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Rolls-Royce Holdings plc
Annual report 2011

Trusted to deliver excellence

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Below are some examples of the type of information and services available:

- ▶ **The Group's business**
- ▶ **Governance**
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- ▶ **People**
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www.rolls-royce.com/investors

Directors' report

The Directors' report which includes the Business review is set out on pages 1 to 70.

Forward-looking statements

This Annual report contains forward looking statements. Any statements that express forecasts, expectations and projections are not guarantees of future performance and will not be updated. By their nature, these statements involve risk and uncertainty and a number of factors could cause material differences to the actual results or developments.

This report is intended to provide information to shareholders, is not designed to be relied upon by any other party or for any other purpose and the Company and its directors accept no liability to any other person other than under English law.

Introduction

Rolls-Royce is a global company providing power solutions for customers in civil and defence aerospace, marine and energy markets. We support our customers through a worldwide network of offices, manufacturing and service facilities in over 50 countries.

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

	2010	2011	% change
Order book – firm and announced	£59.2bn	£62.2bn	+5%
Underlying revenue*	£10,866m	£11,277m	+4%
Profit before financing	£1,134m	£1,189m	+5%
Underlying profit before tax*	£955m	£1,157m	+21%
Underlying earnings per ordinary share*	38.73p	48.54p	+25%
Payments to shareholders	16.00p	17.50p	+9%

* See explanation in note 2 on page 84

Chairman's statement

Performing strongly in challenging conditions

Rolls-Royce continued to perform well during 2011 with our order book growing to a record £62.2 billion. Underlying profits increased 21 per cent to £1,157 million. We are proposing a final payment to shareholders of 10.6 pence per share, bringing the full year payment to 175 pence per share. This is an increase of nine per cent and reflects the Board's continuing confidence in the Group's future.

This strong performance has been achieved against a background of macro-economic weakness and uncertainty. The recovery, which many people had been expecting in Europe and North America, failed to materialise in 2011 and is still some way off. Fiscal imbalances, austerity programmes, disruption in the Eurozone and political tensions in the Middle East continue to affect world markets, undermining confidence about future macro-economic expansion even in Asia and South America. It is a tribute to everyone who works at Rolls-Royce that the Group has continued along its path of long-term growth despite these testing times.

Rolls-Royce is a long-term business which has maintained a consistent strategy over many years. We continually invest in advanced technology so that we can address both the present needs of our customers and meet their requirements for many years to come. Our power systems have life cycles that stretch over decades and we generate long-term revenue streams by servicing the products we sell. We have customers in 120 countries and we continue to broaden our customer base across the four segments in which we operate: civil aerospace, defence aerospace, marine and energy, including civil nuclear. These characteristics have combined to make Rolls-Royce an increasingly resilient business. However, we are not complacent and continue to invest for the future. In 2011, we invested £520 million from Group resources in research and development. This continuing commitment to technological innovation lies at the heart of our business model.

It is important to remember that Rolls-Royce sustains a global supply chain. Around 8,000 companies in some 70 countries, all generating employment, paying taxes and creating wealth, depend upon us and share in our success. For every person we employ, more than six jobs are

generated in the broader economy. As we grow in scale and strength, these effects are multiplied. Innovation driven by Rolls-Royce has generated wider societal benefits over many years. Engineering breakthroughs pioneered by this Group have had wide applications in fields as diverse as medical research and the automotive industries. Engineers and scientists trained by Rolls-Royce have gone on to make a significant contribution across enterprise and academia, while our growth will create future employment for many of the brightest young scientists studying at schools and universities around the world today. This is why advanced economies depend so critically on successful enterprises like Rolls-Royce and why it is of such importance that their wider contribution to society is recognised. As a global business we recognise that to stay competitive we need to attract, retain and develop the best talent from the greatest range of people worldwide. Our Global Diversity Steering Group reinforces our commitment to promoting diversity and equality throughout the Group and creating an environment in which each individual has the opportunity to realise his or her full potential.

The UK Government recently outlined a number of recommendations to improve gender diversity in UK boardrooms. We support these recommendations and are committed to making demonstrable progress by 2015.

During 2011, more than 400 young graduates joined Rolls-Royce, from more than 25 countries. In addition, 295 people joined our apprentice schemes. It is a tribute to the quality of our training that around 50 per cent of our apprentices go on to achieve an honours degree and that so many of our senior managers started their working lives at Rolls-Royce as apprentices.

Continuous training and development is extremely important to our success. Over the past five years we have invested over £150 million improving the knowledge and skills of our people. In order to maintain the highest standards of ethical behaviour and business integrity, we review continually our procedures and training programmes, which are mandatory for all staff. As well as developing our own workforce we recognise our wider responsibility towards the next generation of scientists and engineers through the promotion of science, technology, engineering and maths (STEM) in schools and universities. We invest in a wide range of educational projects around the world and encourage our staff to take leadership roles as school governors and STEM ambassadors.

As part of our responsibilities to the communities in which we work, the Board is committed to reducing the environmental impact of our products and operations. Across our portfolio we can demonstrate the progress that

Rolls-Royce has a highly-skilled and motivated team – proud of its heritage and ambitious for its future

Sir Simon Robertson
Chairman

February 8, 2012

is being made. One good example is the Boeing 787 Dreamliner that entered service in September 2011. This extraordinary aeroplane is designed to be 20 per cent more fuel efficient than the earlier generation of aircraft it replaces, thanks largely to advances in aero-engine technology. Our marine business has advanced hull designs, engines, and integrated propulsion systems that are reducing emissions dramatically. In our energy business we have continued to make good progress developing the scope of our civil nuclear capabilities.

I would like to thank my fellow directors for their great support and hard work in the past year. I would also like particularly to express my gratitude to Andrew Shilton, who retired from the Board at the year end. Andrew served Rolls-Royce as Finance Director for nine years and has done an outstanding job. I wish him well in his future endeavours. My congratulations go to Mark Morris, who succeeds Andrew and was appointed to the Board in January 2012. Mark joined Rolls-Royce as a graduate 25 years ago.

Sir John Rose, who had been with the Group for 27 years and was Chief Executive for 15 years, retired at the end of March and was succeeded by John Rishon. I have paid tribute to John Rose on a number of occasions including in last year's Annual report. Suffice it for me to say, we owe John a huge amount for what he achieved. I am very pleased to report that John Rishon has made a tremendous start as our new Chief Executive.

Sir Peter Gregson has expressed his wish to retire as a non-executive director of Rolls-Royce at this year's Annual General Meeting (AGM) and therefore will not be seeking re-election. Peter has made a valuable contribution during the past five years and I would like to thank him for his commitment. I am delighted to welcome both Lewis Booth and Sir Frank Chapman onto the Board as non-executive directors. Lewis Booth, who chairs the audit committee, is Executive Vice President and Chief Financial Officer of Ford Motor Company and one of the most senior leaders within the auto industry. Sir Frank has been Chief Executive at BG Group for the past 11 years. He brings an additional deep technical understanding and knowledge of advanced engineering to the Board. He has agreed to chair a new safety committee that will be formed in 2012.

We are fortunate to benefit from the advice of an International Advisory Board (IAB), comprised of some of the world's most distinguished business and political leaders. The IAB, whose membership is detailed later, provides invaluable strategic advice about the global markets in which we operate under the able guidance of Lord Powell of Bayswater. I would like to thank its members for their time and wisdom.

Through the disciplined application of a long-term strategy, Rolls-Royce has doubled its revenues in the past decade and we are confident of doubling them again in the coming ten years. Rolls-Royce has a strong balance sheet and we intend to run our business so that we maintain a single 'A' credit rating. In all parts of our business we see opportunities for profitable growth, building on the firm foundations I have described above.

At the heart of our business lie our people. Our past, current and future success rests entirely with them. I believe Rolls-Royce has a highly-skilled and motivated team which is proud of its heritage and ambitious for its future. The strength of our order book demonstrates the confidence our customers have placed in us. We are focused on delivering these commitments for the long-term good of the families and communities who depend upon us and for the benefit of our customers and of our shareholders.

Chief Executive's review

Delivering for customers and investing in the business

Demand for our products and services in 2011 remained strong. Despite the global economic turbulence of recent years, Rolls-Royce has continued to grow.

In my first year as Chief Executive, I have spent much of my time visiting Rolls-Royce sites around the world to meet employees, customers, suppliers and investors to hear what they have to say about your company. Without exception, the employees I have met are dedicated, professional and committed to delivering our brand promise – 'trusted to deliver excellence'. Our customers are supportive and enthusiastic about our technology and, of course, they want even better performance both from our products and our team. Our suppliers are excited by the opportunity for growth and understand our requirement for better quality, on time delivery and lower cost. Investors express support for our strategy and naturally share our desire for still better financial performance in the future.

At the 2011 AGM, I confirmed that we will continue to follow the strategy that has been in place for many years, and can be summarised as:

- 1 addressing four global markets: civil aerospace, defence aerospace, marine and energy,
- 2 investing in technology, capability and infrastructure,
- 3 developing a competitive portfolio of products and services,
- 4 focusing on growing market share and our installed product base, and
- 5 adding value for our customers through product-related services.

This strategy has stood the test of time and has proved itself in battle. Since 2007, and despite the turbulence of recent years, Rolls-Royce has grown underlying revenue by 44 per cent, underlying profits by 45 per cent and payments to shareholders by 35 per cent. We have doubled our revenues in the past decade and, through organic growth alone, we are confident that we will do the same in the decade ahead.

While we continue to follow this strategy, in the coming years, I see three main priorities:

1 Delivering the promises we have made

With a record order book of £62.2 billion, our customers have placed a huge amount of trust in us and it is essential we meet our commitments. This will require a very significant increase in capacity. To put this growth into perspective, since we started building Trent engines 18 years ago we have delivered just over 2,000 units. We will deliver the next 2,000 in just five years, which means more than doubling our current rate of production. To achieve this we continue to invest in new facilities around the world. These investments include our new plants at Crosspointe in Virginia, USA, where we are making discs for civil jet engines and Seletar, in Singapore, where we will make wide-chord fan blades and assemble and test Trent engines. We are also expanding and renewing our facilities in the UK where we still invest half of our capital expenditure and more than half of our research and development budget. As well as investing in our own facilities, we are working hard with our suppliers and partners to make sure our global supply chain can support our growth and keep pace with demand.

2 Deciding where we invest for future growth

We can see opportunity in all areas of our business but we need to concentrate our resources and decide which opportunities we are going to pursue and which we are not.

3 Continuing to improve the financial performance of the business

Although we are subject to inflationary pressures and tough competition, we will benefit from the growth of the business, from investments that will improve efficiency and from an increasing focus on cost performance and cash conversion.

In support of our strategy, during 2011 we made three very important decisions for the future:

The first was our acquisition of the German industrial engines group Tognum, our biggest acquisition, that we made in a joint offer with Daimler. It will bring together highly complementary product and technology portfolios and creates significant new opportunities for our marine and energy businesses.

Second, we signed an exclusive deal with Airbus to power the long-range Airbus A350-1000 aircraft, for which we will develop an enhanced Trent XWB engine.

*Our strategy has stood the test of time
 and has proved itself in battle*

John Rishton
 Chief Executive

February 8, 2012

Third, we agreed to sell our equity stake in International Aero Engines (IAE) to Pratt & Whitney, at the same time announcing our intention to form a new joint venture to develop engines for the next generation of mid-size aircraft. This agreement builds on a long and successful partnership with Pratt & Whitney, and charts a clear course for our future in this important market segment.

In addition, we have continued to extend our portfolio and have advanced a number of important programmes. These are described in greater detail later in this Annual report, but it is encouraging to note progress in each of our customer facing businesses.

In civil aerospace, we celebrated the first commercial flight of the Boeing 787 Dreamliner, operated by All Nippon Airways (ANA) and powered by Trent 1000 engines. The Trent XWB engine programme for the Airbus A350 XWB is progressing well with over 1,500 test hours completed. Our BR725 engine, developed for Gulfstream's new flagship executive jet, the G650, is due to enter service later this year.

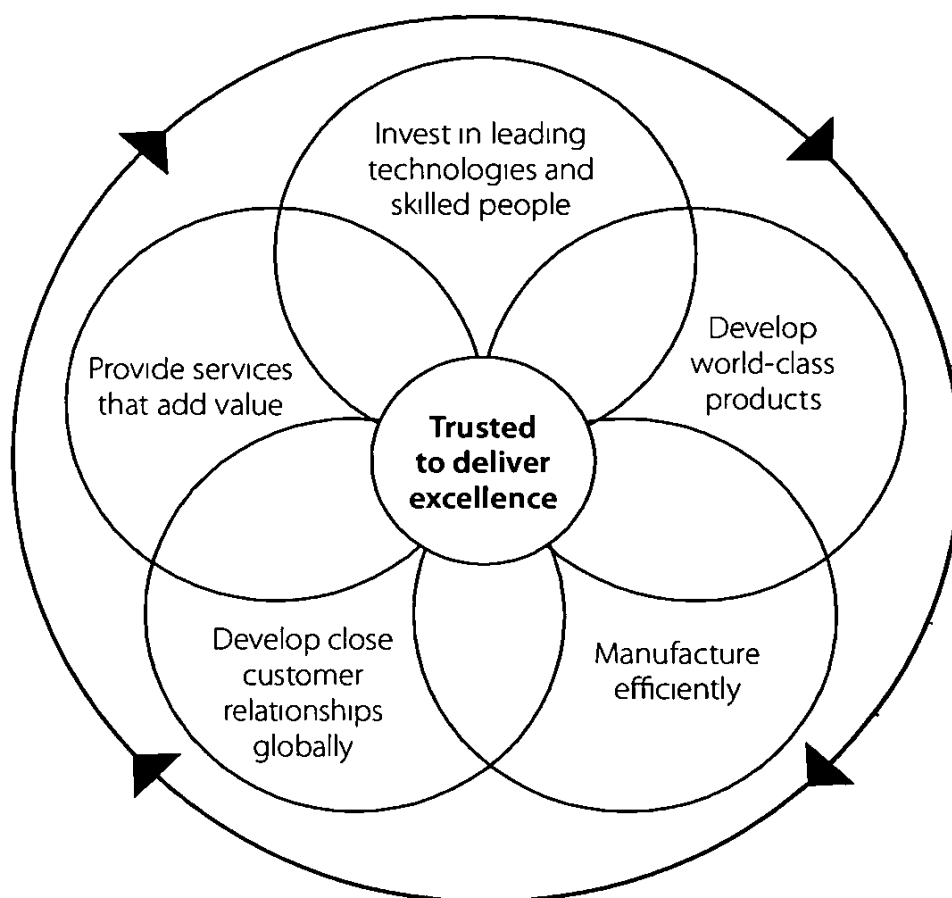
In defence, our LiftFan™ system for the Joint Strike Fighter has performed well during intensive flight tests that included more than 70 short take-offs and vertical landings on board the aircraft carrier *USS Wasp*. The TP400 engine for the Airbus A400M is on course to enter service in 2013, further strengthening our position in the military transport market.

In our marine business, we have secured the first orders for our award-winning Envision ship, a cargo vessel powered by liquid natural gas that substantially increases fuel efficiency through a combination of innovative hull design and power systems. In May 2011, the UK Government awarded Rolls-Royce the contract to develop a new propulsion system for the next generation of nuclear-powered submarines.

Our energy business signed its biggest ever single contract to supply Petrobras, Brazil's leading oil company, with 32 gas turbine generation packages to support its offshore operations. Within our civil nuclear business we have continued to expand our instrumentation and controls business while strategic relationships with reactor vendors and utility operators were further strengthened during 2011 through a number of cooperation agreements.

In 2011 Rolls-Royce performed well in difficult market conditions. We have a £62.2 billion order book, underlying revenue has grown to £11.3 billion and underlying profit has increased 21 per cent to £1.2 billion. This success is due to the extraordinary team of over 40,000 people that work for Rolls-Royce. I thank all of them for their support and effort in 2011. Their skills, the breadth of our portfolio, the strength of our order book and the access we have to parts of the world where demand for our products and services remain strong, make your company increasingly resilient.

Our business model and strategy



Rolls-Royce is a global company providing power solutions for customers in civil and defence aerospace, marine and energy markets. The Group has an ongoing commitment to investing in research and development (R&D) which provides the technologies and intellectual property that allow us to compete on a global basis and creates high barriers for entry to our markets.

Two-thirds of our annual R&D funding is aimed at improving the environmental performance of our products. We maximise our R&D investment through our approach of 'invest once use many times' in products across the four major segments. Our manufacturing operations and supply bases are integrated and global.

**Address four
global markets**

A leading producer of mission-critical, integrated power systems and services for use in civil and defence aerospace, marine and energy segments

**Invest in
technology
infrastructure
and capability**

We invest close to £1 billion annually in R&D and during 2011 we invested £467 million in capital projects to grow our global capability and productivity

**Develop a
competitive
portfolio of
products
and services**

We have 40 major engineering programmes under management. We continue to introduce major new products, including the Trent 1000. In 2011, our key projects will help define the power systems markets for many years ahead.

**Grow market
share and
our installed
product base**

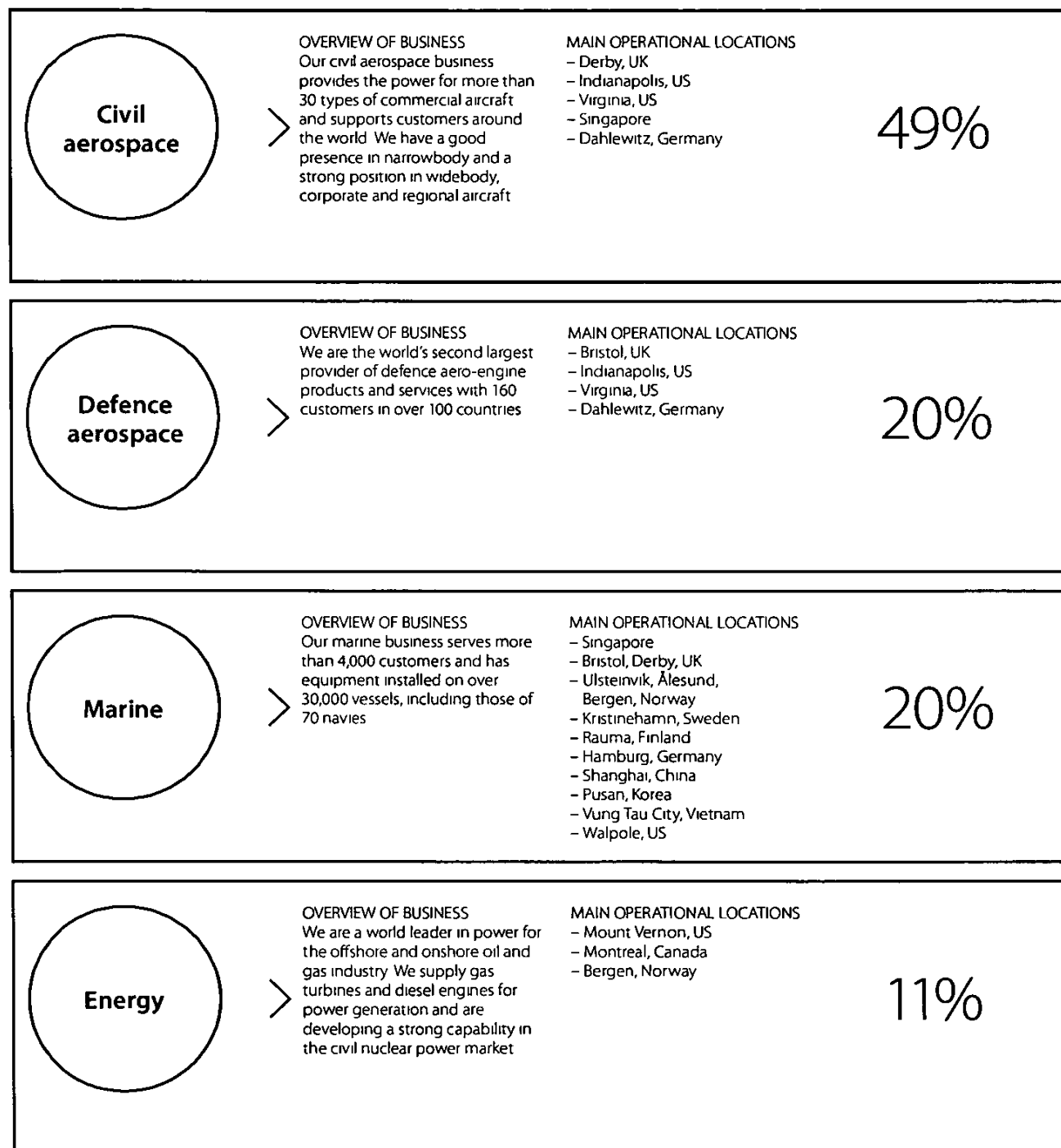
Across the Group the growing installed product base and integrated systems will generate attractive returns for many decades.

**Add value
for customers
through the
provision of
product-related
services**

Over half our revenues come from services. We seek to develop our customer relationships, through long-term service contracts where we can grow strong business collaboration.

Our business segments

(charts show business segment revenue as a percentage of total revenue)



Market opportunities over the next 20 years

The Group's forecast predicts faster growth rates for long-haul markets and those markets to, from and within Asia. Factors affecting demand include GDP growth, aircraft productivity, operating costs, environmental issues and the number of aircraft retirements. We forecast a demand for civil aero engines of US\$800 billion over the next 20 years and for services of US\$600 billion over the same period.

US\$800bn

Civil engine market

US\$600bn

Civil services market

With traditional defence markets under budget pressures there may be delays in new programmes but these will be offset by longer term services on current programmes where we are well placed. Demand for military engines over the next 20 years is estimated at US\$155 billion and for services and support equipment we estimate a market of US\$260 billion over the same period.

US\$155bn

Defence engine market

US\$260bn

Defence services market

The Group forecasts a demand for marine power and propulsion systems valued at US\$215 billion over the next 20 years. Marine aftermarket services are expected to generate significant opportunities with demand forecast at US\$125 billion over the same period.

US\$215bn

Marine equipment market

US\$125bn

Marine services market

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

US\$120bn

Energy engine and services market

Based on the International Energy Agency forecasts, the Group has conservatively estimated that demand for mission-critical equipment, systems and engineering services for the nuclear island could reach US\$390 billion over the next 20 years while demand for associated reactor support services could amount to US\$250 billion over the same period.

US\$640bn

Civil nuclear equipment and services market

Key performance indicators

The Board uses a range of financial and non-financial indicators to monitor Group and segmental performance in line with the strategy

+4%
▲

UNDERLYING REVENUE

Monitoring of revenues provides a measure of business growth. Underlying revenue is used in order to eliminate the effect of the decision not to adopt hedge accounting and to provide a clearer year-on-year measure. The Group measures foreign currency sales

at the actual exchange rate achieved as a result of settling foreign exchange contracts from forward cover

+19%
▲

UNDERLYING PROFIT BEFORE FINANCING

Underlying profit before financing is presented on a basis that shows the economic substance of the Group's hedging strategies in respect of the transactional exchange rate and commodity price movements. In particular (a) revenues and costs denominated in US dollars and euros are presented on the basis of the exchange rates achieved during

the year (b) similar adjustments are made in respect of commodity derivatives, and (c) consequential adjustments are made to reflect the impact of exchange rates on trading assets and liabilities and long-term contracts on a consistent basis. The derivation of underlying profit before financing is shown in note 2 on page 84 of the consolidated financial statements

-608%
▼

CASH FLOW

The figure for 2011 includes investment of £1496 million in Tognum

In a business requiring significant investment, the Board monitors cash flow to ensure that profitability is converted into cash generation both for future investment and as a reward for shareholders. The Group measures cash flow as the

movement in net funds/debt during the year after taking into account the value of derivatives held to hedge the value of balances denominated in foreign currencies. The figure in 2007 includes a £500 million special contribution to the Group's UK pension schemes as part of the restructuring of these pension schemes

+0.5%
▲

RETURN ON CAPITAL EMPLOYED

Return on capital employed is calculated as the after-tax underlying profit divided by the average net assets during the year adjusted for net cash, net post-retirement deficit and goodwill

previously written off. It represents a measure of the return the Group is making on its investments.

Underlying revenue
Underlying profit before financing
Cash flow
Return on capital employed
Net research and development charge
Gross research and development expenditure
Net research and development expenditure as a proportion of underlying revenue
Capital expenditure

Order book
Training and development
Underlying revenue per employee
Engine deliveries
Installed thrust – civil aerospace
Percentage of civil fleet under management
Underlying services revenue
Emissions

+10%

▲

NET RESEARCH AND DEVELOPMENT CHARGE

Investment in research and development underpins all the elements of the Group's strategy. Programme expenditure is monitored in conjunction with

a gated review process on each programme and progress is reviewed at key milestones

-2%

▼

GROSS RESEARCH AND DEVELOPMENT EXPENDITURE

The Group's research and development activities comprise both self-funded and customer funded programmes. Gross expenditure measures total research and development activity

and is an indicator of the actions taken to enhance the Group's intellectual property

-2%

▼

NET RESEARCH AND DEVELOPMENT EXPENDITURE AS A PROPORTION OF UNDERLYING REVENUE

R&D is measured as the self-funded expenditure both before amounts capitalised in the year and amortisation of previously capitalised balances. The Group expects to spend approximately five per cent of revenues on research and development although this proportion will fluctuate depending

on the stage of development of current programmes. This measure reflects the need to generate current returns as well as to invest for the future

+29%

▲

CAPITAL EXPENDITURE

To deliver on its commitments to customers, the Group invests significant amounts in its infrastructure. All proposed investments are subject to rigorous review to ensure that they are consistent with forecast activity and will provide value for money

Annual capital expenditure is measured as the cost of property, plant and equipment acquired during the period

+5%



ORDER BOOK

The order book provides an indicator of future business. It is measured at constant exchange rates and list prices and includes both firm and announced orders. In civil aerospace, it is common for a customer to take options for future orders in addition to firm orders placed. Such options are excluded from the order book. In defence aerospace, long term programmes

are often ordered for only one year at a time. In such circumstances, even though there may be no alternative engine choice available to the customer, only the contracted business is included in the order book. Only the first seven years' revenue of long term aftermarket contracts is included

+15%



TRAINING AND DEVELOPMENT

Training and development is a core element of the Group's investment in its capability and is measured as the expenditure on the training and development of employees, customers and suppliers

Effectiveness is monitored by using a range of external and internal sources and by gathering user feedback.

+6%



UNDERLYING REVENUE PER EMPLOYEE

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

+12%



ENGINE DELIVERIES

The Group's installed engine base represents an opportunity to generate future aftermarket business. This is measured as the number of Group products delivered during the year within

each business except for manne as its products do not lend themselves to this measure due to their diversity

+5%


INSTALLED THRUST – CIVIL AEROSPACE

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

-3%


PERCENTAGE OF CIVIL FLEET UNDER MANAGEMENT

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

+9%


UNDERLYING SERVICES REVENUE

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

EMISSIONS

Around two thirds of our research and development expenditure is focused on reducing emissions of the Group's products. The Group measures both the emissions of its products and the emissions of its manufacturing operations. These measures are described in detail in

the environment report 'Powering a better world' which is available on the Group's website at www.rolls-royce.com

Finance Director's review

A strong performance

Demand for our products and services remains robust

Mark Morris
Finance Director

Summary

Summary data – £ million	2011	2010	Change
Order book	62,201	59,153	+5%
Underlying revenue*	11,277	10,866	+4%
Underlying profit before tax*	1,157	955	+21%
Underlying earnings per ordinary share*	48.54p	38.73p	+25%
Full year payment to shareholders	17.5p	16.0p	+9%
Reported revenue	11,124	11,085	0%
Reported profit before financing	1,189	1,134	+5%
Net funds	223	1,533	
Average net funds	320	960	

* See explanation in note 2 on page 84

The difficulties faced by the global economy, by the Eurozone and by those governments with budgetary imbalances are well publicised. However, demand for our products and services remains robust, particularly in developing markets. This demand results from the breadth and diversity of our businesses, customers and programmes, the competitive strength of our products and the relative youth of our installed base.

The visibility of significant growth in the next decade provided by the record order book underpins our continued investment in technology, operations and services. These investments safeguard our competitive advantage, support delivery on our commitments to customers and improve our operational effectiveness. The Group's 2011 performance was achieved after absorbing a ten per cent increase in net R&D expense to £463 million and a 29 per cent increase in capital expenditure to £467 million.

The Group's joint venture with Daimler now owns over 99 per cent of Tognum for which Rolls-Royce paid cash consideration of £1.5 billion in 2011. This joint venture investment made a £30 million net contribution (after costs and financing) to underlying profit before tax but did not impact the Group's 2011 revenues. On January 2, 2012, the Group contributed its Bergen Diesels business to the joint venture, resulting in a cash benefit to the Group of €200 million.

The Group's proposed sale of its 32.5 per cent shareholding in IAE is subject to regulatory approval and did not impact 2011 financial performance. Rolls-Royce will continue to play an active role as a first tier supplier to IAE of high-pressure compressors and fan blades and remains responsible for the final assembly of 50 per cent of the production engines. The announced new joint venture with Pratt & Whitney to develop an engine to power the next generation of mid-size aircraft is also subject to regulatory approval and had no effect on 2011 financial performance.

