.4p**	14.6p	**16.0p**
Expected volatility	**32%**	33%	**30%**
Correlation	**36%**	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%	**1.9%**

Expected volatility is based on the historical volatility of the Company's share price over the seven years prior to the grant or award date. Expected dividends are based on the Company'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 and which incorporates into the valuation the interdependency between share price performance and TSR vesting. This adjustment increases the fair value of the award relative to the share price at the date of grant.

ShareSave

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.

22 Operating leases

Leases as lessee

	2011 £m	2010 £m
Rentals paid – hire of plant and machinery	**104**	82
– hire of other assets	**29**	20
Non-cancellable operating lease rentals are payable as follows:		
Within one year	**117**	92
Between one and five years	**401**	265
After five years	**479**	215
	997	572

22 Operating leases (continued)

Leases as lessor

	2011 £m	2010 £m
Rentals received – credited within revenue from aftermarket services	**36**	29
Non-cancellable operating lease rentals are receivable as follows:		
Within one year	**3**	3
Between one and five years	**8**	10
After five years	**2**	3
	13	16

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 **£3m** (2010 £23m) and sublease receipts of **£23m** (2010 £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 **£5m** (2010 £18m) and sublease receipts expected to be received is **£4m** (2010 £3m).

23 Contingent liabilities

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

Contingent liabilities are disclosed on a discounted basis. As the directors consider the likelihood of these contingent liabilities crystallising to be remote, this amount does not represent a value that is expected to crystallise. However, the amounts are discounted at the Group's borrowing rate to reflect better the time span over which these exposures could arise. The contingent liabilities are denominated in US dollars. As the Group does not generally 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:

	2011		2010	
	£m	$m	£m	$m
Gross contingent liabilities	**612**	***951***	633	*991*
Contingent liabilities net of relevant security [1]	**124**	***192***	121	*190*
Contingent liabilities net of relevant security reduced by 20% [2]	**201**	***312***	200	*314*
[1] Security includes unrestricted cash collateral of:	**67**	***104***	68	*106*

[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. As a consequence of the insolvency of an insurer as previously reported, the Group is no longer fully insured against known and potential claims from employees who worked for certain of the Group's UK based businesses for a period prior to the acquisition of those businesses by the Group. While the outcome of some of these matters cannot precisely be foreseen, the directors do not expect any of these arrangements, legal actions or claims, after allowing for provisions already made, to result in significant loss to the Group.

The Group's share of equity accounted entities' contingent liabilities is **£68m** (2010 £24m).

24 Related party transactions

	2011 £m	2010 £m
Sales of goods and services to joint ventures and associates	**2,864**	2,681
Purchases of goods and services from joint ventures and associates	**(2,380)**	(2,163)
Operating lease payments to joint ventures and associates	**(77)**	(58)
Guarantees of joint ventures' and associates' borrowings	**124**	43
Dividends received from joint ventures and associates	**76**	68
RRSP receipts from joint ventures and associates	**13**	12
Other income received from joint ventures and associates	**56**	79

The aggregated balances with joint ventures are shown in notes 12 and 16. Transactions with Group pension schemes are shown in note 19.

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 GLT as set out on pages 38 to 40. Remuneration for key management personnel is shown below:

	2011 £m	2010 £m
Salaries and short-term benefits	**18**	13
Post-retirement schemes	**1**	2
Share-based payments	**14**	8
	33	23

More detailed information regarding the directors' remuneration, shareholdings, pension entitlements, share options and other long-term incentive plans is shown in the Directors' remuneration report on pages 55 to 65.

25 Acquisitions

On September 1, 2011, the Group acquired 100 per cent of the issued share capital of R. Brooks Associates Inc., a leading specialist civil nuclear reactor services business in the United States. Of the **US$30m** acquisition cost (net of cash acquired), **US$12m** has been allocated to identifiable intangible assets and **US$5m** to other assets and liabilities. The balance of **US$13m** is recognised as goodwill.