Underlying figures are considered more representative of the trading performance by excluding the impact of year end mark-to-market adjustments of outstanding financial instruments on the reported performance, principally relating to the GBP/USD hedge book. In addition the net post-retirement financing is excluded and, in 2011, adjustments have been made to exclude one-off past-service credits on post-retirement schemes and the effect of acquisition accounting. The adjustments between the underlying income statement and the reported income statement are set out in more detail in note 2 of the financial statements. This basis of presentation has been applied consistently since the transition to IFRS in 2005.

Underlying income statement

Underlying income statement extracts – £ million	2011	2010	Change
Revenue	11,277	10,866	+4%
civil aerospace	5,572	4,919	+13%
defence aerospace	2,235	2,123	+5%
marine	2,271	2,591	-12%
energy	1,199	1,233	-3%
Profit before financing costs and taxation	1,206	1,010	+19%
civil aerospace	499	392	+27%
defence aerospace	376	309	+22%
marine	323	332	-3%
energy	24	27	-11%
engine holding (Tognum JV)	36	-	-
central costs	(52)	(50)	-4%
Net financing costs	(49)	(55)	+11%
Profit before taxation	1,157	955	+21%
Taxation	(261)	(236)	+11%
Profit for the year	896	719	+25%
EPS	48.54p	38.73p	+25%
Payment to shareholders	17.5p	16.0p	+9%
Other items	-	-	-
Other operating income	70	87	-20%
Gross R&D investment	908	923	-2%
Net R&D charged to the income statement	463	422	+10%

Underlying revenue increased four per cent to £11.3 billion. This includes a nine per cent growth in services revenue to £6.0 billion that more than offset a one per cent reduction in original equipment (OE) revenue to £5.3 billion. OE performance included a strong 18 per cent growth in civil aerospace offset by a greater than anticipated reduction of 23 per cent in marine OE revenue. Underlying services revenue continues to represent more than half (53 per cent) of the Group's underlying revenues. In 2011, growth in underlying services revenue was due to a number of factors: the installed base of products grew and the services network expanded; defence aerospace benefited from one-off contract termination settlements resulting from the Strategic Defence and Security Review (SDSR) of the UK Ministry of Defence (MoD), and marine services saw further growth of nine per cent.

Underlying profit before financing costs and taxation increased 21 per cent to £1.16 billion. This was due to a number of factors, a better mix between OE and services, a significant improvement in productivity resulting from the focus on cost, net foreign exchange (FX) benefits of £54 million including an eight per cent improvement in the achieved rate

on selling USD income, £30 million from Tognum net of the costs of the acquisition and a number of one-off items, the most significant which relates to a £60 million benefit from the SDRS settlements referred to earlier.

Further discussion of trading is included in the business segment reports on page 18 to 25.

Underlying financing costs reduced 11 per cent to £49 million, including a small reduction in financial Risk & Revenue Sharing Partnerships (RRSPs) costs and lower funding costs due to the settlement of the Group's €750 million Eurobond during the year.

Underlying taxation was £261 million, an underlying tax rate of 22.6 per cent compared with 24.7 per cent in 2010. This reduction reflects increased profits from joint ventures (which are accounted for on a post-tax basis) and some adjustments to prior year estimates.

Underlying EPS increased 25 per cent to 48.54 pence, in line with the increase in the underlying profit after tax.

Payments to shareholders At the AGM on May 4, 2012, the directors will recommend an issue of 106 C Shares with a total nominal value of 10.6 pence for each ordinary share. The final issue of C Shares will be made on July 2, 2012 to shareholders on the register on April 27, 2012 and the final day of trading with entitlement to C Shares is April 24, 2012. Together with the interim issue on January 3, 2012 of 69 C Shares for each ordinary share with a total nominal value of 6.9 pence, this is the equivalent of a total annual payment to ordinary shareholders of 17.5 pence for each ordinary share.

The payment to shareholders will, as before, be made in the form of redeemable C Shares which shareholders may either choose to retain or redeem for a cash equivalent. The Registrar, on behalf of the Company, operates a C Share Reinvestment Plan (CRIP) and can, on behalf of shareholders, purchase ordinary shares from the market rather than delivering a cash payment. Shareholders wishing to redeem their C Shares or else redeem and participate in the CRIP must ensure that their instructions are lodged with the Registrar, Computershare Investor Services PLC, no later than 5pm on Friday June 1, 2012.

Other operating income relates to programme receipts from RRSPs, which reimburse past R&D costs. These receipts decreased by 20 per cent in 2011 due to the phasing of major programmes such as the Trent XWB.

Net R&D charged to the income statement increased by ten per cent to £463 million. The Group recruited an additional 1,000 engineers to develop the products of the future and to help improve the in-service performance of the existing installed base of products. This investment and the 29 per cent increase in capital expenditure to £467 million will prepare our infrastructure and global supply chain for significant growth in the next decade. The Group continues to expect net R&D investment to remain within four to five per cent of Group underlying revenue.

Balance sheet

Summary balance sheet – £ million	2011	2010
Intangible assets	2,882	2,884
Property, plant and equipment	2,338	2,136
Net post-retirement scheme deficits	(397)	(856)
Net working capital	(1,098)	(973)
Net funds	223	1,533
Provisions	(502)	(544)
Net financial assets and liabilities	(718)	(627)
Share of results of joint ventures and associates	1,680	393
Assets held for sale	178	9
Other net assets and liabilities	(67)	24
Net assets	4,519	3,979
Other items		
USD hedge book (US\$ million)	22,000	20,900
Net TotalCare assets	956	920
Gross customer finance contingent liabilities	612	633
Net customer finance contingent liabilities	124	121

Intangible assets relate to goodwill, certification costs, participation fees, development expenditure, recoverable engine costs, software and other costs that represent long-term assets of the Group. In aggregate, these assets remained broadly unchanged at £2.9 billion; this was largely due to increased development, certification and software costs being offset by the reclassification of V2500 assets on the balance sheet as assets held for sale. The carrying values of the intangible assets are assessed for impairment against the present value of forecast cash flows generated by the intangible asset. The principal risks remain: reductions in assumed market share, programme timings, increases in unit cost assumptions, and adverse movements in discount rates. There have been no impairments in 2011. Further details are given in Note 8 of the financial statements.

Property, plant and equipment increased by nine per cent to £2.3 billion due to the ongoing development and refreshment of facilities and tooling as the Group prepares for increased production volumes.

Net post-retirement scheme deficits decreased 54 per cent to £397 million, including (i) the impact of the change in pensions' indexing to CPI in the UK (£130 million), (ii) revised healthcare benefits in certain overseas schemes (£74 million), and (iii) the reduction in discount rates having a larger impact on the value of the assets than the obligations (calculated on an IAS 19 basis).

Overall funding across the schemes has improved in recent years as the Group has adopted a lower risk investment strategy that reduces volatility going forward and enables the funding position to remain stable. Interest rate and inflation risks are largely hedged, exposure to equities has reduced to around 20 per cent of scheme assets, this has been achieved against the headwind of increasing life expectancy assumptions.

In 2011, the Group made further arrangements to reduce volatility and enable future funding to be predicted with more certainty. A longevity swap was transacted with a third party to eliminate the risk of increasing life expectancy of pensioners in the largest UK defined benefit scheme. No significant change is expected to the ongoing funding levels of the UK pension schemes in 2012.

Net funds decreased by 85 per cent to £223 million largely due to the £1.5 billion consideration paid during the year for the Group's shared investment in Tognum. As a result, average net funds fell by £640 million to £320 million (£805 million excluding acquisitions).

Investment – joint ventures and associates increased in the year as a result of the investment in Tognum.

Assets held for sale represent the assets and liabilities expected to be derecognised or as a result of the anticipated restructuring of IAE.

Provisions largely relate to warranties and guarantees provided to secure the sale of OE and services. These provisions reduced modestly during the year.

Net financial assets and liabilities relate to financial RRSPs and the fair value of foreign exchange, commodity and interest rate contracts, set out in detail in note 17 to the financial statements. The change largely reflects the impact of the change in the GBP/USD exchange rate on the valuation of foreign exchange contracts.

The **USD hedge book** increased five per cent to US\$22.0 billion. This represents around four and a half years of net exposure and has an average book rate of £1 to US\$1.60. Current forward market exchange rates are similar to current average book rates.

Net TotalCare* assets relate to long-term service agreement (LTSA) contracts in the civil aerospace business, including the flagship services product TotalCare. These assets represent the timing difference between the recognition of income and costs in the income statement and cash receipts and payments.

Customer financing facilitates the sale of OE and services by providing financing support to certain customers. Where such support is provided by the Group, it is generally to customers of the civil aerospace business and takes the form of various types of credit and asset value guarantees. These exposures produce contingent liabilities that are outlined in note 23 to the financial statements. The contingent liabilities represent the maximum aggregate discounted gross and net exposure in respect of delivered aircraft, regardless of the point in time at which such exposures may arise.

During 2011, the Group's exposure remained stable with gross and net exposures of £612 million and £124 million respectively. As has been well-publicised, some banks that have been active in recent years in providing funds for aircraft financing have chosen during 2011 to substantially reduce their exposure in this market segment. Although this may have some effect on the terms and pricing of new aircraft finance transactions in the near future, the Group expects that other providers of USD funding and ongoing support from the export credit agencies will largely fill the gap left by these banks.

Group 2012 guidance

Excluding the impact of the Tognum acquisition and the proposed IAE transaction, in 2012 the Group expects to see good growth in underlying revenue and underlying profit with a cash flow around breakeven as we continue to invest for future growth

In civil aerospace, we anticipate good growth in underlying revenue and strong growth in underlying profit. In defence aerospace, we expect modest growth in underlying revenue and profit. In marine, we expect a modest increase in underlying revenue, with underlying profit broadly flat. And in energy, we see growth in revenue and some improvement in profit.

Other relevant data

Foreign exchange. neutral

Taxation. the underlying tax rate is expected to be around 24 per cent

R&D: a modest increase in expenditure combined with lower net capitalisation and higher amortisation due to the phasing of new programmes

Capital expenditure a modest increase, including increased investment in IT

Pensions: no material changes expected to funding levels

Intangible assets modest increase compared with 2011 due to a modest increase in recoverable engine costs partially offset by a decrease in development costs due to the phasing of new programmes

Property, plant and equipment: modest increase compared with 2011 as we continue to invest in capability and infrastructure

Tognum

Tognum is expected to contribute in the first half to the Group's share of results of joint ventures and associates. Tognum's results are expected to be fully consolidated around the half year with Daimler's 50 per cent share of the result recorded as a non-controlling interest. For 2012, Tognum will be reported separately. As Tognum remains a listed company and will issue its preliminary results on March 8, 2012, the Group is not providing guidance at this time.

IAE

The sale of the Group's 32.5 per cent shareholding in IAE is expected to receive regulatory approval during 2012, at which time the initial cash consideration of US\$1.5 billion will be received. For the first full year following settlement, the impact of the sale on subsequent trading will have a small negative effect on underlying revenue and a positive effect of around £140 million on underlying profit. The impact on the order book will be a reduction of around £4 billion.

Additional financial information can be found on pages 36 and 37

Civil aerospace

Strong programme positions supported further robust order flow in 2011. A 47 per cent increase in the order intake to £11.0 billion contributed to a record order book of £52 billion, up seven per cent on 2010. The order book contains over 5,000 engines that will add, over time, around 250 million pounds of installed thrust, or 65 per cent, to our current installed base of 400 million pounds of thrust.

Mark King
President –
Civil Aerospace

2011 saw a strong performance as revenue increased by 13 per cent. Original equipment (OE) revenue grew 18 per cent, largely as a result of significantly higher deliveries of widebody and corporate and regional engines. Services revenue grew by ten per cent, reflecting the growth in TotalCare revenue during the year, some recovery in time and materials revenue and some benefit from a better achieved USD exchange rate in the period.

£5,572m

Underlying revenue 2011

Highlights

- ▶ Trent 1000 enters service on Boeing 787
- ▶ Trent XWB exclusive contract on longer range Airbus A350 XWB
- ▶ 1,000th Trent 700 delivered for Airbus A330
- ▶ New joint venture announced to address engines for future mid-size aircraft
- ▶ BR725 certification programme for the Gulfstream G650 on course

£499m

Underlying profit 2011

Key financial data

	2007	2008	2009	2010	2011
Order book £bn	35.9	43.5	47.0	48.5	51.9
	+80%	+21%	+8%	+3%	+7%
Engine deliveries	851	987	844	846	962
Underlying revenue £m	4,038	4,502	4,481	4,919	5,572
	+3%	+11%	0%	+10%	+13%
Underlying OE revenue £m	1,484	1,776	1,855	1,892	2,232
Underlying service revenue £m	2,554	2,726	2,626	3,027	3,340
Underlying profit before financing £m	564	566	493	392	499
	+9%	0%	-13%	-20%	+27%

The civil aerospace business is a major manufacturer of aero engines for all sectors of the airliner and corporate jet market. Rolls-Royce powers more than 30 types of commercial aircraft and over 13,000 engines are in service with customers around the world.

In 2011, the airline industry continued a slow but steady recovery despite continued economic uncertainty. Passenger traffic continued to show above average growth but the cargo market slackened. Whilst the small and mid-size business jet market remained flat, Rolls-Royce continued to benefit from the resilience of the market for large-cabin business aircraft.

Widebody

2011 was an important year for the Trent family of engines. In September 2011, Rolls-Royce was proud to power the entry into service of the Boeing 787 Dreamliner with launch customer ANA. During the year two new customers placed orders for Trent 1000s to power their Dreamliners.

Development of the Trent XWB continued apace, with the test programme yielding exceptional results in terms of fuel efficiency and reliability. The Trent XWB for the Airbus A350 XWB, is the fastest ever selling member of the Trent family of engines. Over 1,100 Trent XWBs have been ordered so far, more than the total number of Trent 700s currently in service. Market successes in 2011 included significant orders from Thai Airways International and Air France. Entry into service is now expected in the first half of 2014. In June 2011, Rolls-Royce announced an exclusive engine provider agreement with Airbus for Rolls-Royce to produce a higher-thrust version of the Trent XWB, enabling Airbus to offer increased range and capacity for the A350-1000.

In October 2011, the 1,000th Trent 700 engine was delivered for the A330 programme. During the year, further orders were received for approximately 150 Trent 700 engines from customers around the world including major orders from Cathay Pacific, Saudi Arabian Airlines and Singapore Airlines. There are three engine options for the A330 and the Trent 700 won 75 per cent of the orders contested in 2011.

The Trent 900 continues to be the leading engine for the Airbus A380 in terms of through-life fuel burn and emissions. The Trent 900 has been selected by 11 of the 16 airlines that have so far made an engine choice. China Southern is the latest customer to place Rolls-Royce powered A380s into service. New order announcements in 2011 came from Asiana of Korea and Skymark of Japan.

In November 2011, American Airlines entered Chapter 11 bankruptcy protection. The Group has equipment in service and a joint venture repair and overhaul business with the airline and remains in close contact with the customer as the airline manages this process. There was no significant impact on the financial results.

Narrowbody

A new joint venture with Pratt & Whitney was announced in October 2011 to develop engines for future generation mid-size aircraft. This move enhances the strong position of Rolls-Royce in the mid-size airliner market.

Rolls-Royce is also to sell its shareholding in IAE, manufacturer of the V2500 engine, to Pratt & Whitney. The relevant agreements remain subject to various closing conditions including regulatory approvals. Rolls-Royce will remain a key supplier, responsible for the engineering support and manufacture of high-pressure compressors and the final assembly of 50 per cent of the V2500 engine. Orders for over 150 V2500-powered aircraft were taken in 2011.

Corporate and regional

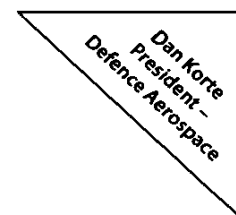
In March 2011, Rolls-Royce delivered the 2,000th BR710 engine from the Dahlewitz plant in Germany where the engine was developed. The BR710 powers a number of Bombardier and Gulfstream business jets. The certification programme for the Gulfstream G650 powered by Rolls-Royce BR725 engines remains on course despite the tragic accident suffered by one of the test aircraft in April 2011. Service entry is expected in mid-2012. The development programme for the AE 3007C engine for the Cessna Citation TEN is on plan and the first flight took place in December 2011. Entry into service is planned by the end of 2013.

Services

Revenue and engine flying hours from TotalCare improved during 2011, driven by the growth of aircraft in service and increased utilisation of existing fleets.

Defence aerospace

A broad and diverse base of customers and products underpinned a resilient performance in 2011. Demand for our products and services, particularly in the military transport sector, held up well. Revenue increased five per cent as a result of an eight per cent increase in OE revenue and a three per cent increase in services revenue.



A seven per cent decline in the order book reflects the cautious budgetary environment in many nations. However, new orders of £1.8 billion provides continued confidence that opportunities remain, both in traditional and in developing markets.

Profit grew 22 per cent as a result of increased revenue, cost reduction and the £60 million benefit of termination settlements as a result of the UK MoD's SDSR.

Highlights

- ▶ TP400 engine for A400M transporter is certified
- ▶ F-35B LiftSystem™ achieves programme and test milestones
- ▶ US Navy renews Adour F405 support contract
- ▶ 750th EJ200 engine delivered for the Eurofighter programme

Key financial data

	2007	2008	2009	2010	2011
Order book £bn	4.4	5.5	6.5	6.5	6.0
	+38%	+25%	+18%	0%	-7%
Engine deliveries	495	517	662	710	814
Underlying revenue £m	1,673	1,686	2,010	2,123	2,235
	+4%	+1%	+19%	+6%	+5%
Underlying OE revenue £m	796	739	964	1,020	1,102
Underlying service revenue £m	877	947	1,046	1,103	1,133
Underlying profit before financing £m	199	223	253	309	376
	+3%	+12%	+13%	+22%	+22%

£2,235m

Underlying revenue 2011

£376m

Underlying profit 2011

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

Transport

We are a world leader in the military transport market with over 6,700 engines in service.

The global fleet of AE 2100 engines, which powers both the Lockheed Martin C-130J and the Alenia C-27J transport aircraft, continues to expand. The Emirate of Qatar and the Indian Air Force both received their first C-130Js in 2011. The global AE 2100 fleet also passed the three million flight hour milestone during the year.

The TP400 engine for the Airbus A400M military transport aircraft received civil certification from EASA in May 2011 and has amassed over 8,000 flying hours as part of the flight-test programme. Delivery of the engines for the first production aircraft are due to begin in early 2012, part of the initial order of 180 aircraft.

Important milestones were achieved in the T56 upgrade programme for legacy variants of the C-130 and P-3 Orion aircraft. This engine variant provides significant fuel and operating cost savings.

Combat

In the combat sector the Rolls-Royce LiftSystem® for the short take-off and vertical landing (STOVL) variant of Lockheed Martin's F-35 Lightning II Joint Strike Fighter achieved its 'Initial Service Release'.

In October 2011, two F-35B aircraft accomplished 72 STOVLs on the *USS Wasp* during a successful three-week testing period of sea trials. In the same month, the first LiftFan™ to be assembled at our new dedicated state-of-the-art factory in Indianapolis, USA, rolled off the production line. In January 2012, probationary status was lifted for the F-35B and the first STOVL aircraft were delivered to the customer.

Funding for the development programme of the F136 engine, in which Rolls-Royce is a 40 per cent partner, for the F-35 Joint Strike Fighter was terminated by the US Department of Defense in February 2011, despite strong continuing Congressional support.

During 2011, we delivered the 750th EJ200 engine on behalf of Eurojet for the Eurofighter programme.

The Eurofighter Typhoon was deployed on combat operations for the first time as part of the NATO operation in Libya, displaying outstanding levels of performance and reliability. The Typhoon is a contender for the KF-X programme in South Korea.

We continue to make good progress on the US Air Force Adaptive Versatile Engine Technology (ADVENT) demonstrator programme. It is designed to significantly reduce fuel consumption, enabling extended mission ranges and loiter times for future generations of military aircraft.

Unmanned vehicles

In the unmanned air systems sector we successfully completed a US Air Force funded flight-test programme for the growth variant of the AE 3007H engine for Global Hawk.

Small engines

GippsAero of Australia selected the M250 turboprop engine to power its new ten seat passenger aircraft, the GA10.

In the helicopter market, the Apache fleet of the UK Army Air Corps, powered by the RTM322 engine, reached 200,000 flying hours.

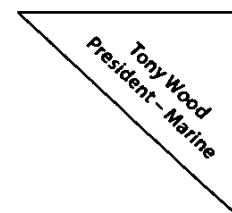
Services

The success of our services business continued in 2011, with MissionCare™ contracts secured to provide availability-based engine support for the C-130 fleets of the UK and US air forces. The US Navy again renewed its US\$100 million support agreement for Adour F405 engines in the T-45 Goshawk trainer.

Rolls-Royce also earned praise for its support of the frontline operations of the UK armed forces air campaign over Libya which involved eight different types of Rolls-Royce powered aircraft.

Marine

Despite the uncertain market and macro-economic conditions, a resilient performance was achieved in 2011, as demand for our products and services gradually returns. New order intake during the year was strong, up 15 per cent to £2.1 billion, although the order book decreased largely due to the slower than expected conversion of OE bid activity to new orders.



Revenue decreased 12 per cent, impacted mainly by slow second half OE revenue that resulted in OE revenue for the full year down 23 per cent. This slower than expected recovery of OE revenue was partially offset by a nine per cent increase in underlying service revenue. Our expanding network of service centres continues to take advantage of the growth in recent years of the global fleet of vessels equipped with our products, engines and propulsion systems.

£2,271m

Underlying revenue 2011

Profit declined by three per cent relative to a fall in revenue of 12 per cent, reflecting an improved revenue mix and an increased focus on costs and operational performance.

£323m

Underlying profit 2011

Highlights

- Significant increase in new orders and continued growth in offshore oil and gas sector
- First contract secured for award-winning NVC 405 Enviroship liquid natural gas-powered cargo vessels
- Service centres in Europe, Africa and Asia opened or expanded
- Customer training and simulator centres opened in Norway and Singapore
- Tognum acquisition largely completed

Key financial data

	2007	2008	2009	2010	2011
Order book £bn	4.7	5.2	3.5	3.0	2.7
	+96%	+11%	-33%	-16%	-8%
Underlying revenue £m	1,548	2,204	2,589	2,591	2,271
	+19%	+42%	+17%	+0%	-12%
Underlying OE revenue £m	1,003	1,492	1,804	1,719	1,322
Underlying service revenue £m	545	712	785	872	949
Underlying profit before financing £m	113	183	263	332	323
	+12%	+62%	+44%	+26%	-3%

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

Offshore

Marine performed strongly in the offshore oil and gas sector. This was largely based on the proven success of our specialist UT vessel design capabilities and our proficiency at integrating sophisticated systems into complex ships.

As the industry continues to explore ever deeper waters, like those in the South Atlantic off the coast of Brazil, we will continue to be a strong partner for our customers for offshore oil and gas exploration, production, service and support.

Merchant

We continue to invest in technology that addresses the need for more efficient and environmentally sustainable power and propulsion systems.

Our successful design and systems integration approach was validated in 2011 through an order by NorLines for two award-winning NVC 405 Environship short sea cargo vessels. These vessels incorporate a wave-piercing hull, a liquid natural gas engine and an integrated rudder and propeller system, which, in combination, reduces fuel consumption and cuts CO₂ emissions by up to 40 per cent compared to conventional vessels.

Naval

Power and propulsion equipment was delivered for the UK's Queen Elizabeth class aircraft carriers. In early 2011, we received an order from Lockheed Martin for the provision of MT30s, the world's most powerful marine gas turbine, to power a further ten US Navy Littoral Combat Ships. The MT30's success on this programme is generating interest from navies in Europe, Asia and South America.

We have established a naval ship design team, specifically to address the growing opportunity in the patrol craft and support ship market. The business now has ship design teams for each of the offshore, merchant and naval sectors.

The submarines business celebrated the UK Government's decision in May 2011, to replace the UK's Vanguard class nuclear submarine with a new design of submarine utilising the Group's Pressurised Water Reactor (PWR) Generation 3 reactor technology.

Services

We expanded our service capacity to better realise the significant opportunity that our large installed base of equipment represents. Five facilities in Namibia, the Netherlands, Poland, Germany and Hong Kong were either constructed or expanded during the year. We also continued developing our service related capabilities by enhancing our spare parts delivery network and opening customer training facilities in Norway and Singapore.

Tognum

Through our joint venture with Daimler, we largely completed the acquisition of Tognum, which owns world-class high-speed reciprocating engine manufacturer MTU Friedrichshafen and subsequently, in January 2012, contributed our Bergen medium-speed engines business into the new entity. The benefits of these complementary technologies create greater design and power and propulsion systems integration opportunities across marine, particularly for our naval and merchant businesses.

Access to a large installed base of equipment, and a mature customer support network, creates further growth opportunities.

Energy

Significant demand for our products and services in offshore oil and gas applications drove a 57 per cent increase in the order intake to £1.5 billion, as the order book increased 28 per cent

Andrew Heath
President – Energy

Revenue declined by three per cent, largely due to the phasing of OE delivery in the power generation business. Demand for aftermarket products and services continued to grow strongly, with an increase of ten per cent over 2010.

Profit fell by 11 per cent to £24 million as a result of a change in revenue mix and the additional charges incurred to develop the civil nuclear business and our options in tidal and fuel cells. This was despite the benefit of the non-recurring industrial Trent retrofit charges incurred in 2010.

Highlights

- ▶ 50 RB211 gas turbine packages ordered for oil and gas applications
- ▶ 50 Bergen diesel engines ordered for land-based power applications
- ▶ Service revenue up ten per cent, with 701 engines under long-term agreements
- ▶ Achieved the prestigious ASME-N accreditation for UK nuclear manufacturing facilities
- ▶ Completed acquisition of leading US Remote inspection services business, R. Brooks Associates
- ▶ Signed a 14-year contract with EDF to supply I&C technologies for the world's largest reactor modernisation project

£1,199m

Underlying revenue 2011

£24m

Underlying profit 2011

Key financial data

	2007	2008	2009	2010	2011
Order book £bn	0.9	1.3	1.3	1.2	1.5
	+80%	+44%	0%	-8%	+28%
Engine deliveries	78	106	87	95	75
Underlying revenue £m	558	755	1,028	1,233	1,199
	+2%	+35%	+36%	+20%	-3%
Underlying OE revenue £m	269	385	558	691	602
Underlying service revenue £m	289	370	470	542	597
Underlying profit before financing £m	5	(2)	24	27	24
	+128%	-140%	+1300%	+13%	-11%

Our energy business supplies customers with gas turbines, compressors, reciprocating engines, and related services to support the efficient production of oil and gas, and power generation around the world. We are establishing a strong position in the civil nuclear sector for the provision of mission-critical equipment, systems and engineering services.

The balanced nature of our portfolio has enabled us to deliver solid revenues of £1.2 billion, broadly in line with 2010. While the power generation sector in mature economies remains suppressed, due to excess generating capacity and low industrial demand, we continue to see growth in developing countries. The demand for oil and gas remains high, driven by a resilient oil price and global demand growth. In the second half of the year we secured significant oil and gas orders, increasing market share in the key Brazilian offshore market.

Oil and gas

In total, 50 RB211 packages were ordered during the year for oil and gas applications, 38 of which were for offshore.

The high price of oil continues to drive capital investment in the sector, particularly in deepwater exploration and production environments where the Group has technologies and expertise that are applicable. The business was awarded a new contract, valued at up to US\$650 million to supply 32 RB211 gas turbine power generation packages and related services to Petrobras to support its long-term production activities offshore Brazil. This order increases the number of Rolls-Royce RB211-powered industrial gas turbine units installed in Brazil over the past ten years to 62.

In February 2011, we announced plans for the construction of a new purpose-built packaging, assembly and test facility in Rio de Janeiro, Brazil. The facility, expected to become operational in the first quarter of 2013, will strengthen our support of Petrobras' exploration and production activities in the rapid growth pre-salt deepwater oil fields offshore Brazil.

In addition, we expanded our role in China's gas pipeline industry with contracts to supply PetroChina, the largest oil and gas producer in China, with six RB211 gas turbine compressor packages for Line 2 of the West-East China Pipeline Project.

Power generation

The power generation sector remains suppressed in the developed world, the traditional market for the Trent gas turbine, which resulted in three new Trent unit orders.

Demand for Bergen reciprocating engines remains strong, reflected by an order intake of 50 units, of which 30 are for Bangladesh to help address the country's power shortfalls, bringing total Bergen engines orders in Bangladesh to 82.

Services

Demand for aftermarket products and services again grew strongly, delivering revenue of £597 million, an increase of ten per cent over 2010. Including the land-based reciprocating engines, there are now a total of 701 units, or 35 per cent of the engine fleet, under long-term service agreements. In 2012, we will launch the RB211 Gzero, an aftermarket upgrade product for the RB211-G gas generator that increases power by a nominal ten per cent.

Tognum

As with the marine business, our energy business will benefit from the acquisition of Tognum through our joint venture with Daimler. By combining our medium-speed diesel and gas Bergen engines business with Tognum's high-speed reciprocating engines, we will create a world leading reciprocating engines offering in the energy industry, significantly enhancing our core product and systems portfolio and global network of sales and service facilities. This will benefit customers across high-growth applications, including offshore and shale gas fracturing, as well as primary, standby and rental land-based power generation. In January 2012, the ownership of Bergen Engines transferred from Rolls-Royce to Engine Holding GmbH, the 50/50 joint venture company formed with Daimler.

Civil nuclear

Rolls-Royce made significant progress in developing its nuclear business in 2011, securing the prestigious ASME-N stamp accreditation at our UK nuclear manufacturing facilities. Plans for a new UK civil manufacturing facility progressed throughout 2011 and the business received outline planning permission for a potential site in South Yorkshire.

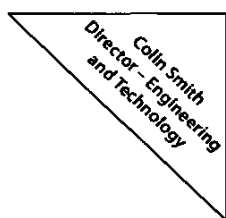
Strategic relationships with reactor vendors and utility operators were further strengthened. An important cooperation agreement was signed with Areva in March 2011, to cover the manufacture of complex components for the first European Pressurised Water Reactors (PWR) to be built in the UK.

Enhanced MoUs were also signed with Nuclear Power Delivery UK and EDF, the world's largest utility operator. Additionally, the business entered into a landmark agreement with Rosatom, the Russian state-owned nuclear company, for the development of global civil nuclear programmes.

As a key step in growing its reactor services business, Rolls-Royce completed the acquisition of US-based R. Brooks Associates, a world leader in remote visual inspection.

We signed a €250 million contract with EDF to supply instrumentation and control (I&C) technologies to the world's largest reactor upgrade programme, being carried out in France. We also opened a dedicated I&C service centre to enhance our operations for customers in China.

Excellence in technology



Our research and development investment represents both a commitment to continuous improvement of our existing portfolio and a long-term investment in future technology

In 2011, Rolls-Royce invested £908 million in gross research and development, of which £520 million was funded from Group resources. Globally, 475 new patent applications were approved for filing – a record number for the Group.

Research and technology

The Group's 12,400 engineers are an increasingly integrated global resource, whose activities include research and technology, product development and in-service support.

Our successful model of collaboration, through a network of 28 University Technology Centres and seven advanced manufacturing research centres, provides access to world-class research.

With the opening of three advanced manufacturing research centres in the UK during 2011, a total of five are now operational. The next two are due to be opened in the US in 2012 and Singapore in 2013. These centres bring companies, industrial sectors and universities around the world together, in a common endeavour to develop step-change improvements across a portfolio of manufacturing technologies.

In addition, the Advanced Simulation Research Centre was opened in Bristol, UK, in March 2011 and is now enabling Rolls-Royce and member organisations to access the latest simulation technologies for product development, reducing the need for costly physical testing and improving product design efficiency.

Civil aerospace

The year was notable for the successful entry into service of our latest large engine, the Trent 1000, as launch engine for the Boeing 787 Dreamliner. The Trent 1000 completed 670 flights in service with launch customer ANA by the year end.

Flight testing of the BR725-powered Gulfstream G650 recovered from the tragic loss of a test aircraft in April to achieve Provisional Type Certification from the Federal Aviation Authority in November 2011.

The Trent XWB development programme continued successfully, with several key functional, maturity and certification tests completed at sites in

475

Patent applications were
approved for filing – a record
number for the Group



four countries. The engine is the only option for the Airbus A350 airliner family. The Trent XWB promises to be the most efficient, large aero gas turbine ever produced.

Our ongoing work to improve the environmental performance of our products continued with key technology demonstrators. The Environmentally Friendly Engine (EFE) completed successful testing of an advanced 'lean burn' combustor. Meanwhile, the latest E3E medium-size, two-shaft demonstrator core completed testing at the University of Stuttgart's altitude facility during the year.

Defence aerospace

Our engineers in Indianapolis are working on key enabling technologies for the US Air Force ADVENT contract. This work focuses on developing and demonstrating variable cycle engine technologies aimed at incorporation in future generation US military aircraft. The team completed designs and procured test hardware in preparation for a core engine test which will take place in 2012 and a full demonstrator engine test in 2013.

In addition, during the year we won contracts for the US Air Force Research Lab (AFRL) Integrated Vehicle Energy Technology (INVENT) and Integrated Power and Thermal Management System Development (IPTMSD) programmes. These both focus on development of electrical and thermal management architectures to support the next generation of military aircraft.

Marine

Engineers in our submarines business are engaged in detailed design of the PWR3 reactor plant, which, in May 2011, was selected for the next generation of Royal Navy submarines. This project now represents the second largest technology programme in Rolls-Royce after the Trent XWB. Rolls-Royce has been designing and supplying nuclear reactors for the Royal Navy for over 50 years, with the PWR2 model currently the latest version in service. At the Nor-Shipping Exhibition in Oslo, our Enviroship concept, the NVC 405 Enviroship, won the 'Next Generation Ship' award, and we launched a new 'concept bridge' for marine vessels.

In other marine programmes, we completed our first production Permanent Magnet Tunnel Thruster, and the Rolls-Royce operated NATO Submarine Rescue Service achieved full operational capability. A prototype carbon fibre azimuthing thruster exceeded performance and noise expectations during sea trials. Azimuthing thrusters rotate 360 degrees allowing them to perform both the propulsion and steering duties for a vessel.

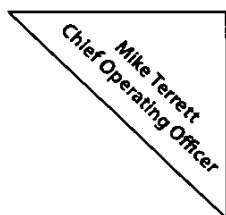
Energy

In civil nuclear, EDF selected Rolls-Royce to modernise the safety-critical I&C systems of 20 French nuclear power plants. This contract, combined with a 25-year services agreement, means we are committed to support our SPINLINE™ technology with EDF until 2048.

Summary

Rolls-Royce has developed a reputation for engineering excellence and has been at the forefront of innovation for over 100 years. We continue to push technological barriers, create intellectual property on behalf of our stakeholders and develop advanced power products across each of our chosen markets.

Excellence in operations



£274k

Underlying revenue per employee

£467m

Capital expenditure on new and improved facilities

We continue to invest in operational capacity to fulfil the commitments we have made to our customers and to enable the long-term growth and productivity of our business

Focused on efficiency and delivery

We are focused on improving the efficiency of all our operational activities while, at the same time, expanding capacity in order to deliver our record order book

In 2011, our capital investment on new and improved facilities was £467 million. Over the past decade underlying revenue per employee has more than doubled from £128k in 2001 to £274k in 2011

Our Group is headquartered in the UK which remains our main employment centre and a key operations and manufacturing base. However, we are an increasingly global company. Early in 2012 we celebrated the opening of our major new facilities at Seletar, in Singapore, where we will manufacture wide-chord fan blades, and assemble and test Trent aero engines – the first time we have undertaken these activities outside the UK. This represents an important commitment to our growing customer base in Asia, and is one of 14 new facilities that we have opened over the past three years in locations including the UK, Germany, the US, Norway, China and Brazil.

As well as extending our global footprint, we continue to expand our product portfolio. 2011 saw the Trent 1000 engine enter service with ANA and the production programme for this latest member of the Trent family come on stream. In other major programmes we started production deliveries of the LiftSystem for the Joint Strike Fighter and the marine gas turbine, MT30 for the US Navy. The BR725 which powers the new Gulfstream G650 is scheduled to enter service later this year.

In October 2011, we announced a new joint venture with Pratt & Whitney to develop engines for the next generation of mid-sized aircraft. We also decided to restructure our participation in IAE, the joint venture which produces the V2500 engine for the A320 family of aircraft. We agreed to sell our equity stake in IAE to Pratt & Whitney, while remaining an important supplier of parts and engineering support for the engine programme. We continue to assemble 50 per cent of V2500 engines.

At the same time we continue to aim to offset all inflationary pressures through improved productivity and waste reduction programmes.

Integrated global approach

As we expand around the world, our operations strategy demands an integrated approach across activities, time zones and locations

We continue to develop local capabilities to meet our customer requirements where appropriate. Brazil is a good example of this. We have had an aero repair and overhaul business there for over 50 years.

In 2009, we opened a service centre to support our growing marine business and, in 2011, we announced plans for the construction of a new US\$100 million-plus gas turbine package, assembly and test facility for our energy business. This is expected to become operational in the first quarter of 2013.

These investments not only grow our global footprint but bring us closer to our customers in Brazil, adding significantly to our capabilities in a key growth market and enabling us to pursue further opportunities.

Supply partnerships and new programmes

Close collaboration with our suppliers is critical to our continued success. Around 70 per cent of our manufacturing is conducted within our supply chain. As we continually develop intellectual property in technology, manufacturing, materials and processes we decide which elements of our programmes we produce ourselves and those which will be subcontracted to our suppliers. Our relationship is open, analytical and collaborative. We estimate that our supply base is currently investing at around twice the level of Rolls-Royce in order to accommodate growth and deliver greater efficiency.

As well as working with suppliers, we partner with universities and manufacturing research centres around the world to develop new technologies and processes which are more effective, efficient and robust.

Rolls-Royce is a long-term business in which consistent investment sustained over many years has delivered expanding global capability, accompanied by steadily improving productivity and performance. These factors coupled with a high focus on product integrity, enable us to effectively address both our customers' current needs and their future requirements.

Sustainability

We remain committed to working with all our stakeholders to develop new approaches and technologies that will help provide solutions to sustainable economic growth

We are striving to power a better world and recognise that we have a key part to play. We will continue to invest for the long term, we have a strong track record of innovation, and a long-standing commitment to research and development. Our sustainability programmes address the environment, our people, and, the communities in which we operate

Business in the Community Corporate Responsibility Index (BitC)

The BitC Index assesses the extent to which corporate strategy is integrated into business practice throughout an organisation. In 2011, Rolls-Royce retained its Gold status with an overall score of 91 per cent. We also scored 94 per cent in the Environmental Index component of the overall survey.

Dow Jones Sustainability World and European Indexes (DJSI)

Rolls-Royce has retained its position in the DJSI for the tenth consecutive year, with an overall score of 78 per cent (aviation and defence sector average 49 per cent).

Carbon Disclosure Project (CDP)

Rolls-Royce continues to be one of the leading companies in the CDP Index. Although our disclosure score in 2011 was lower than the previous year (75 vs 79 per cent in 2010) we remain committed to improving and reporting the carbon footprint of our operations.

Environment

Our environment strategy focuses on three key areas.

- 1 maintain our drive to reduce the environmental impact of all our business activities,
- 2 further reduce the environmental impact of our products, and
- 3 develop entirely new low emission and renewable energy products

1 Maintain our drive to reduce the environmental impact of all our business activities

Greenhouse gas emissions

We recognise the need to reduce the global greenhouse gas emissions (GHG) within our operations. For the past two years individual reduction targets and budgets have been agreed for our top 25 energy consuming sites. This has resulted in a further five per cent reduction (normalised on turnover) during 2011 in total GHG emissions ⁽¹⁾ (including product test and development). Emissions from our facilities (excluding product test and development) have reduced by six per cent since 2009 compared with our five per cent reduction target by 2012 ⁽²⁾. In absolute terms, total GHG emissions have increased to 586.5 kt CO₂e (scope 1 and 2).

⁽¹⁾ Following further validation in 2012 the Group GHG emissions for 2009 have been re-stated.

⁽²⁾ Energy/GHG data for 2011 has been forecast based on data collected during January to October 2011. For details of the methodology see our Basis of Reporting available at www.rolls-royce.com

In 2011, we invested over £3.5 million in energy improvement projects including the upgrade of lighting, boiler controls and metering.

Our new facility at Seletar received the Singapore Government's Building Construction Authority (BCA) Green Mark (Platinum) award in construction, for having a reduced environmental footprint.

Progress on certification

Rolls-Royce continues to maintain accredited third-party certification to ISO 14001 for its environmental management systems, achieving full global re-certification in 2011.

Global supply chain

In 2011, we led Global and Regional Supplier Forums, which focused on near-term and long-term improvements. We also hosted regional supplier groups, culminating in a global best practice sharing event aimed at promoting the application of lean techniques across the supply chain.

2 Further reduce the environmental impact of our products

We believe that we can make a significant contribution to mitigating emissions by providing increasingly efficient products worldwide. We benefit from independent expert advice from an Environmental Advisory Board made up of distinguished academics who are leading authorities in their respective fields to inform business strategy and design process. In 2011, the Group renewed its commitment, now extended to 2050, in taking a leading role in the goals set by the Advisory Council for Aviation Research and Innovation in Europe (ACARE). These challenging goals include:

- reducing aircraft CO₂ emissions by 75 per cent per passenger kilometre
- reducing noise by 65 per cent, and
- 90 per cent reduction in oxides of nitrogen (NOx) relative to the year 2000

The environmental improvements already achieved by the Trent 900 and 1000 engines for the Airbus A380 and Boeing 787 respectively, and in future the Trent XWB for the Airbus A350 XWB, will help us make progress meeting our contribution towards the ACARE goals.

Nuclear power will represent an important component of future low-carbon electricity generation. We have substantial experience in this area gained through supplying power systems for the Royal Navy nuclear submarine fleet for many decades. Our core capabilities in safety and I&C will enable the Group to provide solutions in this area that will help address the requirements for low or zero carbon power generation.

In the marine segment, the Rolls-Royce Environship concept, received the prestigious 'Next Generation Ship' award at the Nor-Shipping event held in Norway. The Rolls-Royce Bergen B-Series lean-burn gas engines, as used in the Environship, emit around 20 per cent less CO₂ than comparative diesel engines. The use of gas fuelled engines means that NOx emissions are reduced by about 90 per cent and SOx emissions are negligible. These emissions already meet the International Maritime Organization legislation due to come into force in 2016.

3 Develop entirely new low emission and renewable energy products

The Group is investing in other renewable energy sources such as tidal power, working in partnership with the UK Energy Technologies Institute. In addition, we are working with customers and fuel companies to ensure that future biofuels, which will be part of the solution for aviation towards 2050, meet our requirements, with the important caveats that they are sustainable, do not compete with the growth of food crops and are used in the most effective way to maximise the reduction in GHG emissions.

Our people**Our working environment**

We seek to create an inclusive working environment that attracts and retains the best people, enhances their flexibility, capability and motivation, and encourages them to be involved in the ongoing success of the Group.

The organisation is experiencing a period of significant change as we grow and invest globally. We continue to place great value on giving a voice to our workforce and engage with our employees in many ways throughout the world to ensure they are kept informed of changes that may impact them. For example, employee opinions are obtained via a two-year rolling engagement programme and improvement activities are then embedded into local and corporate business planning activities. In addition we have established communication channels which provide updates on key business changes and activities.

Rolls-Royce employs 40,400 people in more than 50 countries. Our workforce is dispersed globally across our business segments as follows:

Business segments average number of employees 2011

	Employees
Civil aerospace	20,600
Defence aerospace	6,800
Marine	9,400
Energy	3,600
Total	40,400

Ethics

The Global Code of Business Ethics (Global Code) supports the Group's approach to business conduct and defines its ethical principles and behaviours. Internal and external assessments of the Global Code during 2011 confirmed that it represents best-in-class standards.

During the year, the Group completed a review of its anti-bribery and corruption related policies and procedures. This review considered applicable law, including the UK Bribery Act, which came into force on July 1, 2011. We also put in place a compliance organisation, led by a Chief Compliance Officer. We issued a number of new and updated global policies in multiple languages including raising concerns, conflicts of interest, competitive intelligence and, sponsorships and charitable donations. Training was developed to support these as required.

Rolls-Royce actively supports aerospace and defence industry initiatives to drive responsible business behaviour in the sector. We are represented on the Business Ethics Committee of the Aerospace and Defence Industries Association of Europe (ASD) and we are one of the international companies on the task force managing the International Forum for Business Ethics (IFBEC), a body which brings together US and European aerospace and defence companies to share best practice and develop common standards.

Encouraging diversity

Our global governance framework for diversity includes a senior executive Global Diversity Steering Group that provides leadership and shapes strategic direction.

During 2011, our most senior executives have been reverse mentored by a colleague who is junior to them in the organisation. The reverse mentors are a diverse group in terms of gender, nationality, business, function and their working location. The aim is to give senior executives a different perspective from a colleague who can share diverse experiences and ideas.

Lord Davies of Abersoch, on behalf of the UK Government, outlined a number of recommendations in 2011 to improve gender diversity in UK boardrooms. We will take opportunities to increase diversity at Board level, and have committed to make demonstrable progress on this by 2015.

Overall female representation across our global workforce is 15 per cent, seven per cent at the senior executive level and six per cent in our Group Leadership Team (GLT). Approximately two thirds of our workforce is in engineering or manufacturing roles where female representation has been historically low. We continue to counter this through active involvement in education outreach along with recruitment and development planning in order to maximise the potential of diverse talent across our global business. We are encouraged by some of the progress we are making in graduate recruitment where female representation has steadily increased over recent years. 25 per cent of participants in our graduate development programmes are female and this increases significantly in functions outside of engineering and manufacturing.

We participate in the FTSE 100 Cross Company Mentoring Programme, the objective of which is for the chairmen and chief executives to provide advice and guidance to senior females with the aim of attaining a non-executive and/or an executive director role. Our Chairman is a mentor and three of our female executives have participated to date.

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

Learning

During 2011, we provided over 3,500 learning solutions to our employees from all of our 57 countries, resulting in 35,500 employees undertaking more than 105,000 days of learning. We also built new Learning and Development Centres in Singapore and Ålesund, Norway. The centres will deliver training to both customers and employees in the regions.

Learning investment for 2011 was £38 million.

Recruitment

In 2011, over 2,500 experienced professionals were recruited to support the growth of our business, more than double the previous year. More than 50 per cent were recruited from outside of the UK and 34 per cent came from countries outside the UK/US. We ran major recruitment campaigns across engineering, manufacturing and purchasing and these constituted the majority (61 per cent) of our hiring in 2011.

During 2011, more than 400 young graduates joined Rolls-Royce. Our campus teams actively engaged with more than 60 universities in the UK, Europe, Asia, and Americas and we recruited 242 graduates (up nine per cent) on to our graduate programme from 43 universities and 25 nations globally. We have plans to significantly increase our graduate programme size to 389 (60 per cent increase) in 2012 to accommodate our long-term growth objectives.

In addition, we recruited 295 apprentices in Europe and were awarded top 100 apprenticeship employer status in the UK.

Health and safety at work

Over the past five years our focus on improving our health, safety and environment (HS&E) performance has resulted in the number of significant injuries that occur each year being almost halved from 131 total reportable injuries (TRI) per 100 employees in 2006, to 0.66 TRI per 100 employees in 2011.

Performance improvement is delivered through the implementation of a focused global HS&E strategy covering leadership, capability, management systems, risk, assurance, learning from incidents and informed decision making

As part of a global safety programme, we have invested more than £20 million to further enhance the safety standards of our machinery. More than 11,000 machines have been reviewed worldwide and for around 2,500 machines, opportunities to enhance safety still further were identified such as improving guarding and the fitting of additional safety features

A global programme of review and corrective action is also underway to improve our control of lifting operations. Similarly, a global programme to improve process safety management is focusing on our management of operational processes with hazards

'Leading excellence in HS&E' workshops have been held with leadership teams from all of our sectors and businesses. 'Leadership in Action' days were also held for some 700 senior leaders with HS&E being one of the topics covered

Engaging with our communities

Working with governments

Rolls-Royce seeks to build strategic relationships with host governments in our key market countries. Governments are often our direct customers. They set the legislative and policy framework within which our business must be conducted. They are a potential source of funding and support for R&T, R&D, manufacturing, education and training initiatives, as well as for certain capital projects. And finally, on occasion, they support or sponsor our partners, suppliers and competitors

We engage in dialogue and negotiation to try to align the business needs of Rolls-Royce with the political, social, economic, industrial and commercial requirements of the national government. Where we can achieve such alignment, for example in Singapore, the benefits for both the Group and the country can be considerable

On March 6, 2011, we hosted a meeting of the UK Cabinet in Derby. Sir John Rose addressed the Cabinet before their meeting and later that day, Prime Minister David Cameron performed the official opening of the new technology centre on site

On October 25 and 26, 2011, Rolls-Royce along with the University of Sheffield and Boeing led a series of high profile events in Westminster to highlight the importance of high-value manufacturing. These events generated considerable interest from Government Ministers, Parliamentarians and officials

With a majority of legislation affecting our European operations emanating from the European Union, we are now building extra capacity in our EU Affairs team. Throughout 2011, our key challenge in the EU has been to monitor the EU legislation on financial regulatory reform and its impact on the real economy and potential unintended consequences for non-financial companies like Rolls-Royce. Other policy areas have also required our attention, such as the inclusion of marine emissions in EU's GHG commitment, new noise regulation in the field of aviation, alternative fuel

policies, and renewable energy. We contributed to the development of the Commission's proposal for 'Horizon 2020' – a new Research and Innovation funding framework for 2014-2021, and also 'Flightpath 2050 – Europe's vision for Aviation'

Community investment

Rolls-Royce has a firm, long-standing commitment to the communities in which we operate around the world. During 2011, the Group's total contributions (including money, employee time and gifts in kind) were £71 million

Our community investment activities support the Group's strategy and future success, particularly in the areas of recruitment and employee retention, employee engagement, professional development and the Group's reputation in the community

During the year, the Group approved a new global charitable contributions and social sponsorships policy and procedure, confirming our major areas of support as

- education and skills, particularly in the areas of STEM which are key to our future success, environment, adding value to the Group's environment strategy, social investment, making a positive difference to the communities in which we operate,
- arts and culture, contributing to the cultural vibrancy in geographic areas in which we operate, and
- requests relating to the Group's business such as armed services related, engineering and aviation

The new policy and procedure also sets out a clear structure for global governance, ensuring consistency of approach and global visibility of contributions

2011 charitable contributions and sponsorships, and payroll giving

	£m
Charitable contributions and social sponsorships	
– UK	2.1
– Asia and Middle East £0.3m, Americas £0.7m, Europe £0.6m	1.6
Commercial sponsorship	0.7
Employee time	2.6
Gifts in kind	0.1
Total	7.1
Payroll giving UK £0.5m and North America £0.3m	0.8

£7.1m

The Group's total contributions and sponsorships

Principal risks and uncertainties

It is recognised that the Group's business objectives can only be achieved if risks are taken and managed effectively. By understanding the nature of our risks we can be in a position to make better decisions and maximise the returns of the Group while managing our reputation.

Regular review of risks and actions to address risks takes place at all levels of the Group. Risks are defined as threats to the achievement of business objectives or to the continuing reputation of the Group. The top level corporate risk register reflects the outcomes of lower level programme, function or business unit risk reviews and is reviewed in detail by the risk committee. Nevertheless, the Board retains its strategic responsibility for risk decision making regularly reviewing the corporate risk register and considering these risks in the context of the business strategy, as reported to it by the risk committee.

The risks and uncertainties on these pages are considered to be principal to delivering our strategy and business results, and specific to the nature of our business, notwithstanding that there are other risks that may occur and may impact on the achievement of the Group's objectives.

Risk or uncertainty and potential impact	How we manage it
Significant external events affecting demand for transportation such as terrorism, political change, global pandemic, natural disaster or continued and deeper economic retrenchment	▶ Established a balanced business portfolio ▶ Strong access to parts of the world where demand remains robust ▶ Diversity of global operations ▶ Regularly exercised senior response team
Failure to minimise the environmental impact of the Group's products and operations leading to reputational damage and ultimately loss of market share	▶ R&D in low-carbon technologies such as nuclear power, tidal energy and fuel cells ▶ Significant investment in innovative solutions for aviation, marine and energy markets ▶ Governance structure headed by the environment council to oversee improvements
Reduction in government spending due to global financial uncertainty and budgetary constraint in Europe and the US in particular causing reduced revenues on existing platforms and inhibiting investment in new technologies	▶ Development of a diversified portfolio of products and services for various markets and regions ▶ Proactive lobbying for research and technology funding ▶ Achieve commitments under current contracts
Failure of counterparties , including financial institutions, customers, joint venture partners and insurers, driven mainly by the economic uncertainties and pressures in the current environment, potentially affecting short-term cash flows	▶ Established policy for managing counterparty credit risk ▶ Common framework to measure, report and control exposures to counterparties across the Group using value-at-risk and fair-value techniques ▶ Internal credit rating assigned to each counterparty, assessed with reference to publicly available credit information and subject to regular review
Fluctuations in foreign currency exchange rates affecting operational results or the outcomes of financial transactions	▶ Long-term hedging policy, using a variety of financial instruments (see note 17, page 101 for more information) ▶ Where applicable, currency matching of assets and liabilities to manage translational exposures ▶ Regular review of risks and appropriate risk mitigation performed where material mismatches arise
Regulatory changes relating to financial derivatives may require the Group to post cash collateral, increasing cash flow volatility and the risk of default	▶ Close monitoring of proposed changes ▶ Evaluation of potential financial impact in terms of cash collateral required and use of public trading exchanges ▶ Lobbying politicians and regulators in conjunction with other large European corporates
If the Group's products, services and pricing do not remain competitive, this could result in the loss of market share, with attendant impact on long-term financial performance	▶ Establishment of long-term customer relationships to differentiate products and services and protect margins ▶ Steady focus on improvement in operational performance, for example through the modernisation of facilities ▶ Increased focus on managing the costs of operations and products ▶ Sustained investment in technology acquisition

Risk or uncertainty and potential impact	How we manage it
Non-compliance with applicable legislation and regulations, for example export controls, anti-bribery and authorisation of chemicals and substances compromising the ability to conduct business in certain jurisdictions and exposing the Group to reputational damage and potential financial penalties	▶ A business-wide compliance structure focusing on anti-bribery and corruption legislation ▶ Exports committee, chaired by the Chief Operating Officer directs strategy and policy on exports ▶ Resources to comply with requirements are embedded throughout the business ▶ Employee awareness training
Failure to grow capable resource globally due to demographic trends and limited supply of appropriately skilled personnel affecting programme delivery, damaging reputation and stifling opportunities for future innovation	▶ Continued significant investment in resourcing and capability infrastructure ▶ Objective assessment of performance using improved system for developing and monitoring the competency of individuals ▶ Regularly refreshed framework to develop managers and leaders
Product performance not meeting expectations affecting safety and reliability with adverse long-term financial consequences	▶ Operating a 'safety first' culture, including delivery of regularly refreshed mandated product integrity training to employees and suppliers ▶ Future safety requirements are defined by the product safety assurance team ▶ Activities to improve maturity of products at entry into service ▶ Engineering focus on improvements to product reliability and service lives
Disruption of supply chain due to external factors or failure to deliver parts to committed costs and quality reducing the ability to meet customer commitments, win future business or achieve operational results	▶ Continuous improvement of all processes and project management controls to ensure both technical and business objectives are achieved ▶ Customer excellence centre provides improved response to and analysis of supply chain disruption ▶ Focus on production quality through plant and supplier improvement plans ▶ Providing duality of capability through establishment of world-class manufacturing centres ▶ Pursuit of low-cost sourcing strategies
Downgrade in credit rating restricting the Group's ability to secure funding, hedge forward or provide vendor financing	▶ The Group has developed a strong financial risk profile and continues to improve the business risk profile
Failure to conduct business in an ethical and socially responsible manner causing disruption and reputational damage	▶ Ethics committee established to oversee and maintain the highest ethical standards (see page 50 for its report) ▶ Global Code, in 18 languages, issued to all employees supported by a training and engagement programme to improve awareness of the Group's values ▶ Global telephone and intranet channels are available for employees to report in confidence any concerns regarding potentially unethical behaviours
Failure to manage multiple complex product programmes effectively with potentially significant adverse financial and reputational consequences, including the risk of impairment of the carrying value of the Group's intangible assets and the impact of potential litigation	▶ Continuous improvement of all processes and project management controls to ensure both technical and business objectives are achieved ▶ All major programmes subject to approval and regular review by the Board, with particular focus on the nature and potential impact of emerging risks and the effective mitigation of previously identified threats
Breach of IT security through increasing volumes of data being transmitted electronically across international borders may cause controlled data to be lost, corrupted or accessed by unauthorised users, impacting the Group's reputation	▶ Continual upgrading of security equipment and software ▶ Deployment of a multi-layered protection system that includes web gateway filtering, firewalls and intrusion detection ▶ Specialist resources employed to increase capability ▶ Active sharing of information through industry and government forums
Failure to execute the programme to modernise the IT infrastructure impacting efficiency and effectiveness of business operations	▶ Governance structure established to oversee the programme ▶ Project and risk management methodologies are being followed ▶ Specialist resources have been secured to increase capability ▶ Involvement of multiple service providers to provide competition and remove dependency on any single supplier
Loss or unintended disclosure of Intellectual Property damaging the Group's competitive position and causing potential breach of contractual requirements	▶ Strengthening of resources to manage patents ▶ Creation of a global framework of Intellectual Property officers ▶ Procurement of a global IT system to make patent information more widely available to engineers

Additional financial information

Foreign exchange

Foreign exchange rate movements influence the reported income statement, the cash flow and closing net cash balance. The average and spot rates for the principal trading currencies of the Group are shown in the table below.

		2011	2010	Change
USD per GBP	Year end spot rate	1.55	1.57	-1%
	Average spot rate	1.60	1.54	+4%
EUR per GBP	Year end spot rate	1.20	1.17	+3%
	Average spot rate	1.15	1.17	-2%

Taxation

The Group believes that it has a duty to shareholders to seek to minimise its tax burden but to do so in a manner which is consistent with its commercial objectives and meets its legal obligations and ethical standards. Every effort is made to maximise the tax efficiency of business transactions and this includes taking advantage of available tax incentives and exemptions. However, the Group has regard for the intention of the legislation concerned rather than just the wording itself.

The Group is committed to building open relationships with tax authorities and to following a policy of full disclosure in order to effect the timely settlement of its tax affairs and to remove uncertainty in its business transactions. Where appropriate, the Group enters into consultation with tax authorities to help shape proposed legislation and future tax policy.

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

Investments and capital expenditure

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

The Group has a portfolio of projects at different stages of their life cycles. Discounted cash flow analysis of the remaining life of projects is performed on a regular basis.

Sales of engines in production are assessed against criteria in the original development programme to ensure that overall value is enhanced.

Financial risk management

The Board has an established and structured approach to financial risk management. The Financial Risk Committee (FRC) is accountable for managing, reporting and mitigating the Group's financial risks and exposures. These risks include the Group's principal counterparty, currency, interest rate, commodity price, liquidity and credit rating risks outlined in more depth in note 17 to the financial statements. The FRC is chaired by the Finance Director. The Group has a comprehensive financial risk policy that advocates the use of financial instruments to manage and hedge business operations risks that arise from movements in financial, commodities, credit or money markets. The Group's policy is not to engage in speculative financial transactions. The FRC sits quarterly to review and assess the key risks and agree any mitigating actions required.

Capital structure

Capital summary – £ million	2011	2010
Total equity	4,519	3,979
Cash flow hedges	52	37
Group capital	4,571	4,016
Net funds	223	1,533

Operations are funded through various shareholders' funds, bank debt, bonds, notes and finance leases. The capital structure of the Group reflects the judgement of the Board as to the appropriate balance of funding required.

Funding is secured by the Group's continued access to the global debt markets. Borrowings are funded in various currencies using derivatives where appropriate to achieve a required currency and interest rate profile. The Board's objective is to retain sufficient financial investments and undrawn facilities to ensure that the Group can both meet its medium-term operational commitments and cope with unforeseen obligations and opportunities.

The Group holds cash and short-term investments which, together with the undrawn committed facilities, enable it to manage its liquidity risk.

After repayment from cash resources of the €750 million Eurobond, the Group retained at year end aggregate liquidity of £2.5 billion. This liquidity comprised net funds of £223 million and aggregate borrowing facilities of £2.3 billion, of which £1.2 billion remained undrawn. This represents a 34 per cent decrease in net drawn borrowing facilities during the year.

The maturity profile of the borrowing facilities is regularly reviewed to ensure that refinancing levels are manageable in the context of the business and market conditions. No facilities mature in 2012. There are no rating triggers in any borrowing facility that would require the facility to be accelerated or repaid due to an adverse movement in the Group's credit rating.

During 2011, the £250 million bank revolving credit facility (RCF) due in 2012 and £750 million RCF due in 2013 were both refinanced with a new £1 billion RCF due in 2016 provided by a syndicate of relationship banks. The borrowing margin for this new RCF varies for a given credit rating. Depending on the extent drawn, the current margin would be 0.40 per cent to 0.70 per cent over sterling LIBOR.

The Group conducts some of its business through a number of joint ventures. A major proportion of the debt of these joint ventures is secured on the assets of the respective companies and is non-recourse to the Group. This non-recourse debt is further outlined in note 10 to the financial statements.

Credit rating

Rating agency	Rating	Outlook	Grade
Moody's Investors Service	A3	Stable	Investment
Standard & Poor's	A-	Positive	Investment

The Group subscribes to both Moody's Investors Service and Standard & Poor's for independent long-term credit ratings. At December 31, 2011, the Group maintained investment grade ratings from both agencies.

As a capital-intensive business making long-term commitments to our customers, the Group attaches significant importance to maintaining or improving the current investment grade credit ratings.

Accounting and regulatory

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU.

In 2011, there were no changes that have had a significant effect on the Group's financial statements.

A summary of changes which have not been adopted in 2011 is included within the accounting policies in note 1 to the financial statements.

Governments and regulators around the world continue to consider reforms to the financial markets with the aim of improving transparency and reducing systemic risk. Although the proposed reforms are predominantly directed at financial institutions, they will also affect non-financial institutions such as the Group. In particular, proposals by both US and European regulators to reform the Over-the-counter (OTC) derivatives market may have adverse implications for the Group. If, as is being contemplated, parties to future OTC derivative transactions are required to use an exchange to clear the transactions and post cash collateral to reduce counterparty risk, the Group's future funding requirements could be adversely affected and cash flow more volatile.

Share price

During the year the share price increased by 20 per cent from 623p to 746 5p, compared to a 0.7 per cent increase in the FTSE aerospace and defence sector and a 5.6 per cent decrease in the FTSE 100. The Company's share price ranged from 557.5p in March to 746 5p at the year end.

Governance

Board of directors

Sir Simon Robertson
Non-executive Chairman

John Rishton
Chief Executive

Iain Conn
Senior Independent Director

Dame Helen Alexander
Non-executive director

Lewis Booth
Non-executive director

Peter Byrom
Non-executive director

Sir Frank Chapman
Non-executive director

Sir Peter Gregson
Non-executive director

Sir Simon Robertson (70) ^{2*}

Non-executive Chairman
appointed January 2005

Skills and experience: Sir Simon brings to the Board a background in international corporate advisory with a wealth of experience in mergers and acquisitions, merchant banking, investment banking and financial markets. During his career he has worked in France, Germany, the UK and the US. In June 2010 he was honoured with a knighthood in recognition of his services to business.

External appointments: Sir Simon is the founder member of Simon Robertson Associates LLP and Deputy Chairman of HSBC Holdings plc. He is a non-executive director of Berry Bros & Rudd Limited and The Economist Newspaper Limited. Sir Simon is a director of The Royal Opera House Covent Garden Limited and a Trustee of The Eden Project and of the Royal Opera House Endowment Fund.

John Rishton (53) ^{2,5}

Chief Executive,
appointed March 2011

Skills and experience: John is the former Chief Executive Officer of Royal Ahold. He began his career in 1979 at Ford Motor Company and held a variety of positions both in the UK and in Europe. In 1994 he joined British Airways plc where he was Chief Financial Officer from 2001 to 2005. Prior to his appointment as Chief Executive, John had been appointed as a non-executive director of the Company in 2007 and

served as Chairman of the audit committee and a member of the ethics and nominations committees. He is a former non-executive director of Allied Domecq.

Iain Conn (49) ^{1,2}

Senior Independent Director,
appointed January 2005

Skills and experience: Iain joined the BP group in 1986 and has held a number of executive positions within the BP group worldwide.

External appointments: Iain is a Group Managing Director and Chief Executive of Refining and Marketing BP plc. He is also Chairman of the Advisory Board of The Imperial College Business School and a member of Imperial College Council.

Dame Helen Alexander (54) ^{2,3,4}

Non-executive director,
appointed September 2007

Skills and experience: Dame Helen is currently involved with a number of not-for-profit organisations in media, the internet, the arts and education. She has also been a non-executive director of Northern Foods Limited, Centrica PLC and BT Group PLC. She was Chief Executive of the Economist Group till 2008, having joined the company in 1985.

External appointments: Dame Helen is Deputy President of the CBI, where she was President until June 2011. She is Chairman of the Port of London Authority (PLA) Incisive

Media and Deputy Chairman of esure Group Holdings, and senior adviser to Bain Capital. Dame Helen is Chancellor of the University of Southampton.

Lewis Booth (63) ^{1,2,4}

Non-executive director
appointed May 2011

Skills and experience: Lewis has held a series of senior positions within the Ford Motor Company in Europe, Asia, Africa and the United States. Lewis began his career with British Leyland before joining Ford in 1978.

External appointments: Lewis is executive Vice President and Chief Financial Officer of Ford Motor Company, a position he has held since November 2008.

Peter Byrom (67) ^{2,4}

Non-executive director,
appointed January 1997

Skills and experience: Peter was a director of AMEC plc from 2005 to 2011 and of NM Rothschild & Sons Limited from 1977 to 1996. He is a Fellow of the Royal Aeronautical Society.

External appointments: Peter is Chairman of Domino Printing Sciences plc.

Sir Frank Chapman (58) ^{2,3}

Non-executive director
appointed November 2011

Skills and experience: Sir Frank has worked in the oil and gas industry for 37 years, including operational and business development roles within

Royal Dutch Shell plc and BP plc. Sir Frank graduated with first class honours in Mechanical Engineering from Queen Mary College, London University and is a Fellow of the Institution of Mechanical Engineers. He was knighted in 2011 for services to the oil and gas industries.

External appointments: Sir Frank has been Chief Executive of BG Group plc for the past 11 years, managing the Group through a period of transformational growth and international diversification.

Sir Peter Gregson (54) ^{2,3}

Non-executive director
appointed March 2007

Skills and experience: Appointed to the academic staff at the University of Southampton in 1983, Sir Peter became Professor of Aerospace Materials in 1995 and Deputy Vice-Chancellor in 2000. He is a Fellow of the Royal Academy of Engineering and a Member of the Royal Irish Academy and has served on the Councils of the Royal Academy of Engineering and the Central Laboratory of the Research Councils. He was knighted in 2011 for services to higher education.

External appointments: Sir Peter is President and Vice-Chancellor of Queen's University Belfast; he serves on the Council of CBI Northern Ireland and is a member of the Board of the UK Universities and Colleges Employers Association. He is Deputy Lieutenant of Belfast.

Governance

Board of directors

John McAdam Non-executive director	John Neill CBE Non-executive director	Ian Strachan Non-executive director	James Guyette President and Chief Executive Officer of Rolls-Royce North America Inc
Mark Morris Finance Director John McAdam (63) ^{2,3} Non-executive director appointed February 2008 Skills and experience John was the Chief Executive of ICI plc until ICI's acquisition by Akzo Nobel. He has held a number of positions at Unilever, within its Birds Eye, Walls, Quest International and Unichema International businesses External appointments John is Chairman of United Utilities Group PLC and of Rentokil Initial plc, the Senior Independent Director of J Sainsbury plc and a non-executive director of Sara Lee Corporation	Colin Smith Director – Engineering and Technology non-executive director of Johnson Matthey plc, Commercial Union and Reuters Group plc External appointments Ian is a non-executive director of Xstrata plc, Transocean Inc and Caithness Petroleum Limited James Guyette (66) ⁵ President and Chief Executive Officer of Rolls-Royce North America Inc., appointed January 1998 Skills and experience Before joining the Company, Jim was Executive Vice President, Marketing and Planning of United Airlines	Mike Terrett Chief Operating Officer Colin Smith (56) ⁵ Director – Engineering and Technology, appointed July 2005 Skills and experience Colin joined Rolls-Royce in 1974. He has held a variety of key positions within the Company including Director – Research and Technology and Director of Engineering and Technology – Civil Aerospace. Colin is a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institution of Mechanical Engineers Mike Terrett (55) ⁵ Chief Operating Officer, appointed September 2007 Skills and experience Mike joined Rolls-Royce in 1978. He has held a variety of senior positions in the development of new aero-engine programmes including Managing Director of Airlines and President and Chief Executive Officer of IAE based in the United States. Prior to his appointment as Chief Operating Officer he was President – Civil Aerospace. Mike is a Member of the Institute of Mechanical Engineers and a Fellow of the Royal Aeronautical Society	Paul Davies (56) Acting Company Secretary Skills and experience Paul joined Rolls-Royce in 2008. He began his career in the secretariat of Ford Motor Company in 1980 and progressed via roles with Burberrys and Hunter Saphir plc. He was appointed Company Secretary of Norwest Holst plc in 1991 of Kingsbury Group plc in 1997 and, after the takeover of Kingsbury of Galliford plc. He then worked for United Utilities plc (for seven years) as both Deputy Company Secretary and acting Company Secretary, before joining Rolls-Royce as Deputy Company Secretary
John Neill CBE (64) ^{1,2} Non-executive director appointed November 2008 Skills and experience John is a member of the Council and Board of Business in the Community, is Vice President of the Society of Motor Manufacturers and Traders, BEN, the automotive industry charity and The Institute of the Motor Industry. He was awarded a CBE in June 1994 for his services to industry Ian Strachan (68) ^{1,2,4} Non-executive director, appointed September 2003 Skills and experience Ian is the former Chief Executive of BTR plc, former Deputy Chief Executive and Chief Financial Officer of Rio Tinto plc, former non-executive Chairman of Instinet Group Inc and a former	External appointments Jim is Chairman of PrivateBancorp Inc. of Chicago, Illinois and he is a director of priceline.com Inc., of Norwalk, Connecticut. Jim is Chairman of the Smithsonian National Air and Space Museum, Washington DC Mark Morris (48) ⁵ Finance Director, appointed January 2012 Skills and experience Mark joined Rolls-Royce in 1986. He has held a number of senior positions throughout the Group and prior to his appointment as Finance Director was Group Treasurer from 2001	Committee membership ¹ Audit committee ² Nominations committee ³ Remuneration committee ⁴ Ethics committee ⁵ Risk committee • Denotes chairman of committee Non-executive directors Executive directors Acting Company Secretary	

International Advisory Board (IAB)

The IAB, formed in 2006, advises the Board on emerging worldwide trends and, in 2011, considered implications of the World Outlook, the US/China relationship, cyber security and cyber warfare

Membership of the IAB is as follows

Lord Powell of Bayswater

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

Fernando Cardoso

Former President of Brazil and professor emeritus, University of São Paulo

Bernard Duc, CBE

Senior Partner HMI Ltd (Hong Kong), Chairman of the Rolls-Royce South East Asia Advisory Board

Sir Rod Eddington

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

Dr Fan Gang

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

Ambassador Hills

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

General Sir Mike Jackson

Former Chief of the General Staff, UK Ministry of Defence

Mustafa Koç

Chairman of Koç Holding, A Ş

Taizo Nishimuro

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

Lubna Olayan

CEO and Deputy Chairperson of the Olayan Financing Company

Eduardo Serra

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

Rair Simonyan

Chairman, Morgan Stanley, Russia, former first VP of Russian State oil company, Rosneft

Ratan Tata

Chairman of Tata Sons Limited

Matthias Wissmann

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

Lee Hsien Yang

Chairman, Fraser and Neave Limited

Ernesto Zedillo

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

The Group Leadership Team (GLT)

John Rishton, Chief Executive, chairs meetings of the GLT. The GLT acts as an important communications channel between the executive directors and the Group's senior managers. In addition to John Rishton, its other members are

Miles Cowdry

Director – Global Corporate Development

Kath Durrant

Director – Human Resources

James Guyette

President and Chief Executive Officer of Rolls-Royce North America Inc

Michael Hardinger

President – Rolls-Royce Deutschland Ltd & Co KG

Lawrie Haynes

President – Nuclear

Andrew Heath

President – Energy

Harry Holt

Director – Global Government Relations

Mark King

President – Civil Aerospace

Dan Korte

President – Defence Aerospace

Alain Michaelis

President – Gas Turbine Supply Chain & Deputy Chief Operating Officer

Mark Morris

Finance Director

Peter Morgan

Director – Corporate Affairs

John Paterson

President – Marine and Industrial Power Systems

Colin Smith

Director – Engineering and Technology

Mike Terrett

Chief Operating Officer

Robert Webb

General Counsel

Tony Wood

President – Marine

Chairman's introduction

Following the introduction of the UK Corporate Governance Code, I am pleased to be able to provide a fuller view of the operation of the Board and to confirm how the Company has met its obligations

The working of a Board cannot be captured and tabled by a 'standard' approach and this introduction, and the following pages, allied to the usual committees' reports, will I hope provide a clear insight into the corporate governance structure and practices of Rolls-Royce

The Board's committee structure has been reviewed during the year and due to the importance of safety in our business, both in terms of the safety of our products and the health and safety of our employees, the Board has agreed to the introduction in 2012 of a safety committee, which will be chaired by Sir Frank Chapman. The safety committee's terms of reference, once reviewed and approved by the Board, will be added to those of the other committees on the Group's website

In accordance with the provisions of the UK Corporate Governance Code (the Code), all Board directors are required to seek re-election at the AGM in 2012. Following the performance evaluation process, I am pleased to confirm that each of the non-executive director's performance and contribution continues to be timely, thoughtful, challenging and relevant. In addition, each has provided, and continues to provide, excellent commitment to the role, ensuring sufficient time is available for meeting preparation and non-scheduled meetings. However, I would advise that Sir Peter Gregson has decided to retire at the 2012 AGM and will not seek re-election

The Board continues to support our longest serving non-executive director, Peter Byrom, who has been a Rolls-Royce Board member since 1997. We are a complex and technologically advanced company with a long business cycle from the development of an engine to its eventual retirement, and the Board greatly values Peter's independent experience and his continuing contribution to debate. In supporting Peter, the Board has taken full account of the Code's requirement to consider carefully a non-executive director's independence where that director has served on the Board for more than nine years from the date of their first election

The Group values its communications with existing and potential shareholders who offer a rich and diverse source of capital to fund the future growth of the Group. Our engagement with shareholders is described in more detail on page 42

In 2011, the nominations committee commissioned an external review of the Board's effectiveness by JCA Partners LLP. I am very pleased to report that the review found that all members of the Board were united in believing the Board worked very well and that it is seen as an effective Board with a unity of purpose. The review is described in more detail in the nominations committee report on page 48

In September 2011, we issued our response to the Davies Report on women on boards confirming our support for the development of a diverse workforce. We govern this through our Global Diversity and Inclusion Steering Group, the membership of which includes main board directors and senior executives. The nominations committee discusses this topic regularly and expects to make demonstrable progress in this area by 2015

In this report, the Board has taken account of the concerns expressed by the Financial Reporting Review panel (February 2011) about how companies are reporting risks and the discussions of the Financial Reporting Council (FRC) summarised in 'Boards and Risk' (September 2011)

In December 2011, the Board received a detailed report from the risk committee (including a review of all internally significant risks), which, following discussion, confirmed and defined the Board's tolerance for risk, ensured all directors understood the Group's risk exposure and provided an impact review of potential changes in risk

We have therefore endeavoured to make sure that the risks we identify on pages 34 and 35 are indeed the key risks facing the Group, to ensure that we eliminate risks expressed in generic terms and to show how risks are managed. A description of our risk management process is set out in the risk committee report, detailed on page 51

In December 2011, the FRC published a paper entitled 'Developments in Corporate Governance 2011' in which it expressed concern about the level of reporting of the activities of a company's committees in the annual report, particularly the work of the audit committee. As a result, I have asked the committee chairmen to make personal reports in this year's Annual report in order to provide greater insight into committee work

In January 2012, the UK Government announced its intention to introduce reforms to the way directors' remuneration is set, approved and reported. At Rolls-Royce, we believe strongly in the alignment of executive rewards to the creation of long-term shareholder value. In the report by the chairman of the remuneration committee on pages 52 to 54 we have endeavoured to provide a clearer view of how we believe we achieve that and we will engage in a positive way with the proposals outlined by the UK Government

I believe that the strength of the Company's corporate values, its reputation and its ability to achieve its objectives are influenced by the effectiveness of the Company's approach towards corporate governance, which is why the Board will continue to attach the highest priority to its compliance with the Code's principles

Sir Simon Robertson
Chairman

UK Corporate Governance Code

The Code

In the year to December 31, 2011, the revised principles and provisions of the Code (published in May 2010 by the FRC) applied to the Company

A printed copy of the Code can be obtained free of charge from FRC Publications, 145 London Road, Kingston upon Thames, Surrey KT2 6SR – telephone +44 (0)20 8247 1264 and online at www.frcpublications.com

This report, which includes the Directors' remuneration report on pages 55 to 65, explains how the Company discharges its corporate governance responsibilities

The Board confirms that throughout 2011, the Company complied with the provisions of the Code, with the following exception

Code provision	Explanation
C.3.4 – The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters	The Board considered it appropriate that this provision of the Code be the responsibility of the ethics committee which refers matters of improprieties in matters of financial reporting to the audit committee

Board membership

The nominations committee monitors the composition and performance of the Board and the composition of its committees. During 2011, the Board's composition changed with the appointment of a new Chief Executive and two new independent non-executive directors. Following Andrew Shilston's retirement, the committee also agreed the proposed appointment of a new Finance Director. These appointments are discussed in more depth in the nominations committee report on page 48

Roles and responsibilities

Sir Simon Robertson, as Chairman of the Board of directors, is responsible for leadership of the Board and ensuring its effectiveness on all aspects of its role. John Rishton is the Chief Executive responsible for the leadership, operational and performance management of the Group, defined by the strategy and business plan agreed by the Board. The division of responsibilities between them is set down in writing and agreed by the Board and a copy of this document can be found on our website at www.rolls-royce.com. Iain Conn is the Company's Senior Independent Director

Role of the Board

The principal role of the Board is to ensure that the Group's strategy creates long-term success for the Group, within an acceptable risk profile, and providing value for the long-term investor

The Board retains responsibility for the approval of certain matters which affect the shape and risk profile of the Group, as well as items such as the annual budget and performance targets, the financial statements, payments to shareholders, major capital investments, substantial changes to balance sheet management policy and the strategic plan

The division of responsibilities between the Board and the executive team is set out in detail in a schedule approved annually by the Board, which also defines those decisions which can only be taken by the Board

The day-to-day running of the Group is delegated by the Board to the executive team under the leadership of John Rishton, the Chief Executive

To achieve its long-term success, the Board has set itself the following tasks to:

- ensure the development of the Group's strategy, together with monitoring of both its achievement and the Group's risk appetite,
- ensure the safety of its products and its people,
- uphold the values of the Group, including its brand and corporate reputation,
- oversee the quality and performance of management and ensure it is maintained at world-class standards, through effective succession planning and remuneration policies, and maintain an effective corporate governance framework, with transparent reporting

Directors' induction and training

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

Issues	Facilitated by
Operation of the Board and governance	Chairman and Company Secretary
Group strategy development and current issues	Chief Executive
Financial structure	Finance Director
Risk strategy	General Counsel
Operational strategy	Chief Operating Officer
Technology and engineering issues	Director – Engineering and Technology
Key site visits	Director – Engineering and Technology
Committee technical requirements	Committee chairman internal or external experts

Shareholder relations

Communications with shareholders regarding business strategy and financial performance are coordinated by a dedicated Investor Relations department that reports to the Finance Director. Communications regarding the general administration of shareholdings are coordinated by the Company Secretariat, reporting to the Company Secretary

The two primary written sources of information about the Group for shareholders are the website (www.rolls-royce.com) and the published Annual report, an online version of which is also available on the website. The website also carries a wealth of financial and other information about the Group that includes current business strategy, historical financial data, recent presentation materials as well as factual data about the Group's businesses, products and services

The Group conducts a dedicated investor relations programme with institutional investors which includes various formal events during the year, as well as a regular series of one-to-one and group meetings

The purpose of the events is to highlight a particular issue, theme or announcement that the Group believes warrants further explanation or clarification. The events also provide opportunities for shareholders to

meet members of the senior management team to discuss topics of interest. Examples of these events in 2011 were the preliminary and half-yearly results announcements, the AGM, the announcement of the intention with Daimler AG to acquire Tognum AG, the update given at the Paris Air Show on trends in the civil and defence aerospace businesses, the announcement with Pratt & Whitney to restructure the Group's participation in IAE and form a new joint venture, the annual investor briefing, visits to the Group's sites, and industry conferences.

The one-to-one and group meetings provide additional context around the Group's business strategy and financial performance such that shareholders are able to consistently and fairly value the Group's businesses. In 2011, around 350 meetings took place with 1,350 existing and potential institutional shareholders. Of those meetings, the Chief Executive attended over 50 meetings and the Finance Director 30 meetings. From a regional perspective, the majority of meetings took place in the UK (approximately 250) with over 500 investors. Forty meetings occurred in the USA involving 90 investors and a further 25 European meetings included around 55 investors.

As well as providing context and answering questions about the announcements during the year, the principal areas discussed with shareholders and potential investors were the Group's continued investment over decades in complex technology, people and infrastructure that creates high-cost barriers to entry, the breadth, balance and diversity of the product portfolio that underpins the resilient financial performance of the Group during this time of relative economic uncertainty, the scale of the record order book that provides opportunities for operational leverage, the importance of the Group's strong balance sheet, the potential impact of budgetary pressures, particularly in the defence aerospace business, development of the services model in the marine business, the options for future growth in the energy business and the initial views of the Chief Executive.

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

The Annual General Meeting (AGM)

This year's AGM will be held at 11.00am on Friday May 4, 2012 at the QEII Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE. The Notice of AGM and the Annual report will be available to view on the Group's website. Shareholders unable to attend the AGM are invited to vote on the business of the meeting by completing a proxy form and returning it to the Computershare Investor Services PLC (the Registrar). Following agreement to receive electronic communications, shareholders are able to vote online.

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

The Board

The Board met 12 times during the year, seven of which were scheduled. Five meetings were called at short notice to discuss such issues as the acquisition of Tognum AG, the provision of a new higher thrust version of the Trent XWB to Airbus for the A350-1000 and the agreement of a new joint venture with Pratt & Whitney to develop new engines for future generation mid-size aircraft. The attendance by individual directors at meetings of the Board and its committees in 2011 is shown in the table below.

Board and committee attendance 2011

	Board	Audit	Remuneration	Nominations	Ethics	Risk
Sir Simon Robertson (Chairman)	12(12)			3(3)		
Dame Helen Alexander	11(12)		5(5)	3(3)	3(3)	
Lewis Booth ¹	6(6)	2(2)		1(2)	2(2)	
Peter Byrom	11(12)			3(3)	3(3)	
Sir Frank Chapman ²	1(1)		0(1)	0(1)		
Iain Conn ³	9(12)	4(4)		3(3)		
Sir Peter Gregson	12(12)		4(5)	2(3)		
James Guyette	12(12)					2(2)
John McAdam	11(12)		5(5)	3(3)		
John Neill CBE	11(12)	4(4)		3(3)		
John Rishton	11(12)			3(3)		2(2)
Sir John Rose ⁴	4(4)			0(0)		0(0)
Andrew Shilston ⁵	12(12)					2(2)
Colin Smith	12(12)					2(2)
Ian Strachan	10(12)	4(4)		3(3)	3(3)	
Mike Terrett	12(12)					2(2)

Figures in brackets denote the maximum number of meetings that could have been attended (seven Board meetings were scheduled and five called at short notice). The figures include meetings of the former holding company Rolls Royce Group plc to May 23 2011.

¹ Lewis Booth was appointed as a non-executive director on May 25 2011.

² Sir Frank Chapman was appointed as a non-executive director on November 10 2011.

³ Iain Conn attended six out of seven scheduled Board meetings.

⁴ Sir John Rose retired as Chief Executive on March 31 2011.

⁵ Andrew Shilston retired as Finance Director on December 31 2011 and was replaced by Mark Morris who joined the Board with effect from January 1 2012.

There are currently 15 directors on the Board comprising the non-executive Chairman, the Chief Executive, four other executive directors and nine non-executive directors. Executive directors are employees who have day-to-day responsibilities as executives of the Group in addition to their duties as directors. Non-executive directors are not employees and do not participate in the daily business management of the Group. Each executive director receives a service contract on appointment and each non-executive director receives a letter setting out the conditions of his or her appointment (see pages 58 and 65, respectively, for further information).

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

Non-executive directors are appointed for an initial term of three years, which may be extended with the agreement of the Board, although reappointment is not automatic and their term of office is subject to annual re-election by shareholders at the AGM. Under Article 112 of the Company's Articles of Association, all directors (with the exception of Sir Peter Gregson) will offer themselves for re-election at the 2012 AGM.

The work of the Board in 2011

During the year, in addition to its routine business, matters considered by the Board included:

- an investment to create a replacement new disc facility at a site close to Sunderland,
- the resolution of the issues arising from the Qantas QF32 incident and lessons learned,
- the offer by Engine Holding GmbH, a joint venture with Daimler AG, to acquire the whole of the issued share capital of Tognum AG,
- the introduction and listing of a new holding company for the Group, Rolls-Royce Holdings plc,
- the impact on the Group's people, its operations and its suppliers of the earthquake in Japan,
- the withdrawal of support by the US Secretary of Defense of the F136 programme,
- plans to modernise the Group's IT infrastructure,
- development of a new higher thrust version of the Trent XWB for the Airbus A350-1000,
- the restructuring of the Group's participation in IAE with Pratt & Whitney, together with a new partnership for a joint venture to develop engines for future generation mid-size aircraft, and
- the effects of consolidation in the industry and the European sovereign debt crisis.

In addition, executive directors (and senior executives, as appropriate) supplied reports on business and financial performance together with regular updates on health, safety and the environment, IT infrastructure and disaster recovery arrangements, corporate governance, corporate affairs and quality and process excellence. All Board committee chairmen provided verbal reports on the activities of their committee at the next Board meeting. In September 2011, the Board held its annual day-long strategy meeting, which included discussions with the presidents of each of its business sectors and presentations on the ten-year financial plan, customer relations, delivery of the order book, technology acquisition and low-carbon technologies.

Independence of the non-executive directors

The Board applies a rigorous process in order to satisfy itself that its non-executive directors remain independent by reviewing the independence of the non-executive directors every year, based on the criteria in the Code. This review was undertaken in November 2011 and the Board concluded that all the non-executive directors were independent in character and judgement.

The Code does not consider the test of independence to be appropriate to the chairman of a company. However, Sir Simon Robertson did meet the Code's independence criteria upon his appointment as Chairman in January 2005. His other external commitments are described on page 38.

As referenced in the Chairman's introduction on page 41, the Board will again be asking shareholders to reappoint Peter Byrom as a director, even though he has served as a director of the Group since January 1, 1997.

Conflicts of interest

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

Indemnity

The Company has entered into separate Deeds of Indemnity in favour of its directors. The deeds provide substantially the same protection as that already provided to directors under the indemnity in Article 216 of the Company's Articles of Association. The Company has also reviewed, arranged and maintains appropriate insurance cover for any legal action taken against its directors and officers.

Board committees

The Board has established a number of committees, the principal ones being audit, remuneration, nominations, ethics and risk. A safety committee will also be established during 2012. Terms of reference for each committee are, or will be available, on the Group's website at www.rolls-royce.com. The membership, responsibilities and activities of these committees are described in this governance report on pages 46 to 65.

Executive committees

During the year, the governance structure of the group below Board level developed further with the establishment of the Executive Board as the primary channel for executive approval. The Executive Board, comprised of all executive directors, carries out a pre-approval review of those items requiring the approval of the Board and acts as the primary approval channel for matters below Board level, in accordance with the Group's delegated authorities manual. It establishes corporate priorities, assists the Board in the development of Group policy and strategy, decides on senior succession and makes recommendations to the nominations committee in relation to succession to the Executive Board itself and to the GLT.

At each meeting the Executive Board reviews the HS&E performance of the Group, considers customer relations, reviews financial and operational performance and receives an update on potential acquisitions and disposals.

The GLT, which generally meets immediately after the Executive Board meeting, receives an update from the Chief Executive on the work transacted at that meeting

The GLT's responsibilities are

- a) to provide input and advice to the Executive Board on policy and strategy,
- b) to discuss Group performance, and
- c) to act as an important communications forum between the executive directors and the Group's senior management

During the year, the GLT met on a face-to-face basis ten times and held regular catch up meetings by teleconference between each of its meetings. Like the Executive Board, it routinely considers the HS&E performance of the Group, customer relations and financial and operational performance at each of its formal meetings. In addition to its routine business, the committee received presentations on such subjects as the Group's anti-bribery and corruption programme, the introduction of worldwide all-employee global grading (together with the existing system of performance appraisal/management), government relations and product safety.

In addition to the Executive Board and the GLT, the Operations Executive, chaired by the Chief Operating Officer, considers detailed operational issues in its pursuit of world-class performance in terms of cost, quality and delivery. The Group's functions are placed under similar scrutiny by the Functional Executive chaired by the Finance Director. Each of the Group's business segments have their own governance structures which broadly mirror that of the holding company. Meetings at sector level generally take place a week ahead of the Executive Board and GLT meetings.

Report from Lewis Booth Chairman of the audit committee

I am pleased to present my first report describing the work of the audit committee, having taken on the role of chairman of the committee from July 31, 2011

I would like to acknowledge the work of my predecessor, Ian Strachan, who took the chair at short notice in October 2010, ensuring the committee maintained its critical appraisal. The results of the recent Board evaluation confirmed that the audit committee works well and has a good relationship with the finance function, which I intend to continue under my chairmanship.

Membership

The committee (consisting of non-executive directors) met four times in 2011 and attendance by the members is shown in the table on page 43.

During the year, KPMG (KPMG Audit Plc – the external auditors), the Head of Business Assurance and the General Counsel and Company Secretary attended the meetings, together with the Chairman of the Board, Chief Executive and Finance Director. Other Board members and/or senior executives attend meetings at my invitation.

The General Counsel, and the Head of Business Assurance, have direct access to the committee.

Responsibilities

The committee recommends the financial statements to the Board and reviews the Group's financial reporting and accounting policies, including formal announcements and trading statements relating to the Company's financial performance. It oversees the relationship with KPMG and the role and effectiveness of the internal audit function (business assurance). The committee reviews the Group's procedures for detecting, monitoring and managing the risk of fraud and the Group's internal controls and systems for assessing and mitigating risk.

The committee's terms of reference are available on the Group's website at www.rolls-royce.com.

The Board's review of the risk management process and its statement on internal control as required by the 'Turnbull guidance' is contained on page 69.

Work of the committee in 2011

Financial reporting

The committee reviewed the form and content of the Group's Annual report and financial statements, half-yearly results announcement and interim management statements. In conducting its reviews of these publications, the committee considered reports prepared by management, business assurance and the external auditor.

Amongst other things, these reports covered the key areas of judgement and sources of estimation uncertainty described in note 1 of the financial statements, such as long-term aftermarket contracts, the carrying value of intangible assets, including the forecasts on which these are based, post-retirement benefits, provisions, and contingent liabilities.

The focus at the meetings in February and July was on the Annual report and financial statements and half-yearly results announcement respectively, including the going concern statement therein. The May and November meetings reviewed the interim management statements and considered those matters which it was expected would require consideration at the following half year and full year.

Business assurance

In May and November, the Head of Business Assurance presented a summary of the reviews performed in the previous six months and the results of control self assessment returns from the businesses. The committee reviewed the effectiveness of the internal control environment and the progress on the phased increase in business assurance resources. It noted the introduction of audit committees at business sector level, attended by KPMG, to improve the governance structure and, at the November meeting, reviewed and agreed the work plan for 2012.

In February, the Head of Business Assurance tabled a report on the compliance with the Group's policies in respect of expenses incurred by the director's and other senior executives.

Auditors

KPMG presented its group audit strategy and plan and the proposed audit fee and in February, the committee reviewed the directors' representation letter to be given to KPMG in respect of the Annual report and considered the independence and objectivity of the auditors.

Non-audit fees

The committee reviewed non-audit fees charged by KPMG at each meeting and performed its annual review of the limits for pre-approval of non-audit fees.

Expenditure on audit and non-audit services is set out in note 7 to the financial statements.

Other matters

During the year, the committee received presentations on risk management from the Chief Information Officer and the President of the Gas Turbine Supply Chain. The committee reviewed and amended its own terms of reference including the removal of its oversight of the whistle-blowing policy. This will now be the responsibility of the ethics committee, subject to any financial irregularity being reported to the audit committee.

Private meetings

As part of the governance structure, during the year, the committee met with the Finance Director, KPMG and the Head of Business Assurance. In advance of each meeting, I also meet the lead audit partner in private.

Non-audit services provided by KPMG

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

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

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

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

Audit committee pre-approval – this is required for non-audit fees exceeding pre-determined thresholds which vary according to the nature of the service being proposed. As noted above, the audit committee reviews the level of non-audit fees at every meeting

External auditors' appointment

Annually, the committee reviews the effectiveness and performance of the external auditors with feedback from committee members, business assurance and group finance. The lead audit partner is required to rotate every five years and other key audit partners are required to rotate every seven years. The current lead audit partner has served four years of his term. No contractual obligations restrict the committee's choice of external auditors. The committee and the Board has recommended the reappointment of the existing auditors

Accordingly, resolutions to reappoint the external auditors, KPMG Audit Plc, and to authorise the directors to determine the auditors' remuneration, will be proposed at the AGM on May 4, 2012. I hope that you will vote in favour of the resolutions as the directors intend to do in respect of their own shareholdings

Lewis Booth*Chairman of the audit committee*

Report from Sir Simon Robertson Chairman of the nominations committee

My first priority is to ensure that Rolls-Royce has a strong leadership team

During 2010, the nominations committee was required to find a suitable successor to Sir John Rose as Chief Executive. Following a search process with the assistance of independent consultants, the committee unanimously agreed that John Rishton, who had already served as a non-executive director for the previous four years, had all of the necessary qualities to make a success of that role. John Rishton became Chief Executive at the beginning of April 2011 on John Rose's retirement.

During 2011, Andrew Shilston expressed his wish to retire as Finance Director at the end of the year. The committee believed strongly that the new Finance Director should know the business well and therefore ideally would be an existing employee. Mark Morris is an outstanding individual, having served the Group ably for many years across many disciplines, latterly as the Group Treasurer. Following leadership evaluations conducted independently by Korn Ferry and Egon Zehnder, the nominations committee recommended Mark's appointment, which was announced in September 2011. Mark was invited to attend Board meetings from the date of the announcement as part of his induction before formally taking up the post on January 1, 2012.

In addition, the committee recommended the recruitment of two new independent non-executive directors. An independent consultant, MWM Boardroom Consulting LLP, was appointed to conduct the search. The committee recommended a person of the highest calibre in Lewis Booth, the Chief Financial Officer of Ford Motor Company. Lewis was appointed to the Board on May 25, 2011 and, after the publication of the interim results in 2011, took over the chairmanship of the audit committee from Ian Strachan, who had taken over the role on a acting basis from John Rishton.

The second non-executive search conducted by MWM in the year was to find a non-executive who could fulfil a role as chairman of a new safety committee which the Board intends to form in 2012. We selected Sir Frank Chapman who has spent over 37 years in the oil and gas industry, the last 11 years as Chief Executive of BG Group (formerly British Gas plc). Frank joined the Board on November 10, 2011 and has an extensive engineering and technological background, and experience in a safety conscious industry.

During the year, the committee considered the tenure of office of the existing non-executive directors and discussed, at length, plans for an orderly succession to ensure the necessary skill sets continued to be represented on the Board, reflecting the increasing range and geographical spread of activities carried out by the Group.

The committee also invited the executive directors to attend one of its meetings in 2011 to discuss detailed succession plans for the executive directors and the GLT. The committee considered carefully arrangements to ensure that those executives identified as potential successors would receive suitable development opportunities to broaden their experience.

Following the publication of the Davies Report, the committee spent some considerable time looking at the composition of the Board and opportunities to increase diversity on the Board in its widest sense by considering a number of potential non-executives of high calibre who could clearly bring an additional dimension to Board debate. Rolls-Royce continues to be committed to developing a diverse workforce and equal opportunities for all, improving diversity at all levels of leadership and to making appointments based on merit at the most senior levels of our organisation. As already noted, the development of a diverse workforce and equal opportunities is governed through our Global Diversity and Inclusion Steering Group, membership of which includes Board directors and senior executives. We expect to make demonstrable progress in this area by 2015.

In support of our executive succession planning process, we continue to participate in the FTSE 100 Cross Company Mentoring Programme, the objective of which is to increase the pool of eligible senior female candidates for UK Board positions. We have also issued guidance to executive search companies outlining the importance of diverse candidate short lists.

In the autumn of 2011, JCA Partners LLP conducted a Board review which took the form of a facilitated self-evaluation by the Board. The review included confidential, unattributable, one-on-one interviews with each Board member, the incoming Finance Director and the HR Director which covered corporate governance, Board effectiveness, strategy development, risk management and Board and committee organisation, composition, operation and dynamics. All Board members unanimously agreed that the Board was working as an effective whole. The Board reviewed the way it had operated during the Qantas incident and conducted a thorough 'lessons learnt' exercise. Following the arrival of a new Chief Executive, and Finance Director, the Board is reviewing future key performance indicators and areas for discussion, which will enable it to assess how the agreed Group strategy is being executed. The Board is reviewing the committee structure to optimise its focus on safety. Also, the nominations committee will give increased focus to long-term succession planning for both executives and Board members.

The principal role of the committee is to consider, and recommend for approval to the Board, the appointment of suitable persons as directors of the Company and to lead the process for such appointments. The committee is also responsible for reviewing and overseeing senior management development to ensure orderly succession planning at, and immediately below, Board level. The full terms of reference for the committee are available on the Group's website at www.rolls-royce.com

During 2011, the committee met three times and details of the members who attended can be found in the table on page 43

In addition to the work described above, the committee also carried out the following tasks during the year

- reviewed its terms of reference,
- considered the independence of the non-executive directors,
- agreed to extend the terms of office of Peter Byrom and John Neill,
- dealt with the authorisation of potential conflicts of interest, reviewed such authorisations previously agreed by the Board and recommended their renewal,
- upon the resignation of the Company Secretary, recommended the appointment of an Acting Company Secretary,
- considered time commitments of non-executive directors who had declared additional directorships, and
- considered the content of this report

In conclusion, I would like to confirm that my first priority as chairman of the nominations committee and of the Board is to ensure that Rolls-Royce has a strong leadership team and it follows that the committee will continue to review, recommend and appoint the most able and appropriate candidates

Sir Simon Robertson

Chairman of the nominations committee

Report from Ian Strachan Chairman of the ethics committee

Conducting our business in accordance with the highest ethical standards is critical to the long-term success, profitability and prosperity of Rolls-Royce

The ethics committee was formed in 2008 and consists exclusively of independent non-executive directors. During 2011, the committee met three times and details of its membership and attendance can be found in the table on page 43. The Director of Risk, who had executive responsibility for ethics during the year, attended the meetings as did the General Counsel and Company Secretary. The Chairman of the Board, the Chief Executive, the Head of Business Ethics and the Chief Compliance Officer were also invited to attend meetings of the committee on a regular basis.

Responsibilities

The Board believes strongly that the Group's business should be conducted in a way that reflects the highest ethical standards and established the ethics committee to

- review compliance with the Group's Global Code, which sets out the principles and rules to be followed by employees when conducting business;
- review recommendations on ethical matters made by external regulatory authorities, or other bodies, and make recommendations to the Board about whether these should be applied to the Group; and
- monitor reports on issues raised through the Group's confidential reporting line and review the results of any subsequent investigations.

The full terms of reference for the committee are available on the Group's website at www.rolls-royce.com

The work of the committee during 2011

During the year, the committee received reports on the ethics and compliance programmes which continued the extensive activity undertaken in 2010. Reports were received on the following key topics:

Anti-bribery and corruption (ABC) compliance programme

In 2011, the Group reviewed its policies and procedures ahead of the introduction of the UK Bribery Act (the Act). This work included updating the Group's policies covering gifts and hospitality, as well as third party intermediaries and other related areas. The Company also created a compliance organisation, led by a Chief Compliance Officer, to oversee the introduction of the new procedures and to ensure staff received appropriate training. The Group was fully compliant with the new Act upon its introduction on July 1, 2011.

Use of third party intermediaries

At each meeting, the committee received reports upon the Group's use of third party intermediaries. The committee ensures that agreements with intermediaries are subject to strict and continual review. These reviews cover matters such as payments to intermediaries, their qualifications and the business case behind the necessity for their use.

Global Code and supporting policies

At the July and November 2011 meetings, the committee reviewed the Global Code, issued in 2009. Following internal and external scrutiny of its quality, which demonstrated that it continued to represent best-in-class standards, it was decided that the Global Code would not require a major update in 2012.

Nevertheless, the committee agreed that continued training and communications should take place to ensure the Global Code maintained a high profile across the organisation. New and updated policies in support of the Global Code were reviewed and endorsed. These included policies covering 'whistle-blowing', conflicts of interest and competitive intelligence. These policies, supported by appropriate training and communications activity, became effective during the year.

Confidential helpline reports

At each meeting the committee received reports on calls made to the confidential reporting line ('Tell Us') and the helpline ('Ask Us'). These reports summarised the trends in the numbers of contacts, including analysis by category of geographical spread and the outcomes of the investigations undertaken. Information on the nature of the higher risk cases was also reviewed.

Global Principles of Business Ethics for the Aerospace and Defence Industry

At its February 2011 meeting, the committee agreed that Rolls-Royce should sign a statement of the Global Principles of Business Ethics for the Aerospace and Defence Industry. As a signatory, the Group has committed to follow programmes and policies that foster ethical business conduct. More information about the Global Principles can be found at www.ifbec.info.

The committee believes that Rolls-Royce maintains an environment in which all employees understand the standards of behaviour expected of them and feel able to report any suspected breaches of the Global Code and that conducting business in accordance with the highest ethical standards is critical to the long-term success, profitability and prosperity of Rolls-Royce.

Ian Strachan

Chairman of the ethics committee

Report from John Rishton Chairman of the risk committee

We have a well established approach to risk management

The risk committee is responsible for developing and, following Board review and approval, implementing the Group's risk management strategy and mitigation policy. Its full terms of reference can be found on our website at www.rolls-royce.com. All of the executive directors are members of the committee and, during the year, the Director of Risk, the General Counsel and Company Secretary and all of the members of the GLT attended the meeting. In 2011, the committee met twice and details of the members who attended can be found in the table on page 43.

The committee has noted the challenges made by the Financial Reporting Review Panel (February 2011) as well as the recent summary on 'Boards and Risk' issued by the FRC (September 2011). We have made a number of improvements in this area over the year, including expanding our employee training and enhancing our focus in the Asia-Pacific region.

Work of the committee during the year

In 2011 the committee continued to discuss and agree proposed additions, deletions and amendments to the top level corporate risk register and considered the mitigation of those risks. This is the committee's principal item of business at each meeting.

At its meeting in June 2011, the Director of the Product Introduction and Lifecycle Management (PILM) programme gave a presentation on the PILM process, which applies across all product programmes covering all of our business sectors and geographical locations. The committee also reviewed an initiative to improve the Group's intelligence on political and country risks as it enters new territories. In addition, it discussed the Group's preparedness in respect of business continuity and crisis management.

In November 2011, the committee considered a report from the Director of Security on data privacy. In addition, it reviewed the Group's insurance programme. It also reviewed and recommended certain minor changes to its terms of reference. The committee also considered the format of its annual report on risk to the Board which

- set out the significant risks that it considered might have a financial or reputational impact to the Group and described the associated plans to manage/mitigate the risks, described changes that had been made to the nature and extent of risks since 2010,

- illustrated the movements in the Group's risk profile over the past five years,
- described improvements that had been made to the risk process, tools and reports,
- reported on the status of the business continuity programme, and
- provided an overview of the Group's insurance programmes.

As noted in the Chairman's introduction, the Board, with the assistance of the risk and audit committees, has determined the Group's approach to the management of risk. The committee ensures all of the risks on the register are discussed at Board meetings, either in the normal course of business or through specific reports. The Group's key risks and uncertainties are described in the table on pages 34 and 35, together with highlights of how the risk will be managed.

Risk management

We recognise that managing risks is a vital part of delivering our business results. Risks are defined as threats to the achievement of business objectives or to the continuing reputation of the Group and may arise from a variety of internal or external sources. Our managers are responsible for applying the global risk policy in their day-to-day management activities and promoting a culture of learning from and sharing prior experience within their teams. The quality of decisions is improved by employees taking responsibility for communicating key risks to appropriate levels of management.

The risk policy and risk management process form a key element of the Group's internal control system. The structured process is used to identify, assess, communicate and manage risks at all levels of the organisation, aided by an enterprise-wide software solution. A dedicated enterprise risk management team, now reporting to the General Counsel, is responsible for disseminating the risk management process and tools throughout the organisation. A global network of risk champions, mentors and facilitators helps share and embed best practice.

The top level corporate risk register reflects the outcomes of business unit, programme and function risk reviews. Risks and associated actions are owned by a senior executive, reviewed and discussed by the risk committee and communicated to the Board. The risk management process is continually improving and has been in place throughout 2011 and up to, and including, the date of approval of this Annual report.

The Board's review of the risk management process and its statement on internal control as required by the 'Turnbull guidance' is contained on page 69.

John Rishton

Chairman of the risk committee

Report from Dame Helen Alexander Chairman of the remuneration committee

Our commitment remains to align pay with performance

Rolls-Royce has followed a consistent strategy towards executive remuneration over many years. We believe that a significant proportion of senior executives' remuneration should be made up of performance-related incentives so that overall reward is closely aligned to the creation of long-term stakeholder value. These principles are well-established in Rolls-Royce. In our report this year, we are showing the link between performance and remuneration in Rolls-Royce even more clearly.

Base salaries

Base salaries are set by the committee at levels required to recruit and retain high quality senior executives with reference to the marketplace for companies of similar size, global reach and complexity, taking account of pay elsewhere in the Group. Salaries are set annually on March 1 with performance taken into account.

Annual bonus outcome 2011

It is an important principle of the Rolls-Royce executive bonus arrangements that no bonus can be paid to anyone unless the entire Group has achieved the financial targets set by the committee. During 2011, the Group delivered 21 per cent growth in underlying profit before tax and, before the cost of acquisition and foreign exchange translation effects, a net cash inflow of £210 million. This strong performance was achieved in challenging economic circumstances whilst maintaining the long-term investment programmes needed to deliver our record order book and future growth.

The committee is satisfied that the annual bonus outcome for the executive directors for 2011 appropriately reflects these results and the significant value delivered to all stakeholders.

For executive directors, 40 per cent of the bonus is delivered in deferred shares which must be held for a period of two years.

2011 PERFORMANCE

Underlying profit before tax (£m)

+21%
▲

Order book (£bn)

+5%
▲

Performance Share Plan (PSP) outcome 2009-2011

The long-term incentive plans at Rolls-Royce are designed to reward long-term value creation, are calculated over three years and measured against Total Shareholder Return (TSR), earnings per share and cash generation. Against all these measures Rolls-Royce has performed well. The Rolls-Royce share price, for example, has increased by 187 per cent between March 10, 2009 (date of grant for the 2009 PSP award) and December 31, 2011, compared to an increase in the FTSE 100 index over the same period of 58 per cent. This has benefited all Rolls-Royce shareholders including many employees. We have arrangements such as ShareSave which we put in place specifically to encourage employees to have a long-term interest in our success. The March 2009 PSP award was made on the basis of a share price of 260.42 pence. By the close of the three-year performance period in December 2011 the share price had increased to 746.50 pence.

The following chart tracks the value of £100 invested in Rolls-Royce shares (to be clear, without taking account of dividends) versus the FTSE 100 index from January 1, 2009 to December 31, 2011, in line with the performance period for the March 2009 PSP award.

LONG-TERM PERFORMANCE**Rolls-Royce versus FTSE 100 TSR growth in each performance year**

	FTSE 100	Rolls Royce
2009	 +14%	 +41%
2010	 +19%	 +37%
2011	 +1%	 +13%

Rolls-Royce TSR over the ten-year period to December 31, 2011 was 372 per cent. Only 69 of the companies which made up the FTSE 100 at the beginning of that period are still trading independently and the median TSR amongst these 69 companies over the same ten-year period is 30 per cent.

Total returns over the period to December 31, 2011

	FTSE 100	Rolls-Royce
Last year	1%	13%
Last 3 years	30%	116%
Last 5 years	4%	71%
Last 7 years	48%	217%
Last 10 years	30%	372%

Over the three-year performance period for the 2009 PSP grant, our performance in terms of cash flow and earnings per share was sufficient to release 100 per cent of the conditional shares originally granted. The Company's TSR was eighth in the FTSE 100 over the three-year performance period. This TSR performance triggers an increase of 50 per cent in the shares released to executive directors and other members of the GLT and an increase of 25 per cent for other executives. The value of the shares vesting under the PSP scheme for the three-year performance period to the end of December 2011 has been estimated using the share price as at December 31, 2011 (the actual value will depend on the share price at the vesting date in March 2012). Executives must retain 50 per cent of the shares they receive under the scheme until they retire from the Company or achieve a minimum shareholding requirement which is 200 per cent of salary for the Chief Executive or 150 per cent for other executive directors. This ensures the directors have a personal financial interest in the long-term success of the business.

Remuneration and opportunities for other employees

All employees worldwide have the opportunity to benefit from our success through participation in our global bonus and share plans. All employees who were with us throughout 2011 will be receiving a bonus of at least two weeks' pay as a result of our 2011 performance. More than a third of our employees currently participate in our global ShareSave plan. More than 6,000 participate in our SharePurchase and ShareBonus plans which allow employees to purchase shares on a regular basis and to convert bonus payments into shares. It is worth noting that Rolls-Royce employees also enjoy competitive salaries, benefits and career opportunities which are made possible through the Group's robust performance in recent years.

The work of the committee during 2011

In February 2011, the committee endorsed the outturn for bonus and long-term incentive plans. It also considered a benchmarking report by Deloitte LLP and assessments of performance before approving salary increases for senior executives. The committee approved the terms for the appointment of the Group HR Director and considered a draft of the Directors' remuneration report which it agreed to recommend to the Board for approval.

In May, the committee selected the Organisation for Economic Cooperation and Development (OECD) index of consumer prices as a measure of the earnings per share (EPS) growth hurdle for the PSP 2011 grant. In 2011, it was confirmed that the personal element of management bonuses would be based on overall performance development ratings rather than on the achievement of specific performance objectives, thereby strengthening the link between overall performance and reward. The committee also agreed the basis for the launch of the 2011 ShareSave offer.

In September, the committee considered the principles to be applied when setting bonus targets and discussed, in particular, whether the cash hurdle could be refined. It also considered the terms of appointment for the new Finance Director. Shareholders are asked to note that in line with the policy applied elsewhere in the Group, the Finance Director's salary has been set at a level which is at the lower end of a market competitive range, allowing headroom for future performance-related growth.

In November, the committee discussed the Department of Business Innovation and Skills (BIS) consultation paper referred to above and agreed its response. It also reviewed the 'Principles of Remuneration' issued by the Association of British Insurers (ABI) in September 2011 and resolved to make every effort to ensure it complied with its overarching principles.

In December, the committee considered the nature of the bonus and PSP targets to be set for 2012. The committee discussed the methodology applied by Deloitte LLP when benchmarking senior executive salaries against current market practice.

Directors' remuneration report

This year's remuneration reflects a strong performance against all measures of success. Rolls-Royce has achieved record underlying revenues, underlying profits, and has a record order book which should ensure that the business will remain strong for many years to come. We support the clear message on executive remuneration sent by BIS in the UK that 'generous rewards for leading executives are not an issue where executive remuneration is well-structured, clearly linked to the strategic objectives of a company, and which rewards executives that contribute to the long-term success of that company'. The committee's view is that the performance of the Group, backed by the growth in the Rolls-Royce share price in recent years, warrants the rewards which our executives will receive in 2012.

Dame Helen Alexander

Chairman of the remuneration committee



Directors' remuneration report

Membership of the remuneration committee

The remuneration committee, which consists entirely of non-executive directors, met five times in 2011 and details of those members attending can be found in the table on page 43. Peter Byrom retired as a member of the remuneration committee on February 8, 2011. He continued to attend meetings by invitation. Sir Frank Chapman was appointed as a member of the committee on November 10, 2011. Sir Simon Robertson, Chairman, John Rishton, Chief Executive, the Director – Human Resources, the HR Director – Performance, Reward and Recognition and the General Counsel and Company Secretary routinely attended the meetings and the committee invited the Finance Director to attend for certain items of business. None of these executives were present during any discussion of their own emoluments.

Responsibilities

The committee is responsible for making recommendations to the Board on the Group's policy regarding executive remuneration and determines, on the Board's behalf, the specific remuneration packages of the Chairman, the executive directors and a number of senior executives.

The main components of remuneration

The main components of remuneration for all executives worldwide comprise base salary, annual incentive arrangements, share-based long-term incentives and benefits. Executives are also entitled to participate in all-employee share plans.

Component	Summary	Time frame	Main features
Base salary	Set by the committee at levels required to recruit and retain high quality senior executives with reference to the marketplace for companies of similar size, internationality and complexity and taking account of pay elsewhere in the Group. Set with reference to the median of market practice.	Not applicable	Normally set annually on March 1. Performance is taken into account.
Annual Performance Related Award plan (APRA)	Annual incentive. Measures set by the committee based on underlying profit, cash flow and individual objectives and performance. Strong link between performance and remuneration. Promotes share ownership and encourages decisions in the long-term interest of shareholders.	One year plus two year deferred element	Compulsory deferral of 40 per cent of bonus into shares. Bonus potential: – for on target performance – 75 per cent of salary for executive directors, and 81 per cent for Chief Executive. – for maximum performance – 125 per cent of salary for executive directors, and 135 per cent for Chief Executive. Bonus can be increased by up to 20 per cent to reflect exceptional personal performance. Shares vest after two years subject to continued employment.
Performance Share Plan (PSP)	Share-based long-term incentive. Conditional on corporate performance. Measures based on Cash Flow Per Share (CPS), TSR and an underlying earnings per ordinary share hurdle (EPS).	Three years	50 per cent must be held until retirement or the minimum shareholding requirement is met. Potential: – for maximum CPS performance – 100 per cent of salary for executive directors and 120 per cent for Chief Executive. – for maximum CPS and TSR performance – 150 per cent of salary for executive directors and 180 per cent for Chief Executive. Shares vest after three years provided performance criteria are met.
All-employee share plans	ShareSave Plan – a savings-related share option plan available to all employees allowing purchase of shares at a discount to the share price at date of grant. 'Free Share' element of the Share Incentive Plan (SIP) where UK employees receive shares as part of any bonus paid. 'Partnership Share' element of the SIP under which UK employees may make regular purchases of shares from pre-tax income.	Not applicable	ShareSave options may be exercised in three or five years from the date of grant. Shares under the SIP vest after five years free from income tax and national insurance.

In addition to the above, pension and other benefits, which are competitive in local markets, are provided.

A copy of the committee's terms of reference is available on the Group's website at www.rolls-royce.com.

Advice to the committee

During 2011, the committee had access to advice from:

- Deloitte LLP¹,
- Kepler Associates, and
- Freshfields Bruckhaus Deringer LLP, the Company's lawyers.

¹ Deloitte LLP advised the Group on tax, assurance, pensions and corporate finance and Deloitte MCS Limited provided consulting services.

The remuneration policy framework

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

Accordingly, we remain committed to a remuneration policy which, whilst sufficiently flexible to take account of future changes in the Group's business environment and in remuneration practice, will continue to reflect the following broad principles

- the remuneration of executive directors and other senior executives should reflect their responsibilities and contain incentives to deliver the Group's performance objectives without encouraging excessive risk taking,
- remuneration must be capable of attracting and retaining the individuals necessary for business success,
- total remuneration should be based on Group and individual performance, both in the short and long term,
- the system of remuneration should establish a close identity of interest between senior executives and shareholders through measures such as encouraging the senior executives to acquire shares in the Company. Therefore, a significant proportion of senior executive remuneration will comprise share-based long-term incentives, and
- when determining remuneration, the remuneration committee will take into account pay and employment conditions elsewhere in the Group

The committee reviews regularly both the competitiveness of the Group's remuneration structure and its effectiveness in incentivising executives to enhance value for all stakeholders over the longer term

Base salaries

The committee has commissioned a range of salary benchmarks from Deloitte LLP. The benchmarks have been prepared using their company size and complexity methodology.

All salary increases must be justified on the basis of performance and are not automatic. The committee is informed of pay and conditions elsewhere in the Group and these are taken into account in determining remuneration for the executive directors.

Annual incentives

Executive directors and selected senior executives participate in APRA. For UK participants, APRA awards do not form part of pensionable earnings.

Target and maximum APRA bonus opportunity

The committee considers that there should be a continuing emphasis on those at-risk elements of remuneration, such as annual and long-term incentives, which directly influence the performance of senior executives. For the Chief Executive, a 162 per cent maximum bonus opportunity means that 62 per cent of combined basic pay and bonus opportunity is directly related to annual financial and personal performance.

Under APRA as operated in 2011, executive directors were eligible for awards in accordance with the table below.

	Target bonus (as a % of salary) ¹	Maximum bonus (as a % of salary) ¹
James Guyette	75	125
John Rishton	81	135
Andrew Shilston	75	125
Colin Smith	75	125
Mike Terrett	75	125

¹ It is possible for a bonus award to be increased by a further 20 per cent to reflect exceptional personal performance. Therefore the overall maximum was 162 per cent for the Chief Executive and 150 per cent for the other executive directors.

The committee has determined that the bonus in respect of 2012 will be operated on substantially similar terms to 2011 except that access to bonus earned through profit performance will now be determined by cash flow based on a linear scale rather than by an all-or-nothing hurdle. The committee is mindful of corporate, environmental, social and governance risks when setting personal objectives. There will be no change to the maximum bonus opportunities for executive directors.

APRA performance measures

For 2011, the performance targets operated so that three Group underlying profit targets were set in respect of bonus levels as follows:

	(% of maximum)
Base	30
Stretch (1)	60
Stretch (2)	100

The bonus payable was also subject to a cash flow hurdle.

For 2011, the performance outturns which resulted in the APRA bonus outturns were as follows:

Cash flow hurdle	Cash flow* for the year was £216 million which exceeded the cash flow hurdle.
Group underlying profit	Group underlying profit* was £1,119 million which exceeded the Base and the Stretch (1) target but was less than the Stretch (2) target. The performance resulted in achievement of 90 per cent of the maximum.

* Cash flow and Group underlying profit are prior to the impact of unbudgeted acquisition adjustments and exclude the effect of unbudgeted foreign exchange translation where material.

Deferred APRA

For executive directors and other senior executives, 40 per cent of APRA is delivered in the form of a deferred share award in the Company's shares. For other participants in APRA, 33 per cent is delivered in the form of deferred shares. Details of deferred shares held under the plan are shown in the table on page 63.

A participant who is granted a deferred share award under APRA must normally continue to remain an employee of the Group for two years from the date of the award in order for the shares to vest, although shares will be released early in certain circumstances including retirement or redundancy.

The value of any deferred share awards is derived from the annual bonus criteria and is therefore dependent on personal and business financial performance. This arrangement provides a strong link between performance and remuneration, promotes a culture of share ownership amongst the Group's senior management and encourages decisions in the long-term interest of shareholders.

Other annual incentives

The same financial targets as set for APRA are used for the Managers' Bonus and All-Employee Bonus Scheme (AEBS). The Managers' Bonus typically enables managers worldwide to receive a bonus of up to ten per cent of pay and the AEBS up to two weeks' pay, based on corporate and business performance. Participants in APRA or the Managers' Bonus do not participate in the AEBS.

PSP

The PSP is designed to reward and incentivise selected senior executives who can influence the long-term performance of the Group. The size of awards under the PSP take into account competitive levels within the marketplace for UK companies of a similar size and complexity to the Group. In 2011, John Rishton received a conditional award of shares with a market value at the time of grant of 120 per cent of his annual salary prorated to his date of appointment as an executive director on March 1, 2011. He also received a special award detailed on page 65. The 2011 grant for other executive directors was 100 per cent of their annual salary, for business heads 80 per cent, and 65 per cent for other members of the Group Leadership Team.

Under the rules of the PSP selected senior executives are granted conditional share awards entitling them to a number of shares determined by reference to corporate performance over a three-year performance period. The measures of corporate performance are CPS, EPS and TSR. These measures are considered particularly important in generating shareholder value and are explained in more detail in the following table. There is no retesting of the performance criteria and no automatic vesting in the event of a takeover. In the three-year period to December 31, 2011, the Company's financial and TSR performance generated 100 per cent of the number of shares conditionally granted in 2009.

Performance measures

Vesting criteria	Purpose of the measure	Performance condition over three-year period
EPS growth	Hurdle to ensure any payouts are supported by sound profitability	If EPS growth exceeds the hurdle the number of shares vesting will be determined in accordance with the CPS targets. If EPS growth does not exceed the hurdle – zero vesting.
Aggregate CPS	Incentivise generation of cash flow in line with the Group's strategy	Below threshold cash flow target – zero vesting. Threshold cash flow target – 30 per cent vesting. Vesting will increase on a straight-line basis between 30 per cent and 100 per cent.
TSR performance against FTSE 100 index	Align interests with shareholders by rewarding out-performance of FTSE 100 returns	50th percentile (median) and below – no additional vesting. Above 50th percentile (median) – vesting will be enhanced by 25 per cent. For executive directors and selected senior executives a straight-line basis will operate from 25 per cent to 50 per cent enhancement for upper quartile TSR performance.

The profit hurdle for the 2012 grant will require EPS to show real growth by exceeding the OECD index of consumer prices.

The following CPS targets will apply to the grants to be made in 2012

Aggregate CPS over three-year performance period	Percentage of maximum award released
56p	30
83p	100

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

PSP awards granted in 2012

For 2012, the size of awards under the PSP will be unchanged from 2011 (except for the additional special award made to John Rishton on his appointment) and will be as follows:

	PSP award (as a % of salary)	PSP award maximum (as a % of salary)
James Guyette	100	150
Mark Morris	100	150
John Rishton	120	180
Colin Smith	100	150
Mike Terrett	100	150

Share retention policy

The committee believes it is important that the interests of the executive directors should be closely aligned with those of shareholders. The deferred APRA award and the PSP provide considerable alignment. However, participants in the PSP are also required to retain at least one half of the number of after tax shares released from the PSP, until the value of their shareholding reaches 200 per cent of salary for the Chief Executive and 150 per cent for other executive directors. When this level is reached, it must be retained until retirement or departure from the Group. Details of the executive directors' share interests are set out on pages 61 to 65. The current executive directors have each complied with the minimum shareholding requirement.

All-employee share plans

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

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

Benefits

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

Service contracts

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

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

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

	Date of contract	Unexpired term	Notice period Group	Notice period Individual
James Guyette	29 September 1997	Indefinite	30 days ¹	30 days
Mark Morris	1 January 2012	12 months	12 months	6 months
John Rishton	10 March 2011	12 months	12 months	6 months
Colin Smith	1 July 2005	12 months	12 months	6 months
Mike Terrett	1 September 2007	12 months	12 months	6 months

¹ James Guyette has a contract with Rolls-Royce North America Inc., drawn up under the laws of the State of Virginia, US. It provides that, on termination without cause, he is entitled to 12 months' severance pay without mitigation and, in addition, appropriate relocation costs.

External directorships of executive directors

During 2011, James Guyette was chairman of PrivateBancorp Inc. and a director of priceline.com Inc. Andrew Shilston was appointed as a non-executive director of Circle Holdings plc on August 5, 2011. In each case the director retained the relevant fees from serving on the boards of these companies, as shown in the table below.

External directorship fees

	Payment received £000
James Guyette ^{1,2}	102
Andrew Shilston	16

¹ James Guyette was paid in US dollars translated at £1=US\$1.6037.

² In addition to an annual fee, James Guyette received 3,621 Restricted Stock Units (RSUs) at US\$13.81 per share in PrivateBancorp. During 2011, 3,651 RSUs vested. He was granted 366 shares of restricted stock at US\$464.79 per share in priceline.com. During 2011, 832 shares of restricted stock vested at US\$469.13 per share and 333 shares of restricted stock vested at US\$464.79 per share.

TSR over five years

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

The graph shows the plc growth in value of a hypothetical £100 holding in Rolls-Royce Holdings plc (previously Rolls-Royce Group plc) ordinary shares over five years, relative to the FTSE 100 index. The values of the hypothetical £100 holdings at the end of the five-year period were £194.00 and £107.90 respectively.

Directors' remuneration report**Directors' aggregate emoluments (audited)**

The individual directors' emoluments are analysed as follows

	2011					2010
	Basic salary/fees £000	Annual Bonus (APRA) ¹ £000	Cash allowance ² £000	Taxable benefits ³ £000	Aggregate emoluments ⁴ £000	Aggregate emoluments ⁴ £000
Executive directors						
James Guyette ⁵	499	561	–	64	1,124	1,120
John Rishton ⁶	739	898	125	148	1,910	69
Sir John Rose ⁷	217	–	–	9	226	2,299
Andrew Shilston ⁸	580	657	–	18	1,255	1,308
Colin Smith	455	546	114	20	1,135	1,027
Mike Terrett	543	619	–	115	1,277	1,270
	3,033	3,281	239	374	6,927	7,093
Non-executive directors						
Dame Helen Alexander	74	–	–	–	74	67
Lewis Booth ⁹	44	–	–	–	44	–
Peter Byrom	60	–	–	–	60	55
Sir Frank Chapman ¹⁰	11	–	–	–	11	–
Iain Conn	72	–	–	–	72	65
Sir Peter Gregson	60	–	–	–	60	55
John McAdam	60	–	–	–	60	55
John Neill CBE	60	–	–	–	60	55
Sir Simon Robertson	370	–	–	15	385	386
Ian Strachan	86	–	–	–	86	71
	3,930	3,281	239	389	7,839	7,902

¹ For executive directors, 60 per cent of APRA is delivered in cash and 40 per cent is delivered in the form of a deferred share award. Shares forming part of the bonus under APRA have been valued at the date of award. The Trustee will acquire the required number of shares at the prevailing market price by March 31, 2012.

² Colin Smith received a cash allowance in lieu of future pension accrual. John Rishton received employer contributions into the executive defined contribution pension arrangement restricted to the annual allowance limits with any excess paid as a cash allowance.

³ Taxable benefits may include the following: a car or car allowance; the use of a driver; private medical insurance and financial counselling; in the case of James Guyette, a housing allowance and club membership fees; in the case of John Rishton, the figure above includes school fees (for one school term following his appointment) paid on his behalf and the tax charge on that benefit paid by the Group; in the case of John Rishton and Mike Terrett, the figure in the above table includes additional housing costs paid on their behalf and the tax charge on that benefit paid by the Group.

⁴ Aggregate emoluments exclude pensions contributions. Details of the directors' pensions are set out on pages 60 and 61.

⁵ James Guyette was paid in US dollars translated at £1 = US\$1.6037.

⁶ John Rishton was appointed as an executive director on March 1, 2011.

⁷ Sir John Rose retired as an executive director on March 31, 2011.

⁸ Andrew Shilston retired as an executive director on December 31, 2011.

⁹ Lewis Booth was appointed as a non-executive director on May 25, 2011.

¹⁰ Sir Frank Chapman was appointed as a non-executive director on November 10, 2011.

Payments made to former directors of the Company (audited)

John Cheffins retired from the Board on September 30, 2007. He has continued in his role as Chairman of Rolls-Royce Fuel Cell Systems Limited and provided non-executive advice to the energy business. He was paid £47,617 and benefits totalling £4,770 in 2011 (paid in Canadian dollars translated at £1 = CAD\$1.5862). Dr Mike Howse retired from the Board on June 30, 2005. He has continued to be retained by the Group for his expertise in engineering and was paid £34,650 in 2011.

Pensions (audited)

The Group's UK pension schemes are funded, registered schemes and were approved under the regime applying until April 6, 2006. They include defined benefit pension schemes, providing at retirement, a pension of up to two thirds of final remuneration, subject to HM Revenue & Customs limits.

Sir John Rose retired on March 31, 2011 and was already in receipt of his pension. John Rishton was appointed to the Board on March 1, 2011 and received employer contributions into the executive defined contribution pension arrangement restricted to the annual allowance limits with any excess paid as a cash allowance. The cash allowance is calculated as equivalent to the cost of the pension contributions allowing for national insurance costs.

Andrew Shilston was a member of one of the Group's UK pension schemes until his retirement on December 31, 2011. He was also a member of the Rolls-Royce Supplementary Retirement Scheme (the Scheme). The purpose of the Scheme is to fund pension provision above the pensionable earnings cap which was imposed on approved pension schemes by the 1989 Finance Act. Membership of the Scheme is restricted to executive directors and to a limited number of senior executives. Employer contributions to the Scheme during 2011 have been added to the increase in transfer value over 2011 for the registered defined benefit plans, and are therefore included in the figures shown in the final two columns of the first table below. Andrew Shilston was replaced on the Board by Mark Morris with effect from January 1, 2012. His pension disclosures will be reported in the 2012 Annual report.

Mike Terrett opted out of future pension accrual with effect from April 1, 2006 and started to receive his pension from November 1, 2009. Since starting to receive his pension, he does not accrue any further pension benefit or allowance in lieu of pension benefit from his ongoing employment with the Group.

Colin Smith opted out of future pension accrual with effect from April 1, 2006. He receives a cash allowance in lieu of future pension accrual. Had he elected to continue to accrue pension the estimated cost of that accrual would be higher than the cash allowance being paid in lieu.

James Guyette participates in pension plans sponsored by Rolls-Royce North America Inc. He is a member of two defined benefit plans in the US, one qualified and one non-qualified. He accrues a retirement lump sum benefit in both of these plans. The aggregate value of the retirement lump sums accrued in these two plans, and the transfer values of these benefits, are shown in the second table below. In addition, James Guyette is a member of two 401(k) Savings Plans in the US, one qualified and one non-qualified, to which both he and his employer, Rolls-Royce North America Inc., contribute. He is also a member of an unfunded non-qualified deferred compensation plan in the US, to which his employer makes notional contributions. Employer contributions to these three plans during 2011 have been added to the increase in transfer value over 2011 for the defined benefit plans, and are therefore included in the figures shown in the final two columns of the second table below.

The transfer values in the tables below have been calculated on the basis of actuarial advice.

Details of the pension benefits, which accrued over the year in the Group's registered UK defined benefit pension scheme¹, are given below:

	Increase in accrued pension during the year ended Dec 31 2011 £000pa	Increase/decrease in accrued pension during the year ended Dec 31 2011 ² £000pa	Total accrued pension entitlement at the year ended Dec 31 2011 ³ £000pa	Transfer value of accrued pension as at Dec 31 2011 ⁴ £000	Transfer value as at Dec 31 2010 of accrued pension at that date ⁵ £000	Increase in transfer value over 2011 net of the member's own contributions £000	Transfer value of increase/decrease in accrued pension over 2011 net of the member's own contributions ⁵ £000
Sir John Rose ⁶	4	(10)	457	10,457	8,828	1,629	(199)
Andrew Shilston ⁷	3	2	20	575	412	327	233
Colin Smith	42	34	302	6,002	4,467	1,535	613
Mike Terrett	1	(6)	241	5,666	4,739	927	(119)

	Increase in accrued retirement lump sum during the year ended Dec 31 2011 £000pa	Increase in accrued retirement lump sum during the year ended Dec 31 2011 ² £000pa	Total accrued retirement lump sum entitlement at the year ended Dec 31 2011 ³ £000pa	Transfer value of accrued retirement lump sum as at Dec 31 2011 £000	Transfer value as at Dec 31 2010 of accrued retirement lump sum at that date £000	Increase in transfer value over 2011 net of the member's own contributions £000	Transfer value of increase in accrued retirement lump sum over 2011 net of the member's own contributions ⁵ £000
James Guyette ⁸	125	92	965	965	839	520	486

¹ Members of the schemes have the option to pay Additional Voluntary Contributions. Neither the contributions nor the resulting benefits are included in the above table.

² This column shows the increase/decrease in pension/retirement lump sum during the year ended December 31 2011 but in this case excluding the effect of inflation.

³ The pension entitlement shown is that which would be paid annually on retirement, based on service to the end of the year or to April 1 2006 for members with enhanced protection from A day. For Sir John Rose and Mike Terrett, the pension shown is the annual pension in payment at December 31 2011.

⁴ The transfer values stated represent liabilities of the Rolls-Royce sponsored pension schemes and are not sums paid to the individuals. The transfer values of the accrued pensions as at December 31 2010 and December 31 2011 have been calculated on a basis adopted by the trustees on October 6, 2008 following receipt of actuarial advice.

⁵ This column shows the transfer value of the increase/decrease in pension/retirement lump sum during the year ended December 31 2011 excluding the effect of inflation and net of the member's own contributions.

⁶ Sir John Rose retired as an executive director on March 31 2011.

⁷ Andrew Shilston retired as an executive director on December 31 2011.

⁸ The lump sum entitlement shown is that which would be paid on immediate retirement based on service to the end of the year.

⁹ Benefits are translated at £1 = US\$1.5541.

Details of the money purchase pension contributions paid by the Group on behalf of the following executive directors are given below

	2011 £000	2010 £000
James Guyette ¹	381	373
John Rishton	115	–
Andrew Shilston ¹	171	166

¹ Employer contributions for the defined contribution plans during 2011 have been included in the increase in transfer value over 2011 for the defined benefit plans and shown in the final two columns of the tables on page 60 for James Guyette and Andrew Shilston.

Directors' share interests (audited)

The directors who held office at December 31, 2011 and their connected persons had the following interests in the ordinary shares and C Shares ¹ of the Company in respect of which transactions are notifiable to the Company under DTR 3.1.2R of the Disclosure Rules and Transparency Rules

	Ordinary shares			C Shares		
	January 1 2011 [#]	Changes in 2011	December 31 2011 [§]	January 1 2011 [#]	Changes in 2011	December 31 2011 [§]
James Guyette	324,231	(49,434)	274,797	–	–	–
John Rishton	8,996	690	9,686	–	–	–
Sir John Rose ²	914,478	153,320	1,067,798	–	–	–
Andrew Shilston ³	525,427	87,830	613,257	–	–	–
Colin Smith	175,179	43,375	218,554	–	–	–
Mike Terrett	428,295	78,871	507,166	–	–	–
Dame Helen Alexander	1,071	–	1,071	–	102,816	102,816
Peter Byrom	218,017	5,304	223,321	–	–	–
Lewis Booth ⁴	–	5,000	5,000	–	–	–
Sir Frank Chapman ⁵	–	–	–	–	–	–
Iain Conn	17,918	2,292	20,210	–	–	–
Sir Peter Gregson	3,407	811	4,218	–	–	–
John McAdam	1,124	447	1,571	116,769	109,311	226,080
John Neill CBE	24,614	11,850	36,464	350,100	1,508,652	1,858,752
Sir Simon Robertson	40,846	993	41,839	–	–	–
Ian Strachan	11,500	–	11,500	–	–	–

[#] Or date of appointment if later

[§] Or date of retirement if earlier

¹ Non-cumulative redeemable preference shares of 0.1p each.

² Sir John Rose retired as an executive director on March 31, 2011

³ Andrew Shilston retired as an executive director on December 31, 2011

⁴ Lewis Booth was appointed as a non-executive director on May 25, 2011

⁵ Sir Frank Chapman was appointed as a non-executive director on November 10, 2011

Directors' interests in the Company's share plans are shown separately on pages 62 (SIP), 63 (share options), 63 (APRA), and 64 (PSP). No director had any other interests, beneficial or otherwise, in the share capital of the Company or any of its subsidiaries as at December 31, 2011.

Changes in the interests of the executive directors and non-executive directors between December 31, 2011 and February 8, 2012 are listed below

	Ordinary shares	C Shares
Dame Helen Alexander	–	73,899
Peter Byrom	2,020	–
Iain Conn	819	11,178
Sir Peter Gregson	137	–
James Guyette	2,488	–
John McAdam	61	103,776
John Neill	254	2,025,978
John Rishton	87	–
Sir Simon Robertson	378	–
Colin Smith	2,115	332,166
Mike Terrett	4,593	112,815

Partnership shares held in trust under the SIP ¹

	Ordinary shares			C Shares		
	January 1 2011	Changes in 2011	December 31 2011 [§]	January 1 2011	Changes in 2011	December 31 2011 [§]
Sir John Rose ²	1,734	(30)	1,704	–	–	–
Andrew Shilston ³	1,734	(123)	1,611	382,710	(382,710)	–
Colin Smith ⁴	1,734	(124)	1,610	382,533	(382,533)	–
Mike Terrett ⁴	1,733	(124)	1,609	382,241	(382,241)	–

§ Or date of retirement if earlier

Free shares held in trust under the SIP ¹

	Ordinary shares			C Shares		
	January 1 2011	Changes in 2011	December 31 2011 [§]	January 1 2011	Changes in 2011	December 31 2011 [§]
Andrew Shilston ³	3,381	(201)	3,180	839,168	(839,168)	–
Colin Smith	3,381	(202)	3,179	839,168	(839,168)	–

§ Or date of retirement if earlier

Unrestricted shares held under the SIP ¹

	Ordinary shares			C Shares		
	January 1 2011	Changes in 2011	December 31 2011 [§]	January 1 2011	Changes in 2011	December 31 2011 [§]
Sir John Rose ²	9,638	89	9,727	–	–	–
Andrew Shilston ³	6,198	1,039	7,237	90,591	(90,591)	–
Colin Smith	3,977	1,041	5,018	90,298	(90,298)	–
Mike Terrett	4,186	359	4,545	90,500	(90,500)	–

§ Or date of retirement if earlier

¹ Under the SIP free shares and partnership shares held in trust for more than five years are classified as unrestricted and are no longer subject to income tax or national insurance contributions on withdrawal. Unrestricted shares can be held in Trust under the SIP for as long as the participant remains an employee of the Group.

² Sir John Rose retired as an executive director on March 31, 2011.

³ Andrew Shilston retired as an executive director on December 31, 2011.

⁴ On January 9, 2012 and February 7, 2012 the ordinary shares held as partnership shares by Colin Smith 28 and 28 and Mike Terrett 27 and 28 respectively were classified as unrestricted shares.

Share options (audited)

The directors held options under the Rolls-Royce Sharesave plans

	January 1, 2011	Granted in 2011	Lapsed in 2011	Exercised in 2011	December 31, 2011	Exercise price	Market price at date exercised	Aggregate gains 2011 £000	Aggregate gains 2010 £000	Exercisable dates
James Guyette	683	-	-	(683)	-	416p	613.00p	1	-	-
John Rishon	-	1,450	-	-	1,450	525p	-	-	-	2017
Colin Smith	1,233	-	-	(1,233)	-	298p	651.50p	4	-	-

The market price of the Company's ordinary shares ranged between 557.50p and 746.50p during 2011. The closing price on December 31, 2011 was 746.50p.

Long-term incentive awards (audited)

The directors as at December 31, 2011 had the following share awards arising out of the operation of APRA¹

	January 1 2011	Dividend enhancement during 2011	Vested during 2011	Granted during 2011	December 31, 2011	Value of shares vested in 2011 £000
James Guyette	-	42,397	1,645	(27,770)	35,595	51,867
Sir John Rose ²	-	73,804	2,772	(46,791)	93,481	123,266
Andrew Shilston ³	-	41,009	1,524	(25,735)	48,540	65,338
Colin Smith	-	29,816	1,090	(18,426)	32,197	44,677
Mike Terrett	-	37,996	1,412	(23,853)	44,127	59,682
Total value of shares vested						853

¹ Or date of retirement if earlier

² Under APRA shares vest after two years. Shares went into trust in 2009, 2010 and 2011 at prices of 289.65p, 537.20p and 601.00p respectively. At December 31, 2011 the amounts stated in the emoluments table representing the 2011 APRA deferred shares had not yet been applied by the Trustee to purchase shares. The market value per share which vested under APRA during 2011 was 605.47p. The effective market value per share which vested under APRA for James Guyette was 569.86p.

³ Sir John Rose retired as an executive director on March 31, 2011.

⁴ Andrew Shilston retired as an executive director on December 31, 2011.

Conditional awards, granted under the PSP to executive directors are shown on page 64. The number of shares released will be dependent upon the achievement of the EPS and CPS targets over the three-year performance period. In respect of awards made up to and including 2008, the number of shares released will be increased by 25 per cent if the TSR exceeds the median for the FTSE 100 index over the three-year performance period. For the 2009, 2010 and 2011 grants, if the Company's TSR is above the median of the FTSE 100 index, the number of shares due to be released to an executive will be increased by between 25 per cent and 50 per cent. This increase is on a straight-line basis between the median and upper-quartile TSR performance in the performance period.

PSP

	January 1, 2011	Granted during 2011	TSR uplift at vesting ¹	Total vested during 2011	December 31, 2011 ²	Value of shares vested in 2011 £000	Performance period	Date of grant	Market price at date of grant
James Guyette	70,672	—	17,668	(88,340)	—	504	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	207,845	—	—	—	207,845	—	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	91,383	—	—	—	91,383	—	Jan 1, 2010 to Dec 31, 2012	March 1, 2010	544.70p
	—	82,404	—	—	82,404	—	Jan 1, 2011 to Dec 31, 2013	March 9, 2011	601.50p
	369,900	82,404	17,668	(88,340)	381,632	504			
John Rishton ²	—	164,866	—	—	164,866	—	Jan 1, 2011 to Dec 31, 2013	March 9, 2011	601.50p
Sir John Rose ³	212,888	—	53,222	(266,110)	—	1,615	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	391,675	—	—	—	391,675	—	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	191,005	—	—	—	191,005	—	Jan 1, 2010 to Dec 31, 2012	March 1, 2010	544.70p
	795,568	—	53,222	(266,110)	582,680	1,615			
Andrew Shilston ⁴	100,183	—	25,046	(125,229)	—	760	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	211,198	—	—	—	211,198	—	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	102,993	—	—	—	102,993	—	Jan 1, 2010 to Dec 31, 2012	March 1, 2010	544.70p
	—	97,091	—	—	97,091	—	Jan 1, 2011 to Dec 31, 2013	March 9, 2011	601.50p
	414,374	97,091	25,046	(125,229)	411,282	760			
Colin Smith	70,356	—	17,589	(87,945)	—	534	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	148,319	—	—	—	148,319	—	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	78,025	—	—	—	78,025	—	Jan 1, 2010 to Dec 31, 2012	March 1, 2010	544.70p
	—	74,813	—	—	74,813	—	Jan 1, 2011 to Dec 31, 2013	March 9, 2011	601.50p
	296,700	74,813	17,589	(87,945)	301,157	534			
Mike Terrett	91,075	—	22,769	(113,844)	—	691	Jan 1, 2008 to Dec 31, 2010	March 3, 2008	439.20p
	191,998	—	—	—	191,998	—	Jan 1, 2009 to Dec 31, 2011	March 10, 2009	260.42p
	93,630	—	—	—	93,630	—	Jan 1, 2010 to Dec 31, 2012	March 1, 2010	544.70p
	—	91,438	—	—	91,438	—	Jan 1, 2011 to Dec 31, 2013	March 9, 2011	601.50p
	376,703	91,438	22,769	(113,844)	377,066	691			
Total value of shares vested						4,104			

⁵ Or date of retirement if earlier

¹ Under the rules of the PSP the number of shares vesting in 2011 was increased by 25 per cent as the TSR exceeded the median of the FTSE 100 index during the three-year performance period to December 31, 2011. The market value per share which vested under the PSP during 2011 was 607.03p. For James Guyette the market value per share which vested under the PSP was 570.76p.

² John Rishton was appointed as an executive director on March 1, 2011.

³ Sir John Rose retired as an executive director on March 31, 2011.

⁴ Andrew Shilston retired as an executive director on December 31, 2011.

Grant of shares

John Rishton received a special grant of shares on joining the Company intended to mirror the fair value and vesting profile of the incentives he forfeited on resigning from his previous employer. This award was reported in the 2010 Annual report and is detailed below:

	Number of shares	Performance period	Vesting date	Market price at date of grant
Performance related	49,099	Jan 1 2009 to Dec 31, 2011	March 1, 2012	601.50p
Restricted shares	126,019	n/a	March 1, 2012	601.50p
Performance related	76,365	Jan 1, 2010 to Dec 31 2012	March 1, 2013	601.50p
Restricted shares	76,143	n/a	March 1, 2013	601.50p
Performance related	63,397	Jan 1 2011 to Dec 31, 2013	March 1, 2014	601.50p
Performance related	40,565	Jan 1, 2012 to Dec 31 2014	March 1 2015	601.50p
Total	431,588			

Non-executive directors' remuneration**Policy**

The committee determines, on the Board's behalf, the remuneration package of the Chairman. The Board determines the remuneration of the other non-executive directors.

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

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

Statutory requirements

The remuneration report has been prepared on behalf of the Board by the remuneration committee.

The committee adopts the principles of good governance as set out in the Code and complies with the Listing Rules of the Financial Services Authority and the relevant schedules of the Companies Act 2006 and the Directors' Report Regulations in Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

The report is divided into audited and unaudited information. The above regulations require the Company's auditors to report on the audited information in their report on page 125 and to state that this section has been properly prepared in accordance with these regulations. The report is subject to shareholder approval at the AGM on May 4, 2012.

The Directors' remuneration report was approved by the Board on February 8, 2012 and signed on its behalf.

	Appointment date	Current letter of appointment start date	Current letter of appointment end date
Dame Helen Alexander	01/09/2007	23/05/2011	31/08/2013
Lewis Booth	25/05/2011	25/05/2011	24/05/2014
Peter Byrom	01/01/1997	01/01/2012	31/12/2012
Sir Frank Chapman	10/11/2011	10/11/2011	09/11/2014
Iain Conn	20/01/2005	23/05/2011	19/01/2014
Sir Peter Gregson	01/03/2007	23/05/2011	28/02/2013
John McAdam	19/02/2008	23/05/2011	18/02/2014
John Neill CBE	13/11/2008	13/11/2011	12/11/2014
Sir Simon Robertson	01/01/2005	23/05/2011	31/12/2013
Ian Strachan	19/09/2003	23/05/2011	18/09/2012

Non-executive directors' fees

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

The fees payable to the non-executive directors are reviewed annually by the Board. The table below shows the current fee structure with effect from February 1, 2011.

	Fee £000
Chairman	370
Other non-executive directors	60
Chairman of audit committee	20
Chairman of remuneration committee	15
Chairman of ethics committee	15
Senior Independent Director	12

Dame Helen Alexander

Chairman of the remuneration committee

Shareholders and share capital

Share capital and voting rights

On December 31, 2011 there were 1,872,240,012 ordinary shares, 6,371,021,124 C Shares and one Special Share in issue. The ordinary shares are listed on the London Stock Exchange.

The Annual General Meeting

This year's AGM will be held at 11.00am on Friday May 4, 2012 at the QEII Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE. The Notice of AGM and the Annual report will be available to view on the Group's website.

Shareholders unable to attend the AGM are invited to vote on the business of the meeting by completing a proxy form and returning it to the Registrar. If you have elected to receive electronic communications, you will be able to vote online.

Payments to shareholders

At the AGM on May 4, 2012, the directors will recommend an issue of 106 C Shares with a total nominal value of 10.6 pence for each ordinary share.

The final issue of C Shares will be made on July 2, 2012. Together with the interim issue on January 3, 2012 of 69 C Shares for each ordinary share with a total nominal value of 6.9 pence, this is the equivalent of a total annual payment to ordinary shareholders of 17.5 pence for each ordinary share.

The payment to shareholders will, as before, be made in the form of redeemable C Shares which shareholders may either choose to retain or redeem for a cash equivalent. The Registrar, on behalf of the Company, operates a C Share Reinvestment Plan (CRIP) and can, on behalf of shareholders, purchase ordinary shares from the market rather than delivering a cash payment. Shareholders wishing to redeem their C Shares or else redeem and participate in the CRIP must ensure that their instructions are lodged with the Registrar no later than 5pm on Friday June 1, 2012.

Share class rights

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

Ordinary shares

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

C Shares

The Company issues non-cumulative redeemable preference shares (C Shares) as an alternative to paying a cash dividend.

Shareholders can choose to

- redeem all C Shares for cash,
- redeem all C Shares for cash and reinvest the proceeds in additional ordinary shares using the CRIP operated by the Registrar, or keep the C Shares.

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

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

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

Special Share

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

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

The latest copy of the Articles of the Company can be found on the Group's website: www.rolls-royce.com

Restrictions on transfer of shares and limitations on holdings

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

Shareholder agreements and consent requirements

There are no known arrangements under which financial rights carried by any of the shares in the Company are held by a person other than the holder of the shares and no known agreements between the holders of shares with restrictions on the transfer of shares or exercise of voting rights. No disposal may be made to a non-Group member which, alone or when aggregated with the same or a connected transaction, constitutes a disposal of the whole or a material part of either the nuclear business or the assets of the Group as a whole, without consent of the Special Shareholder.

Authority to issue shares

At a general meeting in 2011, authority was given to the directors to allot new ordinary shares up to a nominal value of £124,811,895, equivalent to one-third of the issued share capital of the Company. This is called the first section 551 amount. In addition, a special resolution was passed to effect a disapplication of pre-emption rights for a maximum of five per cent of the issued share capital of the Company. These authorities are valid until the AGM in 2012 and the directors propose to renew these authorities at that AGM.

In line with revised guidance issued by the Association of British Insurers in November 2009, it is proposed to seek a further authority, as last year, at the AGM in 2012 to allot up to two thirds of the total issued share capital, but only in the case of a rights issue. This is called the second section 551 amount. The Board believes that this additional authority will allow the Company to retain the maximum possible flexibility (consistent with evolving market practice) to respond to circumstances and opportunities as they arise.

Also at a general meeting in 2011, authority was given to the directors to allot new C Shares up to a nominal value of £350 million as an alternative to a cash dividend. Such authority expires at the conclusion of the AGM in 2012. The directors propose to renew an authority to allot new C Shares at the AGM in 2012 at an increased level of £400 million to provide headroom for potential future payments to shareholders.

Authority to purchase own shares

At a general meeting in 2011, the Company was authorised by shareholders to purchase up to 187,217,843 of its own ordinary shares representing ten per cent of its issued ordinary share capital. The Company did not make use of this authority during 2011.

The authority for the Company to purchase its own shares expires at the conclusion of the AGM in 2012 or 18 months from May 16, 2011, whichever is the earlier. A resolution to renew it will be proposed at that meeting.

Voting rights**Deadlines for exercising voting rights**

Electronic and paper proxy appointments, and voting instructions, must be received by the Company's Registrar not less than 48 hours before a general meeting.

Voting rights for employee share plan shares

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

Major shareholdings

At February 8, 2012, the following companies had notified an interest in the issued ordinary share capital of the Company in accordance with the Financial Services Authority's Disclosure and Transparency Rules.

Company	Date notified	% of issued ordinary share capital
AXA S A	January 11 2010	4.90
BlackRock Inc	September 3 2010	5.02
Invesco Limited	February 4 2008	6.91
Legal & General Group plc	October 14, 2009	3.96

Other statutory information

Political donations

In line with its established policy, the Group made no political donations pursuant to the authority granted at the 2011 AGM. Although the Company does not make, and does not intend to make, donations to political parties, within the normal meaning of that expression, the definition of political donations under the Companies Act 2006 is very broad and includes expenses legitimately incurred as part of the process of talking to members of parliament and opinion formers to ensure that the issues and concerns of the Group are considered and addressed. These activities are not intended to support any political party and the Group's policy is not to make any donations for political purposes in the normally accepted sense.

A resolution will therefore be proposed at the 2012 AGM seeking shareholder approval for the directors to be given authority to make donations and incur expenditure which might otherwise be caught by the terms of the Companies Act 2006. The authority sought will be limited to a maximum amount of £25,000 per Group company but so as not to exceed £50,000 for the entire Group in aggregate.

During the year, the business expenses incurred by Rolls-Royce North America Inc. towards the operation of the Rolls-Royce North America Political Action Committee (RRNAPAC) in the USA was US\$44,436 (2010: nil). PACs are a common feature of the US political system and are governed by the Federal Election Campaign Act.

The PAC is independent of the Company and independent of any political party. The PAC funds are contributed voluntarily by employees and the Company cannot affect how they are applied, although under US Law, the business expenses are paid by the Company.

Such contributions do not require authorisation by shareholders under the Companies Act 2006 and therefore do not count towards the £25,000 and £50,000 limits for political donations and expenditure for which shareholder approval will be sought at the AGM.

Change of control

Contracts and joint venture agreements

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

Borrowings and other financial instruments

The Group has a number of borrowing facilities provided by various banks. These facilities generally include provisions which may require any outstanding borrowings to be repaid or the alteration or termination of the facility upon the occurrence of a change of control of the Company. At December 31, 2011 these facilities were less than 20 per cent drawn.

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

Employee share plans

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

- PSP – awards would vest pro rata to service in the performance period, subject to remuneration committee judgement of Company performance;
- APRA deferred shares – the shares would be released from trust immediately;
- ShareSave – options would become exercisable immediately. The new company might offer an equivalent option in exchange for cancellation of the existing option; and
- SIP – consideration received as shares would be held within the SIP, if possible, otherwise the consideration would be treated as a disposal from the SIP.

Essential commercial relationships

Supply chain

Certain suppliers to the Group contribute key components or services, the loss of which could cause disruption to the Group's deliveries. However, none are so vital that their loss would affect the viability of the business as a whole. When dealing with suppliers, the Group is guided by the Supply Chain Relationships in Aerospace (SCRIA) initiative. It seeks the best possible terms from suppliers and when entering into binding purchasing contracts, gives consideration to quality, delivery, price and the terms of payment. In the event of disputes, efforts are made to resolve them quickly.

Customers

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

Material litigation

During the year, the litigation with United Technologies Corporation in connection with an alleged patent infringement was withdrawn, without financial impact.

Creditor days

As the Company is a holding company and does not itself trade, it owed no amounts to trade creditors at December 31, 2011 and therefore the number of creditor days required to be shown in this report to comply with the provisions of the Companies Act 2006 is nil.

Internal control and risk management*The Board's responsibility for internal control and risk management*

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

The Group's approach to internal control is based on the underlying principle of line management's accountability for control and risk management. In reviewing the effectiveness of the system of internal control, the Board has taken account of the results of the work carried out to audit and review the activities of the Group.

There is an ongoing process to identify, assess and manage risk, including those risks affecting the Group's reputation. This process is subject to continuous improvement and has been in place throughout the financial year to which these statements apply and up to the date of their approval.

In 2011, the effectiveness and consistency of risk management at all levels of the organisation has been measured, improved and reported via the sector and function assurance framework.

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

Financial reporting

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

Financial managers are required to acknowledge in writing that their routine financial reporting is based on reliable data and that their results are properly stated in accordance with Group requirements.

In addition, for annual reporting, business presidents and finance directors are required to acknowledge that their business has complied with the Group Finance Manual.

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

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

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

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

In preparing each of the Group and parent company financial statements, the directors are required to

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

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

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

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

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out on pages 1 to 70 of the business review and a summary of the principal risks affecting the business are shown on pages 34 to 35

The financial position of the Group, its cash flows, liquidity position, borrowing facilities and financial risks are described in pages 14 to 17 and 36 to 37 of the business review

In addition, notes 1, 13, 15 and 17 of the consolidated financial statements include the Group's objectives, policies and processes for financial risk management, details of its cash and cash equivalents, indebtedness and borrowing facilities and its financial instruments, hedging activities and its exposure to counterparty credit risk, liquidity risk, currency risk, interest rate risk and commodity pricing risk

As described on page 36, the Group meets its funding requirements through a mixture of shareholders' funds, bank borrowings, bonds, notes and finance leases. The Group has facilities of £2.3 billion of which £1.1 billion was drawn at the year end. None of these facilities expire in 2012

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

Accordingly, the directors continue to adopt the going concern basis (in accordance with the guidance 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' issued by the FRC) in preparing the consolidated financial statements

Disclosure of information to auditors

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

- i) so far as the director is aware, there is no relevant information of which the Company's auditors are unaware, and
- ii) the director has taken all steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information

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

Responsibility statement

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

- i) each of the Group and parent company financial statements, prepared in accordance with IFRS and UK Accounting Standards respectively, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole, and
- ii) the Directors' report on pages 1 to 70 includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face

By order of the Board



Paul Davies

Acting Company Secretary

February 8, 2012

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Consolidated income statement

For the year ended December 31, 2011

	Notes	2011 £m	2010 £m
Revenue	2	11,124	11 085
Cost of sales		(8,676)	(8 885)
Gross profit		2,448	2,200
Other operating income		69	95
Commercial and administrative costs		(984)	(836)
Research and development costs		(463)	(422)
Share of results of joint ventures and associates	10	116	93
Operating profit		1,186	1,130
Profit on disposal of businesses		3	4
Profit before financing and taxation	2	1,189	1 134
Financing income	3	456	453
Financing costs	3	(540)	(885)
Net financing		(84)	(432)
Profit before taxation¹		1,105	702
Taxation	4	(257)	(159)
Profit for the year		848	543
Attributable to			
Ordinary shareholders		850	539
Non-controlling interests		(2)	4
Profit for the year		848	543
Earnings per ordinary share attributable to ordinary shareholders	5		
Basic		45 95p	29 20p
Diluted		45 33p	28 82p
Payments to ordinary shareholders in respect of the year	17		
Per share		17 5p	16 0p
Total		328	299
¹ Underlying profit before taxation	2	1,157	955

Consolidated statement of comprehensive income

For the year ended December 31, 2011

	Notes	2011 £m	2010 £m
Profit for the year		848	543
Other comprehensive income			
Foreign exchange translation differences on foreign operations		(102)	22
Movements in post-retirement schemes	19	123	(94)
Share of other comprehensive income of joint ventures and associates	10	(10)	(16)
Related tax movements	4	(54)	29
Total comprehensive income for the year		805	484
Attributable to			
Ordinary shareholders		808	480
Non-controlling interests		(3)	4
Total comprehensive income for the year		805	484

Consolidated balance sheet

At December 31, 2011

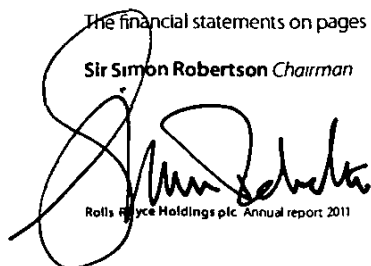
	Notes	2011 £m	2010 £m
ASSETS			
Non-current assets			
Intangible assets	8	2,882	2,884
Property, plant and equipment	9	2,338	2,136
Investments – joint ventures and associates	10	1,680	393
Investments – other	10	10	11
Other financial assets	17	327	371
Deferred tax assets	4	368	451
Post-retirement scheme surpluses	19	503	164
		8,108	6,410
Current assets			
Inventories	11	2,561	2,429
Trade and other receivables	12	4,009	3,943
Taxation recoverable		20	6
Other financial assets	17	91	250
Short-term investments		11	328
Cash and cash equivalents	13	1,310	2,859
Assets held for sale	14	313	9
		8,315	9,824
Total assets		16,423	16,234
LIABILITIES			
Current liabilities			
Borrowings	15	(20)	(717)
Other financial liabilities	17	(111)	(105)
Trade and other payables	16	(6,236)	(5,910)
Current tax liabilities		(138)	(170)
Provisions for liabilities and charges	18	(276)	(276)
Liabilities associated with assets held for sale	14	(135)	–
		(6,916)	(7,178)
Non-current liabilities			
Borrowings	15	(1,184)	(1,135)
Other financial liabilities	17	(919)	(945)
Trade and other payables	16	(1,314)	(1,271)
Deferred tax liabilities	4	(445)	(438)
Provisions for liabilities and charges	18	(226)	(268)
Post-retirement scheme deficits	19	(900)	(1,020)
		(4,988)	(5,077)
Total liabilities		(11,904)	(12,255)
Net assets		4,519	3,979
EQUITY			
Equity attributable to ordinary shareholders			
Called-up share capital	20	374	374
Share premium account		–	133
Capital redemption reserve		173	209
Cash flow hedging reserve		(52)	(37)
Other reserves		433	527
Retained earnings		3,590	2,769
		4,518	3,975
Non-controlling interests		1	4
Total equity		4,519	3,979

Financial statements

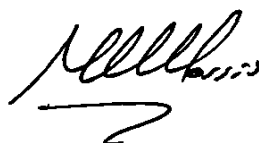
The financial statements on pages 72 to 118 were approved by the Board on February 8 2012 and signed on its behalf by:

Sir Simon Robertson *Chairman*

Mark Morris *Finance Director*



Rolls Royce Holdings plc Annual report 2011



Consolidated cash flow statement

For the year ended December 31, 2011

	Notes	2011 £m	* Restated 2010 £m
Reconciliation of cash flows from operating activities			
Profit before taxation		1,105	702
Share of results of joint ventures and associates	10	(116)	(93)
Profit on disposal of businesses		(3)	(4)
Profit on disposal of property, plant and equipment		(8)	(10)
Net financing	3	84	432
Taxation paid		(208)	(168)
Amortisation of intangible assets	8	169	130
Depreciation and impairment of property plant and equipment	9	241	237
Impairment of investments	10	-	3
(Decrease)/increase in provisions		(28)	99
(Increase)/decrease in inventories		(140)	41
(Increase)/decrease in trade and other receivables		(62)	39
Increase in trade and other payables		416	248
Movement in other financial assets and liabilities		68	(299)
Net defined benefit post-retirement (credit)/cost recognised in profit before financing		(43)	147
Cash funding of defined benefit post-retirement schemes		(304)	(282)
Share-based payments	21	59	50
Dividends received from joint ventures and associates	10	76	68
Net cash inflow from operating activities		1,306	1,340
Cash flows from investing activities			
Additions of unlisted investments		-	(1)
Disposals of unlisted investments		1	46
Additions of intangible assets		(363)	(321)
Disposals of intangible assets		6	-
Purchases of property plant and equipment		(412)	(354)
Government grants received		38	38
Disposals of property plant and equipment		31	38
Acquisitions of businesses		(19)	(150)
Disposals of businesses		7	2
Investments in joint ventures and associates		(1,329)	(19)
Loan to Engine Holding GmbH		(167)	-
Net cash outflow from investing activities		(2,207)	(721)
Cash flows from financing activities			
Repayment of loans		(567)	(108)
Proceeds from increase in loans		-	68
Net cash flow from decrease in borrowings		(567)	(40)
Interest received		19	23
Interest paid		(50)	(77)
Decrease/(increase) in short-term investments		316	(326)
Issue of ordinary shares (net of expenses)		(1)	67
Purchase of ordinary shares		(57)	(124)
Redemption of C Shares		(315)	(266)
Net cash outflow from financing activities		(655)	(743)
Net decrease in cash and cash equivalents		(1,556)	(124)
Cash and cash equivalents at January 1		2,851	2,958
Exchange (losses)/gains on cash and cash equivalents		(4)	17
Cash and cash equivalents at December 31		1,291	2,851

* Restated to show government grants, previously included in trade and other payables separately

Consolidated cash flow statement

For the year ended December 31, 2011

	2011 £m	2010 £m
Reconciliation of movements in cash and cash equivalents to movements in net funds		
Decrease in cash and cash equivalents	(1,556)	(124)
Cash flow from decrease in borrowings	567	40
Cash flow from (decrease)/increase in short-term investments	(316)	326
Change in net funds resulting from cash flows	(1,305)	242
Net funds (excluding cash and cash equivalents) of businesses acquired	-	(1)
Exchange (losses)/gains on net funds	(5)	17
Fair value adjustments	92	26
Movement in net funds	(1,218)	284
Net funds at January 1 excluding the fair value of swaps	1,335	1,051
Net funds at December 31 excluding the fair value of swaps	117	1,335
Fair value of swaps hedging fixed rate borrowings	106	198
Net funds at December 31	223	1,533

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

	At January 1, 2011 £m	Funds flow £m	Exchange differences £m	Fair value adjustments £m	At December 31, 2011 £m
Cash at bank and in hand	1,266	26	(7)	-	1,285
Money-market funds	381	(370)	-	-	11
Short-term deposits	1,212	(1,201)	3	-	14
Overdrafts	(8)	(11)	-	-	(19)
Cash and cash equivalents	2,851	(1,556)	(4)	-	1,291
Short-term investments	328	(316)	(1)	-	11
Other current borrowings	(709)	566	-	142	(1)
Non-current borrowings	(1,134)	1	-	(50)	(1,183)
Finance leases	(1)	-	-	-	(1)
	1,335	(1,305)	(5)	92	117
Fair value of swaps hedging fixed rate borrowings	198			(92)	106
	1,533	(1,305)	(5)	-	223

Consolidated statement of changes in equity

For the year ended December 31, 2011

	Notes	Attributable to ordinary shareholders						Non-controlling interests £m	Total equity £m
		Share capital £m	Share premium £m	Capital redemption reserve £m	Cash flow hedging reserve ¹ £m	Other reserves ² £m	Retained earnings ³ £m		
At January 1, 2010		371	98	191	(19)	506	2,635	–	3,782
Total comprehensive income for the year		–	–	–	(18)	21	477	4	484
Arising on issues of ordinary shares	20	3	64	–	–	–	–	–	67
Issues of C Shares	17	–	(29)	(249)	–	–	1	–	(277)
Redemptions of C Shares	17	–	–	267	–	–	(267)	–	–
Ordinary shares purchased	–	–	–	–	–	–	(124)	–	(124)
Share based payments – direct to equity ⁴	–	–	–	–	–	–	42	–	42
Related tax movements	4	–	–	–	–	–	5	–	5
Other changes in equity in the year		3	35	18	–	–	(343)	–	(287)
At January 1, 2011		374	133	209	(37)	527	2,769	4	3,979
Total comprehensive income for the year		–	–	–	(15)	(94)	917	(3)	805
Arising on issues of ordinary shares	–	–	1	–	–	–	–	–	1
Issues of C Shares	17	–	(120)	–	–	–	(176)	–	(296)
Redemptions of C Shares	17	–	–	317	–	–	(317)	–	–
Ordinary shares purchased	–	–	–	–	–	–	(57)	–	(57)
Share-based payments – direct to equity ⁴	–	–	–	–	–	–	77	–	77
Effect of scheme of arrangement ⁵	–	2,434	(14)	(353)	–	–	(2,069)	–	(2)
Effect of capital reduction ⁵	–	(2,434)	–	–	–	–	2,434	–	–
Related tax movements	4	–	–	–	–	–	12	–	12
Other changes in equity in the year		–	(133)	(36)	–	–	(96)	–	(265)
At December 31, 2011		374	–	173	(52)	433	3,590	1	4,519

¹ See accounting policies note 1

² Other reserves include a merger reserve of £3m (2010 £3m, 2009 £3m) and a translation reserve of £430m (2010 £524m, 2009 £503m)

³ At December 31, 2011, 22,541,187 ordinary shares with a net book value of £116m (2010 28,320,962, 2009 7,156,497 ordinary shares with net book values of £125m and £25m respectively) were held for the purpose of share-based payment plans and included in retained earnings. During the year, 14,822,563 ordinary shares with a net book value of £66m (2010 6,586,568 shares with a net book value of £24m) vested in share-based payment plans. During the year the Company acquired 9,042,788 of its ordinary shares through purchases on the London Stock Exchange.

⁴ Share based payments – direct to equity is the net of the credit to equity in respect of the share-based payment charge to the income statement and the actual cost of shares vesting, excluding those vesting from own shares.

⁵ On May 23, 2011, under a scheme of arrangement between Rolls-Royce Group plc, the former holding company of the Group, and its shareholders under Part 26 of the Companies Act 2006, and as sanctioned by the High Court, all the issued ordinary shares in that company were cancelled and the same number of new ordinary shares were issued to Rolls-Royce Holdings plc in consideration for the allotment to shareholders of one ordinary share in Rolls-Royce Holdings plc for each ordinary share in Rolls-Royce Group plc held on the record date (May 20, 2011). Pursuant to the scheme of arrangement, 1,872,188,709 ordinary shares of 150 pence were issued. As required by Section 612 of the Companies Act 2006, no share premium was recognised.

On May 24, 2011, the share capital of Rolls-Royce Holdings plc was reduced by reducing the nominal value of the ordinary shares from 150 pence to 20 pence as sanctioned by the High Court.

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

	Civil aerospace £m	Defence aerospace £m	Marine £m	Energy £m	Engine Holding £m	Total reportable segments £m
Year ended December 31, 2011						
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						
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

	Total reportable segments £m	Underlying central items £m	Total underlying £m	Underlying adjustments £m	Group £m
Year ended December 31, 2011					
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 RRSFs – 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		2010	
		Per consolidated income statement £m	Underlying financing ¹ £m	Per consolidated income statement £m	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		Overseas		Total	
	2011 £m	2010 £m	2011 £m	2010 £m	2011 £m	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	2010
	Number	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 costs¹		
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
7½% 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
4½% 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

			Assets				Liabilities		Total
	Notes	Basis for determining fair value	Held for trading £m	Loans and receivables £m	Available for sale £m	Cash £m	Held for trading £m	Other £m	£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		2010	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	–	(1,371)	(1,852)	(1,963)
Financial RRSPs	–	(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				
Movements in fair value hedges ¹	–	(144)	199	44
Movements in other derivative contracts ²	–	7	(21)	(14)
Contracts settled ³	–	(370)	29	(342)
	–	171	3	172
At January 1, 2011				
Movements in fair value hedges ¹	–	(336)	21	(140)
Movements in cash flow hedges	–	2	83	85
Movements in other derivative contracts ²	–	(1)	–	(1)
Contracts settled ³	–	(21)	(28)	(48)
	–	(91)	(5)	(274)
At December 31, 2011				
		(447)	(12)	(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				Discounting £m	Carrying values £m
	Within one year £m	Between one and two years £m	Between two and five years £m	After five years £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.

	Effective interest rate %	Total £m	2011 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	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							
7½% 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	1 165.4%	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	11 246.7%	(1)	(1)	–	–	–	–
Effect of interest rate swaps	7 223.7%	(1)	12	–	–	(13)	–
£200m floating rate loan	GBP LIBOR + 0.267	(200)	(200)	–	–	–	–
Unsecured bond issues							
7 ³ / ₄ % Notes 2016 £200m	7.3750%	(200)	–	–	–	–	(200)
6.38% Notes 2013 US\$230m	6.3800%	(162)	–	–	–	(162)	–
Effect of interest rate swaps	USD LIBOR + 1.26	–	(162)	–	–	162	–
6.55% Notes 2015 US\$83m	6.5500%	(60)	–	–	–	(60)	–
Effect of interest rate swaps	USD LIBOR + 1.24	–	(60)	–	–	60	–
4 ¹ / ₂ % Notes 2011 €750m	4.5000%	(642)	(642)	–	–	–	–
Effect of interest rate swaps	GBP LIBOR + 0.911	–	–	–	–	–	–
6.75% Notes 2019 £500m	6.7500%	(506)	–	–	–	–	(506)
Effect of interest rate swaps	GBP LIBOR + 2.98	–	(506)	–	–	–	506
Other secured							
Obligations under finance leases	5 000.0%	(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	12,577	13
Issued	-	299,522	278,115	278
Redeemed	-	(316,531)	(267,312)	(267)
Held in employee share trust	-	(1,999)	-	-
At December 31		4,372	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	4.5	6,383
Longevity swap ²	-	4.7	-	-
Equities	-	6.0	7.5	1,204
Sovereign debt	-	2.8	4.2	23
Corporate bonds	-	4.0	5.2	22
Other	-	2.8	4.2	151
		3.4	5.0	7,783
Overseas schemes				
LDI portfolios ¹	-	5.3	-	-
Equities	-	7.9	9.3	237
Corporate bonds	-	4.0	4.5	170
Other	-	2.5	6.9	27
		5.6	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	274	384	12	154	184	34
Granted	-	-	-	-	55	11
Additional entitlements arising from TSR performance	-	-	-	-	06	-
Additional shares accrued from reinvestment of C Shares	-	-	-	-	-	01
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	31
Exercisable at December 31, 2010	-	-	0.7	125	-	-
Outstanding at January 1, 2011	26.5	384	0.7	125	19.5	31
Granted	10.6	525	-	-	53	2.6
Additional entitlements arising from TSR performance	-	-	-	-	11	-
Additional shares accrued from reinvestment of C Shares	-	-	-	-	-	01
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

Exercise prices (pence)	ShareSave		ESOP		Total	
	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.

Company balance sheet

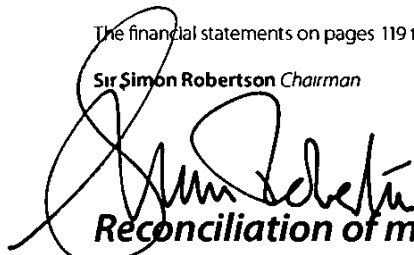
At December 31, 2011

	Notes	2011 £m
Fixed assets		
Investments – subsidiary undertakings	2	11,921
Creditors – amounts falling due within one year		
Financial liabilities	3	(6)
Amounts owed to subsidiary undertakings due within one year		(175)
		(181)
Net current assets		(181)
Total assets less current liabilities		11,740
Capital and reserves		
Called-up share capital	4	374
Merger reserve	5	8,897
Capital redemption reserve	5	173
Other reserve	5	31
Profit and loss account	5	2,265
Equity shareholders' funds		11,740

The financial statements on pages 119 to 121 were approved by the Board on February 8, 2012 and signed on its behalf by

Sir Simon Robertson Chairman

Mark Morris Finance Director




Reconciliation of movements in shareholders' funds

For the period ended December 31, 2011

	2011 £m
On formation	-
As a result of scheme of arrangement	11,885
Issue of C Shares	(180)
Ordinary shares purchased	(1)
Share-based payments – direct to equity	36
At December 31	11,740

Notes to the Company financial statements

1 Accounting policies

Basis of accounting

The financial statements have been prepared in accordance with applicable UK Accounting Standards on the historical cost basis

As permitted by Section 408 of the Companies Act 2006, a separate profit and loss account for the Company has not been included in these financial statements. As permitted by the audit fee disclosure regulations, disclosure of non-audit fees information is not included in respect of the Company. As permitted by FRS 1 *Cash flow statements*, no cash flow statement for the Company has been included. As permitted by FRS 8 *Related party disclosures*, no related party disclosures in respect of transactions between the Company and its wholly owned subsidiaries have been included.

Investments in subsidiary undertakings

Investments in subsidiary undertakings are reported at cost less any amounts written off.

Share-based payments

As described in the Directors' remuneration report on pages 55 to 65, the Company grants awards of its own shares to employees of its subsidiary undertakings, (see note 21 of the consolidated financial statements). The costs of share-based payments in respect of these awards are accounted for, by the Company, as an additional investment in its subsidiary undertakings. The costs are determined in accordance with FRS 20 *Share-based payment*. Any payments made by the subsidiary undertakings in respect of these arrangements are treated as a return of this investment.

Financial instruments

In accordance with FRS 25 *Financial instruments: Presentation*, the Company's C Shares are classified as financial liabilities and held at amortised cost from the date of issue until redeemed.

Taxation

Provision for taxation is made at the current rate and, in accordance with FRS 19 *Deferred tax*, for deferred taxation at the projected rate on timing differences that have originated, but not reversed at the balance sheet date.

2 Investments – subsidiary undertakings

	£m
Cost	
On formation	-
As a result of scheme of arrangement	11 888
Additions	2
Cost of share-based payments in respect of employees of subsidiary undertakings less receipts from subsidiaries in respect of those payments	31
At December 31, 2011	11,921

3 Financial liabilities

C Shares

Movements in C Shares during the year were as follows:

	C Shares of 0.1p Millions	Nominal value £m
Issued and fully paid		
On formation	-	-
Shares issued	179 730	180
Shares redeemed	(173 359)	(173)
At December 31, 2011	6,371	6

The rights attaching to C Shares are set out on page 66.

4 Share capital

	Non-equity			Equity	
	Special Share of £1	Preference shares of £1 each	Nominal value £m	Ordinary shares of 20p each Millions	Nominal value £m
Issued and fully paid					
On formation	-	-	50,000	-	-
Issued as a result of the scheme of arrangement (ordinary shares of 150p each)	-	1	-	1,872	2,808
Capital reduction to 20p each	-	-	-	-	(2,434)
Redemption of preference shares	-	-	(50,000)	-	-
At December 31, 2011	1	-	-	1,872	374

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

In accordance with FRS 25 *Financial Instruments Presentation*, the Company's non-cumulative redeemable preference shares (C Shares) are classified as financial liabilities. Accordingly, movements in C Shares are included in note 3

5 Movements in capital and reserves

	Non distributable reserves					Profit and loss account £m	Total £m
	Share capital £m	Merger reserve £m	Capital redemption reserve £m	Other reserve ¹ £m	Own shares reserve £m		
On formation	-	-	-	-	-	-	-
Scheme of arrangement ²	2,808	9,077	-	-	-	-	11,885
Capital reduction ²	(2,434)	-	-	-	-	2,434	-
Issue of C Shares	-	(180)	-	-	-	-	(180)
Redemption of C Shares	-	-	173	-	-	(173)	-
Ordinary shares purchased	-	-	-	-	(1)	-	(1)
Ordinary shares vesting in share-based payment plans	-	-	-	-	1	(1)	-
Share-based payments – direct to equity	-	-	-	31	-	5	36
At December 31, 2011	374	8,897	173	31	-	2,265	11,740

¹ The Other reserve represents the value of share-based payments in respect of employees of subsidiary undertakings for which payment has not been received

² On May 23 2011 under a scheme of arrangement between Rolls-Royce Group plc (the former holding company of the Group) and its shareholders under Part 26 of the Companies Act 2006 and as sanctioned by the High Court all the issued ordinary shares in that company were cancelled and the same number of new ordinary shares were issued to Rolls Royce Holdings plc in consideration for the allotment to shareholders of one ordinary share in Rolls-Royce Holdings plc for each ordinary share in Rolls-Royce Group plc held on the record date (May 20 2011). Pursuant to the scheme of arrangement 1,872,188,709 ordinary shares of 150 pence were issued. As required by Section 612 of the Companies Act 2006 no share premium was recognised. On May 24 2011 the share capital of Rolls-Royce Holdings plc was reduced by reducing the nominal value of the ordinary shares from 150 pence to 20 pence as sanctioned by the High Court.

6 Contingent liabilities

Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee.

At December 31, 2011 these guarantees amounted to **£1,101m**

7 Other information

Emoluments of directors

The remuneration of the directors of the Company is shown in the Directors' remuneration report on pages 55 to 65

Employees

The Company had no employees in 2011

Share-based payments

Shares in the Company have been granted to employees of the Group as part of share-based payment plans, and are charged in the employing company

Subsidiaries, jointly controlled entities and associates

At December 31, 2011

Incorporated within the UK – held by Rolls-Royce Holdings plc

Rolls-Royce Group plc	Holding company
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Incorporated within the UK – held by Rolls-Royce Group plc

Rolls-Royce plc	Principal trading company
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Incorporated within the UK – indirectly held

Optimized Systems and Solutions Limited	Equipment health management and advanced data management services
Rolls-Royce Fuel Cell Systems Limited	Development of fuel cell systems
Rolls-Royce International Limited	International support and commercial information services
Rolls-Royce Leasing Limited	Engine leasing
Rolls-Royce Marine Electrical Systems Limited	Marine electrical systems
Rolls-Royce Marine Power Operations Limited	Nuclear submarine propulsion systems
Rolls-Royce Power Development Limited	Generation of electricity from independent power projects
Rolls-Royce Power Engineering plc	Energy and marine systems
Rolls-Royce Total Care Services Limited	Aero engine aftermarket support services
Tidal Generation Limited	Development of tidal generation systems

The above companies operate principally in the UK and the effective Group interest is 100 per cent, other than Rolls-Royce Fuel Cell Systems Limited in which it is 80 per cent

Incorporated overseas – indirectly held

Brazil	Rolls-Royce Brasil Limitada	Industrial gas turbines and aero engine repair and overhaul, energy and marine aftermarket support services
Canada	Rolls-Royce Canada Limited	Industrial gas turbines and aero engine sales, service and overhaul
China	Rolls-Royce Marine (Shanghai) Limited	Manufacture and supply of marine equipment
Finland	Rolls-Royce OY AB	Manufacture of marine winches and propeller systems
France	Rolls-Royce Civil Nuclear SAS	Instrumentation and control systems and life-cycle management for nuclear power plants
France	Rolls-Royce Technical Support SARL	Aero engine project support
Germany	Rolls-Royce Deutschland Ltd & Co KG	Aero engine design, development and manufacture
Guernsey	Nightingale Insurance Limited	Insurance services
India	Rolls-Royce India Private Limited	Diesel engine project management and customer support
India	Rolls-Royce Operations (India) Private Limited	Engineering support services
Italy	Europea Microfusioni Aerospaziali S p A	Manufacture of gas turbine engine castings
Norway	Rolls-Royce Marine AS	Design and manufacture of ship equipment
Norway	Scandinavian Electric Holding AS	Marine electrical systems
Singapore	Rolls-Royce Singapore Pte Limited	Aero engine parts manufacturing and engine assembly energy and marine aftermarket support services
Sweden	Rolls-Royce AB	Manufacture of marine propeller systems
US	Data Systems & Solutions LLC	Instrumentation and control systems and life-cycle management for nuclear power plants
US	Optimized Systems and Solutions Inc.	Equipment health management and advanced data management services
US	R Brooks Associates Inc	Specialist civil nuclear reactor services
US	Rolls-Royce Commercial Marine Inc.	Marine aftermarket support services
US	Rolls-Royce Corporation	Design, development and manufacture of gas turbine engines
US	Rolls-Royce Crosspointe LLC	Manufacturing facility for aero engine parts
US	Rolls-Royce Energy Systems Inc	Energy turbine generator packages
US	Rolls-Royce Engine Services – Oakland Inc	Aero engine repair and overhaul
US	Rolls-Royce Defense Services Inc.	Aero engine repair and overhaul
US	Rolls-Royce Naval Marine Inc.	Design and manufacture of marine equipment

The above companies operate principally in the country of their incorporation and the effective Group interest is 100 per cent

Other matters

Subsidiaries, jointly controlled entities and associates
At December 31, 2011

Incorporated within the UK – indirectly held

	Class	% of class held	% of total equity held
Airtanker Holdings Limited	Ordinary	20	20
Strategic tanker aircraft PFI project			
Airtanker Services Limited	Ordinary	22	22
Provision of aftermarket services for strategic tanker aircraft			
Alpha Partners Leasing Limited	A Ordinary	100	50
Aero engine leasing	B Ordinary	–	
Composite Technology and Applications Limited	A Ordinary	100	51
Development of aero engine fan blades and fan cases	B Ordinary	–	
Genistics Holdings Limited	A Ordinary	100	50
Trailer-mounted field mobile generator sets	B Ordinary	–	
Rolls-Royce Goodrich Engine Control Systems Limited	Ordinary	50	50
Development and manufacture of aero engine controls			
Rolls-Royce Snecma Limited (UK & France)	A Shares	–	50
Aero engine collaboration	B Shares	100	
Rolls-Royce Turbomeca Limited (UK & France)	A Shares	–	50
Adour and RTM322 aero engine collaboration	B Shares	100	
Rolls Wood Group (Repair and Overhauls) Limited	A Ordinary	100	50
Industrial gas turbine repair and overhaul	B Ordinary	–	
TRT Limited	A Ordinary	–	49.5
Aero engine turbine blade repair services	B Ordinary	100	
Turbine Surface Technologies Limited	A Ordinary	–	50
Aero engine turbine surface coatings	B Ordinary	100	
Turbo-Union Limited (UK, Germany & Italy)	Ordinary	40	40
RB199 engine collaboration	A Shares	37.5	

The above companies operate principally in the country of their incorporation. The countries of principal operations are stated in brackets after the name of the company, if not the country of their incorporation.

Other matters

Subsidiaries, jointly controlled entities and associates
At December 31, 2011
Incorporated overseas – indirectly held

		Class	% of class held	% of total equity held
China	Xian XR Aero Components Co Limited	Ordinary	49	49
	Manufacturing facility for aero engine parts			
Germany	EPI Europrop International GmbH (effective interest 35.5%)	Ordinary	28	28
	A400M engine collaboration			
Germany	EUROJET Turbo GmbH (UK, Germany, Italy & Spain) (effective interest 39%)	Ordinary	33	33
	EJ200 engine collaboration			
Germany	MTU, Turbomeca, Rolls-Royce GmbH (UK, France & Germany)	Ordinary	33.3	33.3
	MTR390 engine collaboration			
Germany	N3 Engine Overhaul Services GmbH & Co KG	Ordinary	50	50
	Aero engine repair and overhaul			
Germany	Engine Holding GmbH	Ordinary	50	50
	Supplier of engines and power trains for marine propulsion, distributed power generation and industrial 'off highway' sectors. Holding company for Tognum AG			
Hong Kong	Hong Kong Aero Engine Services Limited	Ordinary	45	45
	Aero engine repair and overhaul			
India	International Aerospace Manufacturing Private Limited	Ordinary	50	50
	Manufacture of compressor shrouds, compressor rings, turbine blades and nozzle guide vanes			
Israel	Techjet Aerofoils Limited	A Ordinary	50	50
	Manufacture of compressor aerofoils for gas turbines	B Ordinary	50	
Malaysia	Advanced Gas Turbine Solutions Sdn Bhd	Ordinary	49	49
	Industrial gas turbine aftermarket services			
Singapore	International Engine Component Overhaul Pte Limited	Ordinary	50	50
	Aero engine repair and overhaul			
Singapore	Singapore Aero Engine Services Private Limited (effective interest 39%)	Ordinary	30	30
	Aero engine repair and overhaul			
Spain	Industria de Turbo Propulsores SA	Ordinary	46.9	46.9
	Aero engine component manufacture and maintenance			
Switzerland	IAE International Aero Engines AG (UK, Germany, Japan & US)	A Shares	100	
	V2500 engine collaboration	B Shares	–	32.5
		C Shares	–	
		D Shares	–	
US	Alpha Leasing (US) LLC, Alpha Leasing (US) (No 2) LLC, Alpha Leasing (US) (No 4) LLC, Alpha Leasing (US) (No 5) LLC, Alpha Leasing (US) (No 6) LLC, Alpha Leasing (US) (No 7) LLC, Alpha Leasing (US) (No 8) LLC, Rolls-Royce & Partners Finance (US) LLC, Rolls-Royce & Partners Finance (US) (No 2) LLC	Partnerships	50	–
	Aero engine leasing			
US	Exostar LLC	Partnership	18.5	–
	Business to business internet exchange			
US	GE Rolls-Royce Fighter Engine Team LLC	Partnership	40	–
	F136 development engine for the Joint Strike Fighter			
US	Texas Aero Engine Services, LLC	Partnership	50	–
	Aero engine repair and overhaul			
US	Williams-Rolls Inc. (UK & US)	Common	15	15
	FJ44 engine collaboration			

Unincorporated overseas – held by subsidiary undertaking

US	Light Helicopter Turbine Engine Company (LHTEC)
	Rolls-Royce Corporation has a 50 per cent interest in this unincorporated partnership which was formed to develop and market jointly the T800 engine

The above companies operate principally in the country of their incorporation. The countries of principal operations are stated in brackets after the name of the company, if not the country of their incorporation.

In accordance with Section 410 of the Companies Act 2006, the subsidiaries, jointly controlled entities and associates listed on pages 122 to 124 is of those whose results or financial position, in the opinion of the directors, principally affect the financial statements. A list of all related undertakings will be included in the Company's annual return to Companies House.

Independent Auditor's report

to the Members of Rolls-Royce Holdings plc

We have audited the financial statements of Rolls-Royce Holdings plc for the year ended December 31, 2011, set out on pages 72 to 124. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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

Respective responsibilities of directors and auditors

As explained more fully in the Directors' responsibilities statement set out on pages 69 and 70, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

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

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at December 31, 2011 and of the Group's profit for the year then ended,
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU,
- the parent company financial statements have been properly prepared in accordance with UK Generally Accepted Accounting Practice, and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006, and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006, and
- the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

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

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

Under the Listing Rules we are required to review:

the directors' statement, set out on page 70, in relation to going concern,
the part of the corporate governance statement on page 42 relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review, and
certain elements of the report to shareholders by the Board on Directors' remuneration.

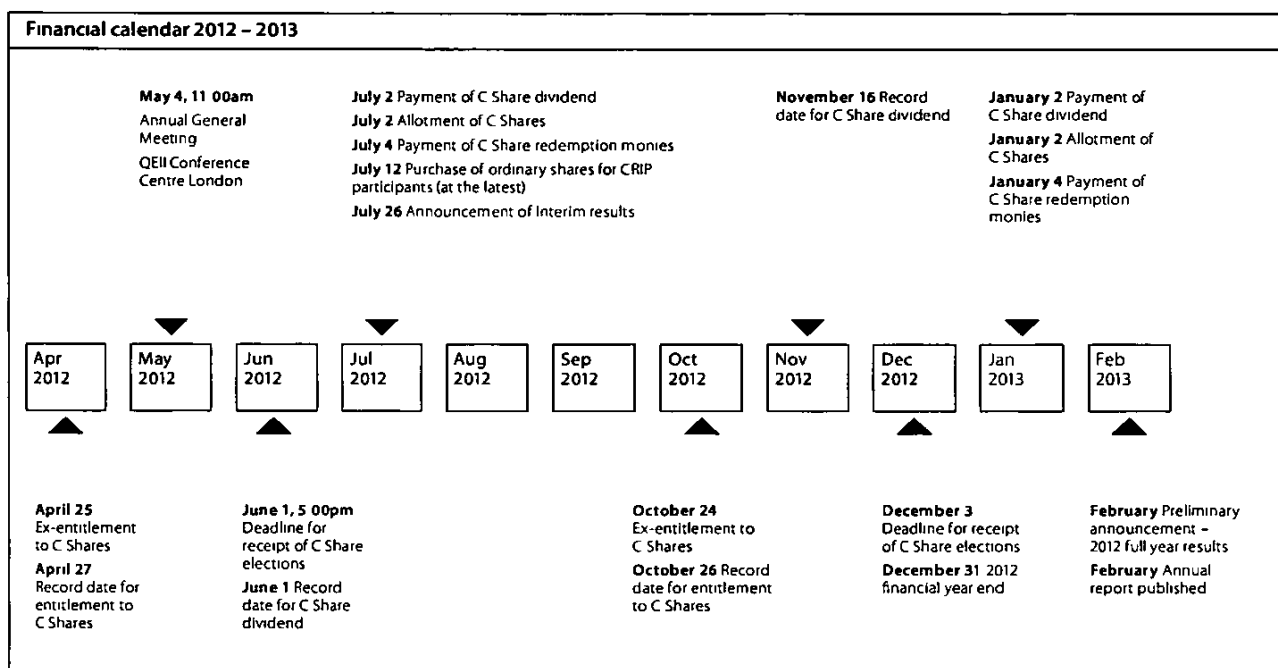
A J Sykes (Senior Statutory Auditor)
for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
London
E14 5GL
February 8, 2012

Group five-year review

For the years ended December 31

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Income statement					
Revenue	11,124	11,085	10,414	9,082	7,435
Profit before net research and development and share of results of joint ventures and associates	1,536	1,463	1,458	1,191	827
Research and development (net) ¹	(463)	(422)	(379)	(403)	(381)
Share of results of joint ventures and associates	116	93	93	74	66
Profit before financing	1,189	1,134	1,172	862	512
Net financing	(84)	(432)	1,785	(2,754)	221
Profit/(loss) before taxation ²	1,105	702	2,957	(1,892)	733
Taxation	(257)	(159)	(740)	(547)	(133)
Profit/(loss) for the year	848	543	2,217	(1,345)	600
Attributable to					
Equity shareholders of the parent	850	539	2,221	(1,340)	606
Non-controlling interests	(2)	4	(4)	(5)	(6)
Profit/(loss)	848	543	2,217	(1,345)	600
¹ Research and development (gross)	(908)	(923)	(864)	(885)	(824)
² Underlying profit before taxation	1,157	955	915	880	800
Earnings per ordinary share[*]					
Underlying	48 54p	38 73p	39 67p	36 70p	34 06p
Basic	45 95p	29 20p	120 38p	(73 63p)	33 67p
Payments to shareholders per ordinary share	17 50p	16 00p	15 00p	14 30p	13 00p
Balance Sheet					
Assets	16,423	16,234	15,422	15,348	11,459
Liabilities	(11,904)	(12,255)	(11,640)	(13,123)	(7,910)
	4,519	3,979	3,782	2,225	3,549
Called-up share capital	374	374	371	369	364
Reserves	4,144	3,601	3,411	1,847	2,815
Equity attributable to equity holders of the parent	4,518	3,975	3,782	2,216	3,179
Non-controlling interests	1	4	—	9	12
	4,519	3,979	3,782	2,225	3,191
Cash flow					
Cash inflow from operating activities	1,306	1,378	859	1,015	705
Cash outflow from investing activities	(2,207)	(759)	(606)	(645)	(572)
Cash (outflow)/inflow from financing activities	(655)	(743)	384	(221)	(473)
(Decrease)/increase in cash and cash equivalents	(1,556)	(124)	637	149	(340)
Net funds	223	1,533	1,275	1,458	888

Shareholder information



Share administration and share dealing

The administration of our shareholder register is managed by the Registrar, who also provides both internet and telephone share dealing services. When making contact with the Registrar quote your Shareholder Reference Number (SRN), an 11 digit number on the right hand side of your share certificate.

You can manage your shareholding online at www.investorcentre.co.uk, speak to the Registrar on +44 (0)870 703 0162 (8 30am to 5 30pm Monday to Friday) or you can write to them at Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8AE.

Only existing shareholders can deal either over the telephone (+44 (0)870 703 0084) or online at www-uk.computershare.com/investor/sharedealing.asp (8 00am to 4 30pm Monday to Friday excluding Bank holidays). Please note that stamp duty of 0.5 per cent is also payable on all purchases, in addition to the any other dealing fees.

There are many other share dealing facilities available and we always recommend that you use a firm regulated by the Financial Services Authority (FSA). You can visit the FSA website and check the FSA register at www.fsa.gov.uk.

Before selling shares, via either internet or telephone dealing, you must ensure that you have a valid Rolls-Royce Holdings plc share certificate. Without a valid share certificate you will be unable to complete any transaction and will be responsible for any costs incurred by the broker.

Payments to shareholders

If you are one of the many shareholders who have chosen to receive cash then we strongly recommend that you arrange for payments to be credited direct to your bank account. This removes the risk of a cheque going astray and also means that cleared payments are credited to your bank account on the payment date. If you have registered to use www.investorcentre.co.uk you can update your bank details online. Alternatively you can request a form by phone from the Rolls-Royce shareholder helpline on +44 (0)870 703 0162.

Keeping in touch and unclaimed payments

It's very important that you keep the Registrar informed of any change to your contact details, especially your postal address. If the Registrar receives two items of undelivered mail from a shareholder's registered address, no further mail will be sent until you confirm or update your registered address. However, the Registrar will securely retain all future mail, issued by the Company, on your behalf.

The Company recently authorised Georgeson, a company that specialises in tracing lost shareholders, to contact shareholders that we have been unable to contact for many years and has so far been able to transfer 323,541 ordinary shares (currently worth over £2.5 million) to 1,155 shareholders and pay over £280,000 to current and former shareholders. Additional claims continue to be processed in order to pay a further estimated £2 million to current and former shareholders.

Other matters

Shareholder information

Warning to shareholders

We are aware some shareholders receive unsolicited phone calls or correspondence concerning investment matters, typically from overseas based 'brokers' who target UK shareholders, offering to sell them what often turn out to be worthless or high risk shares in US or UK investments. Such operations are commonly known as 'boiler rooms' and these 'brokers' can be very persistent and extremely persuasive.

If you receive any unsolicited investment advice

- check that they are properly authorised by the FSA before getting involved via the following web link www.fsa.gov.uk/register/home.do don't pay any money up front
- report the matter to the FSA (UK 0845 606 1234 and overseas +44 20 7066 1000) and,
- if the calls persist, hang up

If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme

IF IT SOUNDS TOO GOOD TO BE TRUE, IT PROBABLY IS!

American Depositary Receipts (ADR)

Rolls-Royce ordinary shares are traded in the US in the form of a sponsored ADR facility with The Bank of New York Mellon as the depositary. Each ADR represents five ordinary shares. For further information about the US ADR programme, please contact your broker or write to BNY Mellon Shareholder Services, PO Box 358516, Pittsburgh PA 15252-8516. Phone +1 888 269 2377 or +1 888 BNY ADRS (toll free within the US). Phone outside the US +1 201 680 6825. Email shrrelations@bnymellon.com. Website www.adrbnymellon.com.

ShareGift

The Orr Mackintosh Foundation operates a charity donation scheme for shareholders with small numbers of shares which may be uneconomic to sell. Details of the scheme are available from ShareGift at www.sharegift.org or you can write to Orr Mackintosh Foundation, 17 Carlton House Terrace, London SW1Y 5AH (telephone +44 (0)20 7930 3737).

Dividends paid on C Shares held

C Share calculation period	C Share dividend rate (%)	Record date for C Share dividend	Payment date
July 1, 2011 – December 31, 2011	0.414	November 18, 2011	January 3, 2012
January 1, 2011 – April 5, 2011*	0.204	April 5, 2011	April 15, 2011

* The C Share dividend was prorated due to the compulsory redemption of all Rolls-Royce Group plc C Shares on April 6, 2011 prior to the corporate restructure. There were no C Shares in issue between April 7, 2011 and June 30, 2011.

Previous C Share issues

Issue date	No of C Shares issued per ordinary share	Record date for entitlement to C Shares	Latest date for receipt of Payment Instruction Forms by Registrar	Apportionment values		CGT apportionment		Date of redemption of C Shares	CRIP purchase date	CRIP purchase price (p)
				Price of ordinary shares on first day of trading (p)	Value of C Share Issues per ordinary shares (p)	Ordinary shares (%)	C Shares (%)			
January 3, 2012	69	October 28, 2011	December 5, 2011	755.25	6.90p	99.09	0.91	January 5, 2012	January 10, 2012	756.62
July 1, 2011	96	April 26, 2011	June 6, 2011	647.75	9.60p	98.54	1.46	July 5, 2011	July 6, 2011	654.29

For previous C Share issues, please refer to the Group's website

Analysis of ordinary shareholders at December 31, 2011

Type of holder	Number of shareholders	% of total shareholders	Number of shares	% of total shares
Individuals	214,392	97.40	110,941,253	6.15
Institutional and other investors	5,727	2.60	1,761,298,759	93.85
Total	220,119	100.00	1,872,240,012	100.00
Size of holding				
1 – 150	68,052	30.92	6,687,131	0.37
151 – 500	113,385	51.51	29,942,853	1.64
501 – 10,000	36,738	16.69	60,049,391	3.28
10,001 – 100,000	1,338	0.61	35,073,218	1.87
100,001 – 1,000,000	420	0.19	152,884,275	7.49
1,000,001 and over	186	0.08	1,587,603,144	85.35
Total	220,119	100.00	1,872,240,012	100.00

Glossary

ABC	Anti-bribery and corruption
ABI	Association of British Insurers
ACARE	Advisory Council for Aviation Research and Innovation in Europe
ADR	American Depositary Receipts Programme
ADVENT	Adaptive Versatile Engine Technology
AEBS	All-Employee Bonus Scheme
AFRL	US Air Force Research Lab
AGM	Annual General Meeting
ANA	All Nippon Airways
APB	Auditing Practices Board
APRA	Annual Performance Related Award plan
ASD	Aerospace and Defence Industries Association of Europe
BDI	Federation of German Industries
BIS	Department for Business, Innovation and Skills
BitC	Business in the Community Corporate Responsibility Index
CAD	Canadian dollar
CDP	Carbon Disclosure Project
CEO	Chief Executive Officer
CGU	Cash-generating unit
CO₂	Carbon dioxide
CPI	Consumer Price Index
CPS	Cash flow per share
CRIP	C Share Reinvestment Plan
DJSI	Dow Jones Sustainability World and European Indexes
EASA	European Aviation Safety Agency
EFE	Environmentally Friendly Engine
EPS	Earnings per ordinary share
ESOP	Executive Share Option Plan
EU	European Union
FSA	Financial Services Authority
GBP	Great British pound or pound sterling
GDP	Gross domestic product
GHG	Greenhouse gas
GLT	Group Leadership Team
HR	Human Resources
HS&E	Health, Safety and Environment
I&C	Instrumentation and control
IAB	International Advisory Board
IAE	IAE International Aero Engines AG
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFBEC	International Forum on Business Ethical Conduct
IFRIC	International Financial Reporting Interpretations Committee

IFRS	International Financial Reporting Standards
INVENT	Integrated Vehicle Energy Technology
IPMTSD	Integrated Power and Thermal Management System Development
ISO	International Standards Organisation
LDI	Liability-driven investment
LIBOR	London Inter-bank Offered Rate
LLP	Limited Liability Partnership
LTSA	Long-Term Service Agreement
MoD	UK Ministry of Defence
MoU	Memorandum of Understanding
MWh	Megawatt hours
NATO	North Atlantic Treaty Organisation
NO_x	Nitrogen oxides
OCI	Other comprehensive income
OE	Original Equipment
OECD	Organisation for Economic Cooperation and Development
OTC	Over-the-counter
PAC	Political Action Committee
PILM	Product Introduction and Lifecycle Management
PLC	Public Limited Company
PSP	Performance Share Plan
PWR	Pressurised Water Reactor
R&D	Research and Development
R&T	Research and Technology
RCF	Revolving credit facility
Registrar	Computershare Investor Services PLC
RRNA	Rolls-Royce North America
RRSPs	Risk and Revenue Sharing Partnerships
RSUs	Restricted stock units
SAP	Systems, applications and products
SCRIA	Supply Chain Relationships in Aerospace
SDSR	Strategic Defence and Security Review
SIP	Share Incentive Plan
SO_x	Sulphur oxides
SRN	Shareholder Reference Number
STEM	Science technology engineering and maths
STOVL	Short Take-Off and Vertical Landing
TRI	Total reportable injuries
TSR	Total Shareholder Return
UK GAAP	UK Generally Accepted Accounting Practices
USD	United States dollar
VDA	Verband der Automobilindustrie (German Association of the Automotive Industry)
VP	Vice President

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